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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

COMMISSION ADVISORY & COMPLIANCE DIVISION
Telecommunications Branch

RESOLUTION NO. T-12079
April 13, 1988

R E S O L U T I O N

PACIFIC BELL. ORDER DIRECTING PACIFIC BELL TO REDUCE ITS ANNUAL REVENUE REQUIREMENTS FOR ATTRITION YEAR 1988 AND PLACE THE AMOUNT IN A MEMORANDUM ACCOUNT.

SUMMARY

Pacific Bell (Pacific) filed Advice Letter No. 15343 on January 29, 1988, as directed by Decision No. 87-10-075, dated October 28, 1987. By this Advice Letter, Pacific requests a 1988 attrition year revenue requirement reduction of $57.661 million. Pacific also requests that the reduction be placed in a memorandum account rather than making an immediate adjustment to the existing billing surcharges/surcredits.[1]

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1 In its Order Instituting Investigation, OII 87-11-033, pg 12-14, the Commission stated that it would accumulate the revenue requirement changes occurring subsequent to Pacific's General Rate Case Phase II Decision in a memorandum account until such time as limited supplementary rate design hearings are held to determine how to reflect such revenue requirement changes in rates.

Based on our review, Pacific's 1988 attrition revenue requirement is a reduction of $64.911 million. The difference between our adopted revenue requirement reduction and Pacific's filed amount is due to 1) the inclusion of the effect of interest accrued as a result of the change in rate base in federal and state income tax calculations[2]; 2) removal of revenue requirement effects of the Direct Customer Access/Directory Information (DCA/DI) Advice Letter No. 15070 per Resolution T-12075, dated March 23, 1988; 3) correction for the use of forecasted data in development of revenue growth factors; and 4) correction of other minor errors. Appendix A of this resolution shows Pacific's filed intrastate results and the adopted 1988 attrition intrastate results of operation.

Summary of Changes	$ in Millions
Correction of growth factors	-$4.718
Removal DCA/DI A.L.	- 1.757
Inclusion of interest effects due to rate base change and other adjustments	- 1.843
Financial attrition	1.068
TOTAL	-$7.250

2 Interest is an element in calculation of state and federal income taxes. For ratemaking purposes, interest is determined by multiplying the rate base by the weighted cost of debt. A change in rate base will result in an incremental change in interest and thereby an incremental change in income taxes and revenue requirements.

Although much of the discussion in this Resolution centers around Division of Ratepayer Advocates' (DRA) protest, the framework of our review of Pacific's 1988 attrition filing is focused upon compliance with the adopted attrition formulas (Decision 85-03-042 as modified by D. 86-12-099) as implemented in Resolution T-12007.

BACKGROUND

This is Pacific's second attrition year filing in the three-year General Rate Case Plan. It is based on a 1986 test year and a 1987 attrition year.

Decision 86-12-099, dated December 22, 1986 sets forth the attrition formulas to be used by Pacific in attrition filings. In January 1987, Pacific filed its 1987 attrition Advice Letter. Resolution T-12007, dated March 25, 1987, ordered a 1987 attrition year revenue requirement reduction and corresponding reduction in rates. Pacific applied for rehearing of D. 86-12-099 and Resolution T-12007. Pacific has appeals of both the decision and resolution pending before the California Supreme Court.

In response to Pacific's application to rehear Resolution T-12007, the Commission granted limited rehearing on the issue of technical update of depreciation. In D. 87-12-048, dated December 17, 1987, the Commission denied Pacific's requested relief for attrition year 1987. However, it granted limited recognition of Equal Life Group (ELG)[3] impact in attrition year 1988 as a "Section M"[4] filing.

