PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

COMMISSION ADVISORY AND
COMPLIANCE DIVISION
Finance Branch

RESOLUTION F-627
September 12, 1990

RESOLUTION

RECOVERY OF COMPENSATED ABSENCE IMPACT FOR PACIFIC BELL RESULTING FROM ADOPTION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) IN D.87-12-063.
(Advice Letter Number 15697)

SUMMARY

By this Resolution Pacific Bell Advice Letter No. 15697 is rejected in part and approved in part.

On February 23, 1990, Pacific Bell (Pacific) filed Advice Letter No. (AL) 15697 in accordance with Ordering Paragraph 5 of Decision 88-09-030, dated September 14, 1988, which requires Pacific to exclude its compensated absence impacts from its USOA balancing account, submit the 1988 compensated absence impact results to the Commission's Division of Ratepayer Advocates (DRA) and file an advice letter to recover the compensated absence impact consistent with D.88-08-024. D.88-08-024 provides that the revenue requirement changes for Pacific be placed in rates through either a refund or a surcredit/surcharge mechanism on a bill-and-keep basis.

Pacific's advice letter requests recovery of $334.832 million for 1985, 1986 and 1987 carry over, embedded, compensated absences and "Projected 1988" compensated absences plus interest on the unrecovered amortization of these compensated absence impacts from January 1, 1988.

We have reviewed Pacific's request to include the "Projected 1988" compensated absence expense, in the amount of $281.776 million, in the embedded compensated absence expense total to be amortized over ten years and find that additional information is necessary in order to determine whether or not the "Projected 1988" amounts should be included in Pacific's compensated absence expense total. Therefore, we shall order expedited hearings to take testimony and evidence from the respective parties to this proceeding, limited to the issues set forth in this resolution.

We have reviewed and find reasonable Pacific's request to include the carry over embedded compensated absence impacts for 1985, 1986, and 1987 amounting to $45.402 million for amortization and recovery over ten years beginning January 1, 1988, consistent with D.88-09-030 and D.87-12-063. Pacific shall supplement Advice Letter No. 15697 to recover the 1988, 1989, and 1990 amortization of the $45.402 million of embedded compensated absence impacts plus interest calculated consistent with D.88-09-030 through a one time refund or surcharge

consistent with D.88-08-024. Pacific is authorized to recover the 1991 through 1997 amortization of the embedded compensated absence impacts of $4.54 million by including this amount as a "Z" factor in its 1991 annual price cap index filing consistent with D.89-10-031. Pacific must reduce its rates beginning January 1, 1998, at the conclusion of the amortization of the embedded compensated absence impacts.

BACKGROUND

On December 22, 1987 the Commission issued Decision (D.) 87-12-063 which adopted, with certain exceptions, the Federal Communications Commission's (FCC) Part 32, Uniform System of Accounts (USOA) for Telephone Corporations and Part 36, Separations Manual beginning January 1, 1988. Pacific, GTE California (GTEC), Contel of California (Contel) and Citizens Utilities Company of California were authorized to initiate a balancing account to record the revenue requirement impacts from the adoption of Part 32 and Part 36.

Decision 87-12-063 adopts Generally Accepted Accounting Principles (GAAP) currently in effect, except as provided in the opinion, as applicable to all telephone utilities under the Commission's jurisdiction. The Commission recognized in doing so that it was necessary to shift certain costs from a cash to an accrual basis for accounting purposes. These costs included workers compensation, incentive awards and compensated absences. The decision further noted that the embedded amounts created by this accounting change should be amortized over a ten-year period to ease rate shock.

On March 31, 1988, pursuant to D. 87-12-063, Pacific filed a summary of its balancing accounts . DRA reviewed the methodologies, underlying data and assumptions employed by Pacific in its estimates of the balancing accounts and filed a report on May 20, 1988, as required by the decision. DRA recommended deferral of the compensated absence impact from the balancing account due to Pacific's inability to provide reliable data on its estimates.

By D.88-09-030, Pacific, GTEC, and Contel were authorized to update their respective USOA balancing accounts to reflect six months of available data. Pacific and GTEC were ordered to file advice letters to close out their USOA balancing account. Pacific was ordered to exclude any compensated absence impacts from its USOA balancing account, provide its 1988 compensated absence impact results to DRA, and after DRA reviewed this data, to submit an advice letter for recovery of the compensated absence impact. Pacific filed AL No. 15697 in accordance with Ordering Paragraph 5 of D. 88-09-030 on February 23, 1990.

