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Decision October 19, 1983

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the Matter of Revision of the Accounting for Station Connections and related Ratemaking Effects and the Economic Consequences of Customer-owned Premise Wiring.

OII 84
(Filed December 2, 1980)

In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California reflecting and passing through to customers increased costs resulting from the Federal Communications Commission decision in Docket No. 79-105.

Application 60510
(Filed May 4, 1981;
amended June 5, 1981)

(See Decisions 93367, 93728, and 82-08-017 for appearances.) ✓

O P I N I O N

Background

In the last general rate proceeding involving the Pacific Telephone and Telegraph Company (Pacific), Application (A.) 59849 et.al., we originally authorized a rate increase of \$610 million on August 4, 1981. The cities of San Francisco and San Diego (Cities) applied for rehearing. They asserted that while Decision (D.) 93367 recognized Pacific would realize a revenue reduction of \$63.7 million because more extensive use of PhoneCenters by subscribers would reduce revenues from tariffed service connection charges, this Commission failed to recognize there would be corresponding reductions in Pacific's test year costs associated with station connections or for installing phones and inside wiring. The costs

in question were, when D.93367 was issued, capitalized, and were predominantly for labor. Rehearing was denied, whereupon the Cities petitioned the California Supreme Court for a writ of review (SF No.24361).

Next, we issued D.93728, in OTI 84 et al., on November 13, 1981. There we ordered that station connection costs, or inside wiring costs, should be prospectively expensed, rather than capitalized, and previously capitalized costs should be amortized or expensed over 10 years; Pacific was authorized a total of \$264 million annually by that decision. The Cities applied for rehearing of D.93728, alleging, again, that a revenue requirement adjustment to reflect and match reduced costs with reduced revenues had not been made. On January 19, 1982 we issued D.82-01-100, which denied rehearing of D.93728 but modified it to require the \$264 million granted Pacific be subject to refund pending a resolution of the Cities' then pending petition for writ of review before the Supreme Court. On January 27, 1982, we issued D.82-01-106 to correct some clerical errors in D.82-01-100.

As this saga unfolded, the Supreme Court granted the Cities' writ of review on March 11, 1982. Then, on May 12, 1982, we issued D.82-05-044, which essentially mooted the Cities' petition before the Supreme Court; there we modified D.93367 by finding a rate base reduction of \$70 million should be made to the test year results of operations adopted by D.93367; this was after the Cities and Pacific reached a settlement. The result, expressed in revenue requirement, was a gross rate reduction of \$12.8 million annually from August 29, 1981 prospectively, the date the \$610 million increase was authorized for Pacific. The \$70 million test year rate base reduction was agreed to by Pacific and the Cities, and after we issued D.82-05-044, essentially ratifying the settlement, the court, ✓

upon the parties' motion, dismissed its writ of review. The procedure for Pacific making the \$12.8 million annual refund and rate reduction is addressed in a decision in its last general rate proceeding, A.59849 et al. ✓

The remaining question of what adjustment, if any, should be made to the \$264 million increase allowed Pacific in D.93728 was considered by us as part of Phase II of OII 84 et al. No further testimony or documentary evidence was received on the issue; instead it was submitted on the original record and the receipt of additional briefs due and filed on July 9, 1982.

Summary of Decision

The Cities, and our staff, contend the \$70 million of estimated expense savings applied to reduce Pacific's \$610 million general rate increase, must ipso facto be applied to reduce the \$264 million awarded Pacific in November of 1981 to compensate for an accounting change which directed that station connection or installation costs to be expensed rather than capitalized. After careful consideration of this issue, we have concluded that although both the \$610 million and \$264 million increase were authorized in 1981, based on 1981 estimated test years, the evidentiary records in support of those two estimates were materially different. For example, the estimates of Pacific 1981 station connection expense developed and adopted in OII 84 et al. were prepared later, with the benefit of 5 months of recorded data.

As such, it is not reasonable to apply the \$70 million adjustment to the later decision authorizing the \$264 million increase. We reaffirm that the \$264 million rate increase authorized for Pacific by D.93728, on November 13, 1981, was just and reasonable.

