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Decision 97-03-042 March 18, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Bell (U-1001-C) in compliance with Ordering Paragraph 5 of Decision 94-06-011, concerning whether the market-based rate of return should be modified.	Application 96-02-052 (Filed February 28, 1996)

ORIGINAL

OPINION

Request

Pacific Bell seeks Commission authority to maintain, without change, its 10.00% market-based rate of return-adopted pursuant to Ordering Paragraph 5 of Decision (D.) 94-06-011 (55 CPUC2d 1 at 61 (1994)). This market-based rate of return is used to determine the amount of profits that Pacific Bell is required to distribute between its shareholders and ratepayers according to the sharing mechanism adopted in D.89-10-031, issued in the New Regulatory Framework (NRF) proceeding for Local Exchange Carriers (33 CPUC2d 43 at 236 (1989)). This mechanism was modified by D.94-06-011.

Background

D.89-10-031, (the NRF Order) implemented an incentive-based regulatory framework which allowed Pacific Bell's shareholders to keep profits up to a 13.00% benchmark rate of return, or 150 basis points above an 11.50% market-based rate of return. Profits above the 13.00% benchmark up to 16.50% were to be shared equally between Pacific Bell's shareholders and ratepayers, with profits in excess of 16.50% being returned entirely to Pacific Bell's ratepayers.

The NRF order also established a trigger mechanism to assess changes in Pacific Bell's financial risk due to changing economic conditions. The change in economic conditions was to be measured by an external index, the 30-year Treasury-Bond yield, found to be the most stable, widely traded, and reportable security.

The trigger mechanism required Pacific Bell to file an application addressing whether its benchmark rate of return should be adjusted, within 60 days following three consecutive months during which the 30-year Treasury Bond yield of 7.99% (base Treasury yield) changed by at least 250 basis points to a high of 10.49% or low 5.49%.

Subsequently, by D.94-06-011 (55 CPUC2d 1 at 61 (1994)), modifications were made to the market-based rate of return, trigger mechanism, and application requirement. Pacific Bell's market-based rate of return was adjusted 150 basis points downward from 11.50% to 10.00%, with a concurrent 150 basis points downward adjustment of the benchmark rate of return from 13.00% to 11.50%. Pacific Bell is now required to share profits in excess of the 11.50% benchmark rate of return up to 15.00% equally between its shareholders and ratepayers, with profits in excess of the 15.00% being split 70.00% and 30.00% between its shareholders and ratepayers, respectively.

The trigger mechanism was modified by reducing the base Treasury yield spread from 250 to 150 basis points and implementing a second criteria to the trigger mechanism. The second criteria requires at least a 150 basis-points spread between the base Treasury yield and the three-year forecast of the same bond for three consecutive months.

The application requirement was modified from requiring Pacific Bell to state its position on whether its benchmark rate of return should be modified to whether its market-based rate of return should be modified. Hence, if both the reported and three-year forecast of the 30-year Treasury-Bond yields change at least 150 basis points from the base Treasury yield to a high of 9.49% or a low of 6.49% for three consecutive months, Pacific Bell must file an application to address whether its market-based rate of return should be modified.

Application

The trigger mechanism was activated in January 1996 because data published by the Federal Reserve showed that the 30-year Treasury-Bond yields for the three consecutive months of October, November, and December 1995 were 6.37%, 6.26%, and 6.06%, respectively. Hence, Pacific Bell filed its application with supporting testimony on February 28, 1996 to address whether its market-based rate of return should be modified.

Pacific Bell's Position

Although December 1995 data shows that the 30-year Treasury Bond yield was slightly greater than 6.00%, it is within range of the 5.96% - 5.94% historically low levels of 30-year Treasury Bond yields which the Commission was keenly aware of at the time both the benchmark and market-based rates of return were recalibrated by D.94-06-011.

Further, the 30-year Treasury Bond yield forecast provides less than a clear indication that a substantial change will occur in the financial market. For example, the "Blue Chip Financial Forecast" shows a consensus projection of 6.50% for 1997 and 6.60% for 1998 and 1999 as compared to the lowest average-rate forecasts projected range of 5.70% to 5.80% over the same period, with individual years varying by 70 to 90 basis points below the Blue Chip Financial Forecast. Similarly, the ten highest average-rate forecasts show a range of 7.20% to 7.50% over the period with individual years varying by 70 to 90 basis points above the consensus Blue Chip Forecast.

Pacific Bell concludes that there is no need to undertake a review of its market-based rate of return at this time because the 30-year Treasury Bond yields have not substantially changed and because of recent testimony on Pacific Bell's market-based rate of return in the Phase II Franchise Impact portion of the Local

Competition proceeding (R.95-04-043). However, Pacific Bell does recommend that the upcoming Phase II of the 1995 NRF Review I.95-05-047 consider discontinuance of the sharing mechanism.