Pacific's AL No. 15697 requests recovery of $327.0 million associated with its embedded or "catch up" amount for compensated absences. The amount as ordered by the Commission is to be amortized over 10 years beginning January 1, 1988. Pacific, therefore, requests a rate recovery of $71 million on a one-time basis for the amortization amounts in years 1988 and 1989 and on a going forward basis, $32.7 million per year for years 1990 through 1997. Pacific's total revenue requirement request including interest amounts to $334.832 million. Pacific's advice letter includes the following attachments in support of its request:

1. July 26, 1989 letter to DRA's Mr. Thomas Lew, Chief - Telecommunications Investigations and Research Branch;
2. July 7, 1989 letter from Coopers & Lybrand to Mr. Kendall T. Murphy, Vice President & Controller, Pacific Bell;
3. Compensated Absence Policy dated July 7, 1989.

PROTESTS

Three protests have been received on Advice Letter No. 15697:

A ratepayer wrote to express concern that Pacific would be allowed to increase rates for "nothing real", "technical accounting changes" involving compensated absences. The protestant states "Nobody is getting any more sick leave or paid vacation, it's just being accounted for differently ..." We find this issue was decided in D.87-12-063 where the Commission recognized that some utilities might have substantial revenue requirement impacts associated with the adoption of the FCC Part 32 and Part 36. The decision allowed recovery of those impacts, including GAAP impacts, after a reasonableness review. D.88-09-030 authorized that recovery.

AT&T filed comments on March 15, 1990, stating that it agrees with Pacific that recovery of embedded compensated absence liability by means of a temporary rate increase from 1990 through 1997 is appropriate. AT&T also states that "...any authorization for such an increase should make clear that Pacific must reduce those rates effective January 1, 1998 upon completion of amortization of the embedded absence liabilities." We find that this request is reasonable and the order should include such language.

DRA filed its protest to Pacific's AL No. 15697 on March 15th, 1990, (protest letter dated February 15, 1990). DRA asserts that Pacific's advice letter incorrectly includes a) a future year of compensated absence expense and b) the use of the net-to-gross multiplier in deriving the revenue requirement. When corrected, DRA believes the resulting revenue requirement increase should be $27.503 million not the $334.832 million Pacific requests.

DRA does not take exception to Pacific's estimates for the 1985, 1986 and 1987 carry over compensated absence expenses. However, DRA opposes inclusion of Pacific's "Projected 1988" compensated absence expenses and the use of the net-to-gross multiplier in developing the revenue requirement impacts. DRA's objections are based on the following reasons:

1) D.87-12-063 authorizes recovery of pre-1988 embedded expenses for compensated absences and does not include expenses for the year

1988. Pacific's "Projected 1988" is a projected expense for 1988 and as such not a pre-1988 embedded expense. It represents a forecast of one year's worth of compensated absence expense for every Pacific employee for 1988.

2) D.88-09-030 defines compensated absence expense to represent the salary expense for employee's earned but unused vacation, personal days, floating holidays, and compensated days plus loadings. Pacific's "Projected 1988" expenses were not earned by its employees in 1987. Pacific's policy is to vest its employees with their compensated absences at the beginning of each year, technically in advance of the time it is earned.

3) Pacific's treatment of "Projected 1988" as 1987 expenses is not in compliance with GAAP. Statement of Financial Accounting Standards No. 43 (SFAS 43) states:

> "An employer shall accrue a liability for employees' compensation for future absences if <u>all</u> of the following conditions are met:
> a. The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered,
> b. The obligation relates to rights that vest or accumulate,
> c. Payment of the compensation is probable, and
> d. The amount can be reasonable estimated."

DRA states that Pacific's employees render service in 1988 for the "Projected 1988" expenses; therefore, "Since condition (a) of SFAS 43 noted above was not satisfied, no accrual of the "Projected 88" should be made."

4) DRA disputes Pacific's characterization that the catch-up of compensated absence expense should include a "catch-up" year plus any carry over from previous years; the "catch-up" year being the "Projected 1988" expenses. DRA asserts that Pacific's "carry over" 1987 amounts pick up the "catch-up" accruals as required by SFAS 43.

5) Pacific's proposal to accrue the "Projected 1988" as 1987 expenses violates the Matching Principle under GAAP. DRA states, "The Matching Principle dictates that the revenue for an accounting period shall be matched with the costs associated with the revenue in order to measure net revenue from operation in that accounting period." Treating "Projected 1988" as 1987 expenses equates to having two years of expenses charged to one year of income. DRA suggests Pacific disclose its 1988 liability by a footnote disclosure in its financial statements.