Issue

The Cities contend the \$70 million rate base adjustment applied to Pacific's general rate decision only takes care of part of the overcollection resulting from not recognizing the cost savings associated with Pacific's PhoneCenter program. They contend the rates set by D.93728, which ordered the expensing of station connections and set an annual revenue requirement, are too high and must also be adjusted. The annual amount, under the Cities' approach, is to recognize the full \$70 million as a direct total company expense savings, since D.93728 directed expensing of such costs; when the adopted .7478 allocation factor for intrastate expense is applied it equates to a \$52.3 million annual rate reduction, but since rates were already to be reduced by \$12.8, the net additional annual rate reduction sought by the cities becomes \$39.5 million (Cities brief, pages 4-5).

We recognized that the \$70 million expense savings could have an effect on the additional revenue requirement set for Pacific in D.93728 (\$264 million), and when we directed the \$12.8 reduction in D.82-05-044 we ordered:

- "4. The scheduled hearings in OII-84 will also consider the limited issues of whether or not our decision herein has any impact on the proper level of rate increases in connection with phase one of OII-84 and, if so, the amount thereof and how that amount should be spread among Pacific Telephone's customers."

Our staff agrees with the Cities that an additional rate reduction is only logical and follows from our finding of a \$70 million test year expense savings. Pacific disagrees. It believes the \$70 million incremental expense savings should not be applied to adjust its \$264 million rate increase authorized by D.93728, and whereas the Cities and staff think the record on this issue is fully developed, with the exception of reviewing Pacific's refund plan, Pacific requested an opportunity to show why an additional \$52.3 million annual intrastate rate reduction is inapplicable. Administrative Law Judge (ALJ) Porter, on June 21, 1982, after oral argument on June 15, tentatively denied Pacific's request (TR Vol. 127, page 13884). Pacific submits further argument on this point in its brief, along with an offer of proof.

Contentions of the Parties

a. Cities

While Pacific contends any PhoneCenter expense saving adjustments were reflected in OII 84's record (Pacific's Brief, page 9), Cities contend that only a \$70 million annual expense savings adjustment can be applied, because that is what this Commission ultimately adopted in D.82-05-044. The \$70 million test year 1981 cost savings were developed by the Staff's witness Franklin in A.59849 et al., Pacific's general rate proceeding, whereas, a \$7.7 million test year 1981 amount was quantified by its witness Mangold in OII 84. Cities contend that since both proceedings used a 1981 test year for prospective ratemaking, Mangold's specific \$7.7 million expense adjustment must be disregarded because: (1) the record shows the staff's Mangold did not relate his \$7.7 million adjustment proposed for test year 1981 in OII 84 to Franklin's \$70 million adjustment developed in A.59849; and (2) the \$70 million adjustment is the one ultimately adopted by this Commission for test year 1981 rate setting purposes, both in Pacific's general rate decision and

OII 84. As such, Cities contend the \$70 million should not even be offset by the \$7.7 adjustment applied when Pacific received its \$264 million increase in OII 84. (Cities Brief, page 7.)

b. Staff

Staff agrees with the Cities. It concludes that both Pacific's general rate decision and our decision in OII 84 used a 1981 test year, and that having adopted a \$70 million test year expense savings for application in one adopted test year results of operations, the same adjustment must be applied to the other (Staff Brief, page 2). It views adjusting the \$264 million revenue requirement in OII 84's D.93728 as a simple incremental adjustment, requiring no additional evidence; it recommends a \$40 million annual intrastate rate reduction and refund.

c. Pacific

Pacific's conclusion in its brief succinctly summarizes its position:

"Decision 82-05-044, and the change it ordered in Application 59849's revenue requirement, resulted from a settlement agreement and not a Commission finding that it had erred. In any case, since even an actual Commission finding on an older record (i.e. the Application 59849 record) would not be relevant with respect to findings in a different case on an updated and more current record (i.e. OII 84), Decision 82-05-044 has no impact on the proper level of rate increases in OII 84. In addition, the Commission's adopted revenue requirement in OII 84 reflects an estimate of station connection costs that is fully supported by the OII 84 record (there is no testimony whatsoever which supports a lower level of station connection costs). This support includes the actual recorded results during those portions of the 1981 test year that were already completed at the time the evidence was presented in OII 84." (Page 18.)