In addition to the limited rehearing of technical update, D. 87-04-078 denied Pacific's petition to modify D. 86-12-099 but established workshops to review the need for attrition and the attrition mechanism. The August 1987 workshop was attended by representatives of local exchange companies, AT&T-Communications of California (AT&T), DRA, Commission Advisory and Compliance Division (CACD) and Toward Utility Rate Normalization (TURN) The workshop participants agreed that there were too many issues before the Commission to arrive at any meaningful consensus about attrition. Both TURN and Pacific stated that formal hearings were the appropriate way to deal with any modifications to attrition.

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3 Equal Life Group is a depreciation class receiving different treatment from vintage groups.
4 Section M of D. 86-12-099 discussed additional matters that may be included in an Attrition filing. These are items imposed by government action, that are easily quantifiable and verifiable (page 25.)

In August 1987, Pacific filed a petition to modify D. 86-12-099 to relieve it from the obligation to file for the 1988 attrition year. Decision 87-10-075 ordered Pacific to file for 1988 attrition "using the adopted methodology (D. 85-03-042, as modified by D. 86-12-099) as implemented in Resolution T-12007, and allow[ing] only the few specific changes to that methodology which may be adopted in other related decisions to be issued before the end of 1987." (page 14, mimeo) Pacific applied for rehearing of D. 87-10-075, contending that the subject to refund provision of that decision violated the rule against retroactive ratemaking. The Commission denied rehearing in D. 88-01-056, dated January 28, 1988.

Pacific filed Advice Letter No. 15343 on January 29, 1988 requesting a revenue requirement reduction of about $58 million for 1988. On February 18, 1988, DRA filed a protest to Pacific's Advice Letter No. 15343, which they supplemented on March 3, 1988. (See Appendix B.) Pacific responded to DRA's protest on March 7, 1988, having requested and been granted a week's extension in the response deadline. (See Appendix C.)

PROTESTS

DRA's protest addresses four major elements of the attrition filing and provides four additional comments and recommendations for future filings. DRA's original estimate of Pacific's 1988 attrition was a reduction in revenue requirement of $231 million. DRA amended its protest on March 3, 1988 to consider the tax effects on changes in revenue. It also amended its recommendation on the labor productivity sharing plan to include refunds with interest. DRA's revised attrition revenue requirement estimate is a reduction of $167 million.

DRA's protest can be divided into factual issues, interpretative issues and procedural issues. These issues are discussed below.

1. Issue of Fact

DRA protests that Pacific compares actual data with forecasted data in its determination of factors for growth in access lines and growth in revenue per access line. These factors are used in developing the estimated 1988 attrition year revenue, labor and labor overhead expense and several other expenses. DRA cites Appendix C, page 1 of D. 86-12-099 which states:

> "Growth rates shall be calculated from the regression equation, not by a comparison of predicted attrition year access lines or revenues to recorded results."

DRA describes the erroneous comparison thus: "...Pacific forecasts the last half of 1987 and for all of 1988. Pacific then calculates an average number of switched access lines for both years. The calculation of average switched access lines for 1987 includes actual 1987 results through June. This calculation is contrary to the attrition formula."

In response Pacific states that it developed its factors for growth in access lines and revenue per access line using the same methodology used in its 1987 attrition filing. Pacific further states, "In addition, Decision No. 86-12-099 requires the use of 'six months of recorded test year data'. Accordingly in its filing Pacific used actual 1987 results through June."

We agree with DRA that Pacific's method of calculating the growth factors contains an error since it compares actual with forecast data. This is a factual error that deviates from the clear wording of D. 86-12-099. The fact that Pacific also made this error in its 1987 attrition filing and the Commission did not discover the error when it issued Resolution T-12007 does not mitigate it being an error. We will not perpetuate this error. The correction results in a $4.718 million reduction in attrition revenue requirements.

2. Issues of Interpretation

The directions for developing growth in access lines and growth in revenue per access line are set forth in Appendix C, page 1 of D. 86-12-099. The complete text of the directions is given below:

> "Growth in access lines and growth in revenue per access line are to be forecast from linear least squares regression models used to correlate access lines and revenue per access line with time. Five years of recorded data, including six months of recorded test year data should be used. Growth rates shall be calculated from the regression equation, not by comparison of predicted attrition year access lines or revenues to recorded results."