6) Use of "Projected 1988" expenses causes double-dipping on the revenue requirement recovery. DRA states, "...D.87-12-063 ...authorized the establishment of the Balancing Account to provide recovery of the embedded unused compensated absence expenses that were not recognized under the cash basis accounting method before 1988. To

this end, the "Carryovers 85/86 and 87" are reasonable and appropriate. The "Projected 1988" is neither reasonable nor appropriate. It is an unjust enrichment to Pacific and should not be the intent of the Commission."

7) The Commission denied a similar request to include current year accruals along with the embedded based in the balancing account for revenue requirement recovery. D.88-09-030 states on pages 15 and 16:

> "DRA also recommends that Citizens exclude $39,000 of 1988 compensated absence impact because the current year accruals are potentially recoverable in future rate proceedings and because D.87-12-063 did not address current year GAAP impacts. Citizens disagrees with DRA's conclusion. Citizens believes that the current year requirement as well as the embedded balance should be included in the USOA balancing account because both conform to the USOA and are a recoverable ratemaking expense."
> "DRA"s interpretation of D.87-12-063 is correct. Citizens should reduce its compensated absence impact by the $39,000 of current year accruals."

8) DRA conducted a survey of other telephone companies (GTEC, AT&T, Citizens, Contel and Roseville) and found that "while all attest to comply with GAAP, none of them is accounting for compensated absence like Pacific."

PACIFIC'S RESPONSE TO DRA'S PROTEST

Pacific states that DRA's claim that inclusion of "Projected 1988" as part of the embedded compensated absence expense results in "double-dipping" and "unjust enrichment" is without merit. Pacific asserts that the Commission in D.87-12-063 recognized that a one-year catch-up necessarily results when changing from a cash to an accrual accounting basis. Pacific states that the accrued liability for 1988 vacation was earned in 1987 and, therefore, is properly included in the calculation of the embedded base. Pacific further notes that its treatment of 1988 vacation time earned in 1987, as part of the calculation of the embedded compensated absence liability, is fully consistent with the Commission's treatment of other items (incentive team awards and workers compensation) when changing from a cash to an accrual basis. In addition, DRA found Pacific's methodology of including "projected hours for 1988 earned in 1987" was reasonable for calculating the embedded compensated absence liability in its Balancing Account Report to the Commission.

Pacific states that DRA's claim that it allows employees to take compensated absences in advance of the time it is earned is incorrect. Pacific cites its Memorandum to its employees in that "a Pacific employee becomes vested on January 1 of each year to the full amount of vacation to which that employee is entitled during that year. Thus, compensated absence time taken by Pacific employees in the current year is earned the previous year."

Pacific disagrees with DRA's interpretation that accruing 1988 compensated absence expense in 1987 violates the matching principle. SFAS 43, paragraph 9 states that "if it is not practicable to restate any prior year, the cumulative effect shall be included in net income in the year in which the Statement is first applied." Pacific concluded that SFAS 43 contemplates the same "catch-up" year treatment of compensated absence as followed by Pacific. A letter from Coopers & Lybrand affirming Pacific's treatment of the "Projected 1988" compensated absence expenses as part of the embedded base is attached to Pacific's comments. Coopers & Lybrand state, "Because amounts vesting as of January 1, 1988 were earned by services performed in 1987, these amounts should be accrued as of December 31, 1987 and should be considered as part of the "embedded base" as of that date. Disclosure of these amounts without appropriate accrual is not adequate (SFAS 5, paragraphs 8 and 59)."

Pacific disagrees with DRA's conclusion that in D.88-09-030 the Commission rejected a similar request by Citizens Utilities Company of California. Citizens' request was for additional revenue requirement because of increases in accrued compensated absence expenses for 1988 due to additional earned but unused sick leave with loadings and vacation benefit loadings. Pacific states "There was no issue presented with respect to Citizens that dealt with the treatment of compensated absence when shifting from a cash basis to an accrual basis, necessitating a "catch-up" year, or that otherwise related to the issue in the present case."

In response to DRA's concerns regarding the appropriateness of applying the net-to-gross multiplier to calculate the revenue requirement associated with embedded compensated absence expenses, Pacific states "... all revenue requirement changes must be grossed up for the inevitable effects of income taxes. Each dollar of revenue change will cause a corresponding income tax effect." In Attachment 4 of Pacific's response to DRA's protest, Pacific states that since California is a "flow through" jurisdiction for ratemaking purposes, tax benefits received by utilities are passed on to ratepayers. "For tax purposes, Pacific took a deduction each year for compensated absences that were earned in that year and expected to be paid the next year (i.e., using accrual accounting)." This tax benefit was flowed through in the ratemaking process.