Pacific stresses that the two evidentiary records, relied on in our ratesetting, were so different in time and content that the \$70 million adjustment cannot automatically be applied to both decisions and their adopted revenue requirements:

"The only evidence in the record on this issue [in OII 84 et al.] was the testimony of Pacific's expert and that of the Commission staff's expert, and those witnesses estimated and supported a level of 1981 station connection costs of \$402.1 million (which the Commission adopted in its decision as a result of the stipulation referred to, supra) or higher. The Cities completely failed to cross-examine Pacific's expert witness on the PhoneCenter subject.

"Furthermore, the staff witness' testimony, since it was prepared on a later date than Pacific's, contained a figure for the actual recorded station connection costs through May of 1981 (i.e., for the first five months of the 1981 test year). That figure was \$165.9 million.* If that figure were annualized to produce an estimate for the full 1981 test year, it would come very close (over \$398 million) to the \$402 million estimate actually adopted by the Commission.

"Thus, very strong and reliable evidence - actual recorded results for the 1981 test year - fully supports the Commission's revenue requirement determination in Decision 93728.

It vividly refutes the Cities' allegations that the proper level for 1981 station connection costs is something like \$70 million less than the \$402.1 million level which the Commission adopted in its decision. To support this grossly reduced level of station connection costs (which the Cities advocate), the actual recorded station connection costs would need to have been at a level of approximately \$138 million for the first five months of 1981, instead of their actual recorded level of approximately \$166 million." (Pacific's brief, pages 13-14.)

*OII 84, Exhibit 25, Chapter III, p. 3, Table 1, last column.

Pacific's brief contains its offer of proof, as it desires to present additional testimony; the new information it wishes to present is an additional 7 months of recorded data for 1981, which if considered, in addition to the 5 months originally available in the OII 84 record, would result in 12 months of recorded 1981 station connection expense.

Discussion

By two prior decisions we indicated we would consider the impact of the \$70 million rate base adjustment in Pacific's general rate decision as it might affect our decision in OII 84 (D.82-01-100 and D.82-05-044). We have carefully considered the matter, and we agree with our ALJ that no further testimony would be useful or appropriate.

We cannot agree with our staff and the Cities that the \$70 million expense savings applied to the general rate proceeding's adopted test year (D.93367) must, ipso facto, be applied in the subsequent decision in OII 84 (D.93728). Upon careful consideration, we find the Cities' argument has appeal, except that the test year, or 1981, costs associated with station connections developed in OII 84 were estimated after the comparable estimates were developed in Pacific's general rate proceeding, and were developed enough later that 5 months of recorded 1981 experience was available to staff and other parties to use in arriving at their estimates. Had the respective estimates been developed at the same time, with the same availability of data, we would be inclined to agree with the Cities and our staff that a \$70 million adjustment should be applied with respect to both proceedings and their respective decisions. In essence, we find the approach urged by the Cities and our staff too simple, and not recognizing the material distinction between the two evidentiary records underlying our decisions.

Our ruling in favor of Pacific is not based on whether we found error in our original decision in its general rate proceeding, which led to our ultimately adopting the \$70 million expense savings estimate in A.59849, or that the Cities and Pacific agreed to the \$70 million adjustment as a settlement in view of the Supreme Court's having granted the Cities' Petition for a writ of review on D.93367. Pacific thinks these factors are important to our determination. Rather, we are not inclined to blur some definitive and meaningful distinctions in the respective evidentiary records by concluding they are so comparable the \$70 million expense savings can be applied in both.