DRA protests Pacific's use of 66 data points of twelve month moving averages based on 77 months of recorded data in its forecast to develop factors for growth in access lines and growth in revenue per access line. To support its protest, DRA quotes D. 86-12-099, cited above. DRA states that Pacific's twelve month moving average technique on 60 months of recorded data as a base would result in 49 data points for the linear regression model rather than 66 data points that Pacific uses. Using 49 data points and the output from the linear regression model, DRA calculates the compounded growth rate over the relevant time span. The compounded growth rates of 3.98% for revenue per access line and 3.30% for access lines result in a further reduction in revenue requirement of $51 million.

Pacific defends its forecasting method to develop factors for growth of access lines (3.53%) and revenue per access line (2.73%). Pacific states it forecasted the level of 1988 access lines and revenue per access line using linear least squares regression model. It then used the forecasted levels to determine the growth factor. Pacific points out that D. 86-12-099 requires the use of a linear least squares regression model to forecast the growth factors. According to Pacific, DRA used only historical data to derive the growth rate (recorded data through June 1987) rather than forecasted data through December 1988 and introduced a compounded growth rate rather than a linear rate. Pacific states,

> "Pacific's use of 66 data points in the regression equation complies with the requirements of Decision No. 86-12-099. That decision states that, in calculating growth in access lines and revenue per access line, Pacific shall use 'five years of recorded data, including six months of [attrition year 1987] data' (D. 86-12-099,

> mimeo Appendix C, p.1). The words 'five years of recorded data' mean five full calendar years of recorded data. In accordance with this requirement, Pacific's 66 data points represent five full calendar years of recorded data (1982-1986) plus the additional half-year of attrition year 1987 required by Decision No. 86-12-099."

The parties interpret the requirements of D. 86-12-099 differently with reqards to the matter of the total number of months of recorded data and the number of points resulting from moving averages. Additionally, DRA introduced the use of compounded growth rates although the Attrition Decision is silent on the use of a compounded growth rate. Because Pacific uses the linear regression model, uses at least five years of recorded data, and uses the same method it used in its 1987 attrition filing, the spirit of the attrition methodology is followed. Therefore, given the directive in D. 87-10-075, page 14, mimeo, we will remain consistent with the methodology as implemented in Resolution T-12007. The parties may raise the issue of the number of months in a future proceeding (such as Phase II of our investigation into alternative regulatory frameworks for local exchange companies, I. 87-11-033) in which the attrition mechanism will be re-examined. This part of the protest is denied without prejudice.

3. Issues of Procedure

A. Billing and Collection for AT&T

DRA protests the inclusion of the revenue requirement adjustment for AT&T's billing and collection take-back (Advice Letter No. 15091) in advice letter contributions to revenue requirement. DRA states this item should be deferred to AT&T's billing and collection investigation, I. 88-01-007. The revenue effect of this item is a $41 million reduction in Pacific's attrition revenue requirement.

Pacific responds that the 1987 revenue requirement effect of the billing and collection advice letter was included in the 1987 attrition filing and implemented by Resolution T-12007. Pacific states I. 88-01-007 may not be timely since DRA has requested an extension of six months in the current schedule for the OII. Furthermore, the OII has no stated intention to provide revenue recovery. For these reasons Pacific states the AT&T billing and collection advice letter effect should remain in the attrition filing.

DRA does not protest the amount of the Billing and Collection Advice Letter No. 15091 revenue requirement adjustment or the inclusion of advice letter revenue requirement adjustments in the attrition mechanism. Adjustments to revenue requirement for advice letters are allowed in the attrition mechanism (D. 86-12-099, Appendix C, page 1).[5] In the 1987 attrition filing, we recognized a similar adjustment. Thus, inclusion of this advice letter in the 1988 attrition filing is consistent with both D. 86-12-099 and Resolution T-12007. We therefore deny this portion of DRA's protest.