DISCUSSION

Use of the net-to-gross multiplier in deriving the revenue requirement increase for the compensated absence impacts.

Subsequent to the filing of Pacific's response to DRA's protest, DRA withdrew its concerns about the appropriateness of using the net-to-gross multiplier in this instance. We agree; Pacific should apply the net-to-gross multiplier to calculate the revenue requirement associated with embedded compensated absence expenses.

1985, 1986 and 1987 carry over compensated absence expenses.

There is no dispute with regard to the inclusion of or the amounts of carry over compensated absence expenses. Pacific should be allowed to amortize in rates the 1985, 1986 and 1987 carry over embedded compensated absence expenses which are grossed up for revenue requirements. These carry over embedded compensated absence impacts amount to $45.402 million and should be amortized over ten years consistent with D.87-12-063. Pacific should be allowed to recover interest on the uncollected revenue requirements beginning January 1, 1988. Pacific should file an advice letter to recover the 1988, 1989 and 1990 amortization through a surcharge. Consistent with D.89-10-031 (Phase II of I.87-11-033, Investigation into Alternative Regulatory Frameworks for Local Exchange Carriers), Pacific should include the 1991 through 1997 amortization ($4.54 million) as a "Z" factor in its annual price cap index filing. Pacific should also be required to reduce its rates beginning January 1, 1998, at the completion of the amortization of the embedded compensated absence expenses.

Inclusion of the "Projected 1988" compensated absence expense amounts.

Pacific and DRA disagree as to whether Pacific's employees have earned (rendered services) for the compensated absences vested January 1, 1988, and whether this, in fact, meets the requirements of SFAS 43. Per Pacific's vacation policy, a Pacific employee becomes vested on January 1 of each year to the full amount of vacation to which that employee is entitled during that year. Pacific interprets this to mean its employees earn the vacation vested on January 1 in the prior year, 1987. However, Pacific has stated that if its employees leave service prior to January 1, then they do not receive compensation for the vacation vesting January 1. DRA has interpreted Pacific vacation policy to mean that its employees do not actually "render services" in 1987 for the vacation vested on January 1, but that the vacation vested is earned by services rendered during the current year.

GAAP requires the matching of revenues with the associated expenses for any given period. SFAS 43 requires companies to restate prior year earnings, and only if not practicable, to include the cumulative effect of applying SFAS 43 in net income in the year in which the Statement is first applied. DRA states that treating the "Projected 1988" as 1987 expenses equates to having two years of expenses charged to one year of income. Pacific states that its treatment is in compliance with SFAS 43 and will not result in "double-dipping".

DRA and Pacific disagree on whether or not the "Projected 1988" amounts were the intent of the Commission in authorizing recovery of the embedded compensated absence impacts.

We do not find the evidence presented by the parties in the advice letter, protests and comments to be adequate to make a determination on the appropriateness of including the "Projected 1988" compensated absence amounts as part of the embedded compensated absence expense impacts to be recovered. We find that additional information is needed to adequately address this issue. Therefore, we reject Pacific's request in AL No. 15697 to recover $281.776 million for "Projected 1988" compensated absence expenses and order expedited hearings to take testimony and evidence from the parties to this proceeding limited to whether the "Projected 1988" compensated absence expenses meet GAAP as defined in SFAS 43 requirements. We will not relitigate whether the Commission should adopt GAAP or whether the Commission should authorize recovery of the embedded compensated absence expense impacts. The Commission, with certain limitations, adopted GAAP for all telephone companies under its jurisdiction by D.87-12-063, dated December 12, 1987. The Commission also authorized recover of the embedded compensated absence expense impacts by D.88-09-030, dated September 14, 1988. Pacific should file an application along with supporting testimony and exhibits requesting recovery of the "Projected 1988" compensated absence expenses. In order to proceed expeditiously and since all parties have had ample opportunity to protest this issue through AL 15697, Pacific's application for recovery should be processed without regard to the normal 30 day protest period.

FINDINGS OF FACT

1. The Commission by Decision 87-12-063 adopted the FCC Part 32 Uniform System of Accounts for telephone companies subject to its jurisdiction.