Another point concerning this issue warrants discussion to fully put today's holding in perspective. Pacific further contends if recorded actual experience parallels and supports the station connection expense estimate adopted in OII 84, we cannot change it (Pacific's Brief, page 16). We disagree. We are reviewing the level of rates set by D.93728, and in prospective ratesetting the test year (albeit a calendar year already past) is a means of integrating various elements of overall expenses and revenues to forecast reasonable estimated operating conditions during a normal year in the future; and there is nothing magic or sacrosanct about recorded results. Recorded results, if timely available and fully analyzed by all parties in a particular proceeding, may be useful as a starting point for estimating in prospective ratemaking. However, recorded results, viewed after the fact, are not nearly as significant in prospective general ratemaking as compared to when we engage in balancing account ratemaking; we recently addressed this general point in another matter:

"There is, under current conditions, unquestionably a place for balancing account offset ratemaking. But it should be used sparingly in lieu of test year ratemaking. Test

year ratemaking serves an extremely important role in providing utilities an incentive to operate efficiently. For example, when we adopt a level of operation, maintenance, and administrative expenses for ratesetting purposes the utility has an incentive to seek operating efficiencies; hence, when the utility spends less than what was authorized it can retain the difference and ultimately benefit the shareholders. We realize that setting rates prospectively for a two-year period is not an exact science; of the numerous expense categories which comprise an adopted test year results of operation we know the utility may ultimately spend more for some items and less for others." (D.83-05-060, issued May 18, 1983, in A.83-05-85; Pacific Gas and Electric Company.)

We made our revenue requirement decision for Pacific on a different record in OII 84; we made it with more current estimates of Pacific's test year station connection expense. Upon careful consideration, we see no reason to modify the \$264 million rate increase authorized for Pacific by D.93728, in OII 84. Neither do we think it useful, at this juncture, to receive more testimony on recorded results, or on this issue generally. We made our decision on an adequate evidentiary record, and it will stand regardless of whether in hindsight it turned out high or low; that is the essence of prospective test year ratemaking.

Findings of Fact

1. D.82-01-100 and D.82-05-044 recognized that Pacific's station connection expense savings from PhoneCenters, as developed in A.59849 et al., could have an impact on the level of station connection expense adopted by D.93728 in these proceedings.

2. As a result of a settlement reached by the Cities and Pacific, in view of Cities' Petition for a writ of review, a \$70 million total company reduction in Pacific's originally adopted rate base in D.93367 was ordered by D.82-05-044; that equated to a gross revenue requirement reduction of \$12.8 million annually.

3. The matter of Pacific's test year station connection expenses was developed in two evidentiary records: (1) A.59849 et al.; and (2) OII 84 and related matters, including Pacific's A.60510. The estimates developed in OII 84 et al. recognized five months of recorded 1981 results, and was prepared after those in A.59849, et al. even though both proceedings involved a 1981 test year for determining revenue requirement.

Conclusion of Law

It is not reasonable to ipso facto apply the \$70 million PhoneCenters adjustment ultimately adopted in A.59849 et al to D.93720, issued in OII 84 et al., as the decisions were based on materially different evidentiary records and adopted test year station connection expense estimates.

O R D E R

IT IS ORDERED that:

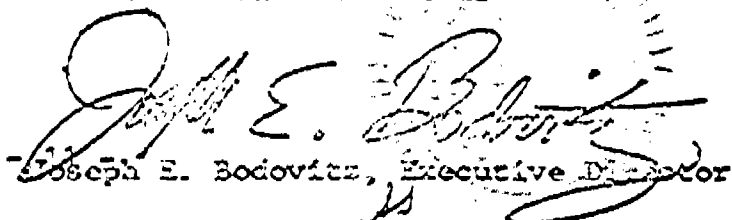
1. The revenue requirement adopted for The Pacific Telephone and Telegraph Company in D.93728 shall not be modified.
2. OII 84 and Application 60510 remain open as additional issues related to inside wiring will be addressed in another opinion and order.

This order becomes effective 30 days from today.

Dated OCT 19 1983, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
PRISCILLA C. GREW
DONALD VIAL
WILLIAM T. BAGLEY
Commissioners

I CERTIFY THAT THIS DECISION
WAS APPROVED BY THE ABOVE
COMMISSIONERS TODAY.


Joseph E. Bodovitz, Executive Director

ALJ/jn

Decision 83 10 035 OCT 19 1983

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