Response to Application

The only party that filed a response to Pacific Bell's application was the Office of Ratepayer Advocates (ORA) formerly known as the Division of Ratepayer Advocates. While ORA concurs with Pacific Bell that a review of Pacific Bell's market-based rate of return is not necessary at this time, ORA does not concur with Pacific Bell's reasons set forth in the application. ORA believes that any consideration of Pacific Bell's recommendation to address discontinuance of the sharing mechanism would result in a controversial hearing and require a review of Pacific Bell's market-based and benchmark rates of return.

ORA concludes that a review of Pacific Bell's market-based and benchmark rates of return should be delayed and addressed with other noncritical Phase II issues after the telecommunications markets have been opened to competition. Hence, ORA recommends that a review of Pacific Bell's market-based and benchmark rates of return be deferred until the next triennial NRF review, scheduled to take place in 1998.

Discussion

Although Ordering Paragraph 5 of D.94-06-011 required Pacific Bell to file its application and supporting testimony addressing whether the market-based rate of return should be modified, it does not require the market-based rate of return be modified. Neither Pacific Bell nor ORA recommends any change in Pacific Bell's market-based rate of return at this time.

As shown by the following tabulation of 30-year Treasury Bond yields reported by the Federal Reserve Statistical Release, of which official notice is taken, the changing economic condition causing Pacific Bell to file this application was short-term in nature and does not currently exist.

DATE		30-YEAR TREASURY YIELD	DATE		30-YEAR TREASURY YIELD
May	1996	6.93%	November	1995	6.25%
April	1996	6.79	October	1995	6.37
March	1996	6.60	September	1995	6.55
February	1996	6.24	August	1995	6.86
January	1996	6.06	July	1995	6.72
December	1995	6.06	June	1995	6.57

Given that no party recommends a change in Pacific Bell's market-based rate of return and given that the external index has increased to a acceptable short-term range of the base Treasury yield, Pacific Bell's proposal to defer addressing the market-based rate of return should be granted. ORA's objection to Pacific Bell's request that the Commission explore the discontinuance of the sharing mechanism during Phase II of I.95-05-047 has been rendered most by our closing of that proceeding with D.96-05-036. However, Pacific Bell should be required to address both its market-based and benchmark rates of return as part of its next triennial NRF review. Such a requirement should not preclude the Commission's Telecommunications Division from recommending that an investigation be opened into the reasonableness of Pacific Bell's market-based rate of return upon further activation of the trigger mechanism.

Findings of Fact

1. Pacific Bell seeks authority to maintain, without change, its 10.00% market-based rate of return.

2. The NRF order established a trigger mechanism to assess changes in Pacific Bell's financial risk.

3. The trigger mechanism, as modified by D.94-06-011, requires Pacific Bell to file an application addressing whether its market-based rate of return should be adjusted within 60 days following three consecutive months during which the actual and forecasted 30-year Treasury Bond yield attain a high or low of at least 9.49% and 6.49%, respectively.

4. Pacific Bell's trigger mechanism became activated in January 1996.

5. Pacific Bell filed the instant application pursuant to D.94-06-011.

6. The 30-year Treasury Bond yields which activated the trigger mechanism were within the range of the historically low levels in existence at the time both the benchmark and market-based rates of return were recalibrated by D.94-06-011.

7. The 30-year Treasury Bond yield forecast provides less than a clear indication that a substantial change has occurred in the financial market.

8. ORA, the only party filing a response to the application, does not oppose deferral of a review of Pacific Bell's market-based and benchmark rates of return until the next triennial NRF review takes place.

9. Official notice is taken of the monthly 30-year Treasury Bond yields reported in the Federal Reserve Statistical Release.

10. The changing economic condition causing Pacific Bell to file this application was short-term in nature, and there is no evidence that it currently exists.

Conclusion of Law

Pacific Bell's market-based rate of return should not be modified at this time.

O R D E R

IT IS ORDERED that:

1. Pacific Bell shall submit testimony on the reasonableness of its market-based and benchmark rates of return during the next triennial review of the New Regulatory Framework.

2. The Commission's Telecommunications Division may recommend opening an investigation into the reasonableness of

Pacific Bell's market-based rate of return upon further activation of the trigger mechanism set forth in Decision 94-06-011.

3. Application 96-02-052 is closed.

This order is effective today.

Dated March 18, 1997, at San Francisco, California.

P. GREGORY CONLON
President
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
RICHARD A. BILAS
Commissioners