B. Composite Salaries and Wages Factor

The DRA protests the benefits portion of the Composite Salaries and Wages factor. It alleges that Pacific incorrectly included adjustments for actual and forecasted changes in benefits as part of wage expenses, thus going far beyond changes to wage

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5 Our adopted intrastate revenue in Phase I D. 86-01-026, dated January 10, 1986, includes revenues for billing and collection services for AT&T. After D. 86-01-026 was issued, AT&T indicated its preference to take-back its billing. In response, Pacific filed AL 15091 on May 20, 1986, requesting authority to provide intrastate billing and collection services under a five-year Specialized Service Arrangement. This provided for five years of revenues that decline each successive year. The Commission approved AL 15091 by Resolution T-15049, dated June 25, 1986.

Billing and collection revenues are included in the adopted intrastate revenues. These are projected to 1987 and 1988 attrition year levels using the attrition formula. The $41 million at issue in DRA's protest reflects the adjustment between the forecasted billing and collection revenue and the declining billing and collection revenue in the Specialized Service Arrangement approved by Resolution T-15049.

agreements which D. 86-12-099 allows. Specifically DRA protests 1) the forecast of increase in number of employees taking advantage of the Pacific savings plan, 2) the increase in benefit expenses by the amount that actual 1987 benefit expenses exceeded the expense included in the 1987 attrition award, 3) the increased benefit expense determined by an inflation factor which is not included in either the wage agreement or the attrition formula, and 4) the decrease in pension expense due to an estimate change. DRA's protest would increase the revenue requirement reduction by $17 million.

Pacific states it employed the same approach it followed in 1987 to calculate the benefits portion of the composite salaries and wages factor. "The various determinants of these expenses, although not expressly provided for in the contract, are directly related to the contract. For example, the vision care plan reimbursement to employees increased by 31% (1988 over 1987) pursuant to contract. This would also logically increase the number of employees that participate in the reimbursement...In addition, non-salaried employees were contractually granted an increased 'Company-match' for savings plan contributions. For attrition purposes, Pacific estimated that a high percentage of employees would take advantage of this benefit during 1988." Pacific states it also used estimates of employee participation levels, and forecasts of inflation and industry-wide expense trends in its 1987 filing.

In Resolution T-12007 we noted that "Although the attrition formula set forth on page 2 of Appendix B of D. 86-12-099 does not specifically mention team incentive plan or benefits plan we will include these items since they are part of the labor contract. However, the inclusion of team incentive plan and benefits plan in attrition should be reviewed in a future appropriate proceeding in which the attrition mechanism will be re-examined." Therefore we will deny the protest without prejudice and let stand this portion of Pacific's filing since it is consistent with Resolution T-12007. We repeat that the inclusion of team incentive plan and benefits plan should be re-examined in the next appropriate proceeding dealing with the attrition mechanism.

C. Productivity Sharing Plan

DRA recommends a methodology to make explicit the manner in which productivity sharing is to be accomplished in 1989 and onward. In its amended protest, DRA further recommends the productivity saving be refunded with interest.

Pacific responds that it intends to comply with the productivity incentive mechanism adopted in D. 87-12-067. However Pacific takes issue with DRA's estimated savings of $80 million and quotes D. 87-12-067, "The labor attrition formula should be recomputed after the attrition year using the actual realized productivity factor" (Ordering Paragraph No. 13, mimeo p.330-331 (emphasis added)). Pacific also states that it believes there is a methodology in place in the Phase II Results of Operations Decision (D. 87-12-067) and alleges that DRA is introducing a different methodology in that the DRA proposes use of average levels rather than end-of-period levels of access lines and employees. Further Pacific believes the earliest date for which interest should begin accruing is January 1, 1989 when the actual amount, if any, will be known.