2. D.87-12-063 adopted Generally Accepted Accounting Principles then currently in effect except as provided in the opinion for all telephone utilities under the Commission's jurisdiction.

3. GAAP accounting for compensated absences was adopted with the embedded amounts to be amortized over a ten year period in D.87-12-063.

4. D.87-12-063 allowed the telephone utilities the opportunity to recover the additional revenue requirement impacts from the adoption of Part 32 by implementing a USOA Balancing Account.

5. D.88-09-030 ordered Pacific, Contel, and GTEC to update their USOA balancing accounts with six months worth of data and file an advice letter for recovery; Pacific's compensated absence impacts were excluded from recovery because of unreliable data.

6. In D.88-09-030, Pacific was required to update its compensated absence impact data and submit it to DRA for review and then file for recovery.

7. On February 23, 1990, Pacific filed Advice Letter No. 15697 to recover the revenue requirement impacts associated with compensated absences.

8. Pacific's advice letter requests revenue requirement recovery for 1985, 1986, and 1987 carry over of earned but unused compensated absence expenses and 1988 projected compensated absence expenses.

9. The net-to-gross multiplier should be used to calculate the revenue requirement effects of the embedded compensated absence impacts.

10. DRA disputes the appropriateness of including the "Projected 1988" compensated absence expenses as embedded compensated absence amounts to be recovered pursuant to D.88-09-030.

11. Additional information is necessary to adequately address the appropriateness of the "Projected 1988" compensated absence expense amounts.

12. Pacific's request for recovery of the "Projected 1988" compensated absence expense amounts is denied pending hearings to gather further information about this issue.

13. There is no dispute regarding the recovery in rates of the 1985, 1986 and 1987 carry over compensated absence impact amounts.

14. The embedded compensated impacts for the 1985, 1986 and 1987 carry over amounts to $45.402 million and should be amortized over ten years consistent with D.87-12-063.

15. Consistent with the intent of D.87-12-063, Pacific should be allowed to amortize and recover in rates the embedded compensated absence impacts beginning January 1, 1988.

16. Consistent with D.87-12-063 and D.88-09-030, Pacific should be allowed to recover interest on the uncollected revenue requirement beginning January 1, 1988.

IT IS ORDERED THAT

1. Pacific Bell's Advice Letter No. 15697 is granted in part and rejected in part.

2. Pacific's request to include $281.776 million for "Projected 1988" compensated absence expenses as part of the embedded compensated absence expense impacts is denied at this time.

3. Expedited hearings are ordered to determine the appropriateness of including the "Projected 1988" compensated absence expense amounts as embedded compensated absence expenses to be recovered pursuant to D.87-12-063 and D.88-09-030. Pacific is authorized to file an application for recovery of the "Projected 1988" compensated absence expenses. Said application shall include Pacific's testimony and exhibits. This application will be processed without regard to the normal protest period.

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4. Pacific is authorized to recover the embedded compensated absence impacts for the 1985, 1986 and 1987 carry over amounts of $45.402 million and shall amortized these amounts over ten years beginning January 1, 1988. Interest is to be calculated on the uncollected revenue requirement beginning January 1, 1988, consistent with D.88-09-030.

5. Pacific is authorized to recover the revenue requirement on the 1988, 1989 and 1990 amortization of the embedded compensated absence expense impacts through a temporary bill-and-keep surcharge to be effective from October 1, 1990 through December 31. 1990. The surcharge shall be applicable to exchange, intraLATA private line, intraLATA toll and access services in accordance to Pacific's Cal. P.U.C. Schedule A-2, Rule No. 33.

6. Pacific is authorized to include the 1991 through 1997 amortization of the embedded compensated absence impacts of $4.54 million annually as a "Z" factor in its annual price cap index filing consistent with D.89-10-031.

7. Pacific Bell shall reduce its rates by $4.54 million beginning January 1, 1998, at the completion of the amortization of the embedded compensated absences.

8. Pacific shall supplement Advice Letter No. 15697 within 10 days of the effective date of this Resolution, to reflect the changes ordered herein.

9. This Resolution is effective today.

I certify that this Resolution was adopted by the California Public Utilities Commission at its regular meeting on September 12, 1990. The following Commissioners approved it:

G. MITCHELL WILK
President
FREDERICK R. DUDA
STANLEY W. HULETT
PATRICIA M. ECKERT
Commissioners

Commissioner John B. Ohanian, being necessarily absent, did not participate.

Neal J. Shulman
Neal J. Shulman
Executive Director

Finance Branch