We find that Pacific has applied the productivity factor in compliance with D. 86-12-099 and used the value, 2.9%, adopted in D. 87-12-067. Since the Productivity Sharing Plan as modified and adopted in D. 87-12-067 was litigated at length in Pacific's A. 85-01-034, it is more appropriate for DRA to express its recommendation for changes in the methodology in a petition for modification of D. 87-12-067. However, we will take steps to implement the Productivity Sharing Plan.

Actual productivity savings for 1988 will not be known until after the year's end. Therefore we will direct Pacific to file its actual realized 1988 productivity factor with CACD for review on or before January 31, 1989, using the Productivity Sharing Plan adopted in D. 87-12-067. If the actual realized productivity factor is greater than 2.9%, Pacific should file an advice letter to flow-through the ratepayers' share of savings at the time it files its productivity factor.

D. 1988 Represcription [6]

DRA recommends that represcription of depreciation be incorporated into the 1988 attrition filing.

Pacific responds that revenue requirement changes due to represcription must be recognized; however, it is inappropriate to hold the attrition proceeding open until mid-year to take these effects into account. Pacific recommends the revenue requirement effect of represcription should be put into memorandum balancing accounts to be considered at a later time.

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6 Represcription of depreciation is a procedure in which all plant accounts, depreciation rates, salvage values and remaining life are evaluated.

Pacific also points out that since the represcription issue was not resolved before the end of 1987, it should not be included:

> "Attrition is intended to take into account only those known changes which are finalized before the start of the attrition year." (D. 87-10-075, mimeo p. 11)

Represcription is not specifically allowed in either the attrition mechanism set forth in D. 86-12-099 or Resolution T-12007. The Commission normally acts on the utility's request for represcription after the Federal Communications Commission has approved its rates. Thus it may be late in the year before represcription is complete. Undoubtedly, in making its recommendation, DRA anticipates a decrease in depreciation accrual and thereby a further reduction in revenue requirement from represcription. Rather than delay this attrition filing, we will direct CACD to provide a recommendation on the disposition of any revenue flow-through at the time the Commission authorizes Pacific's represcription rates.

E. Cost of Capital

DRA recommends that Pacific's cost of captial be re-evaluated in the 1989 attrition filing since the Commission has found

Pacific's return on equity of 15% to be reasonable only through 1988.

Pacific responds that in light of I. 87-11-033, it is premature to decide whether to review Pacific's cost of capital in connection with a 1989 attrition filing.

The Commission has found the 15% return on equity reasonable from the test year 1986 through the succeeding two years. (D. 86-01-026, Finding of Fact No. 3) No finding of reasonableness exists beyond 1988. This implies that a review is needed to determine a reasonable cost of capital for the succeeding years, including a review of capital structure on which the cost of capital is based.

We are currently investigating alternative regulatory frameworks for local exchange companies in I. 87-11-033. We are aware that the implementation of alternative ratemaking processes may replace current procedures altogether or result in modifications to the present General Rate Case Plan. Even though Pacific states it is premature to discuss 1989 attrition in light of our investigation, we want to emphasize that the current ratemaking process is in effect until it is removed or modified. Therefore we must operate and plan in the current regulatory environment.

If Phase II of our investigation is completed by the end of this year it will be necessary to review the capital structure of Pacific as a benchmark for 1989. On the other hand, if Phase II of our investigation is delayed, we will need to review the capital structure of Pacific for 1989 financial attrition. Therefore we direct Pacific to submit an application, testimony and exhibits for a review of its capital structure and cost of capital for 1989 on or before July 15, 1988.

By Resolution ALJ 160, dated October 28, 1987, Pacific is required to make a 1989 attrition year filing, using the advice letter format, in lieu of a 1989 test year general rate case. Therefore in this Resolution we will also direct Pacific to file an advice letter for 1989 operational attrition by October 1, 1988. Our decision on the 1989 attrition year revenue requirement will encompass the effects of our review of the operational attrition advice letter and the evidentiary record developed on financial attrition issues.

F. <u>Use of Total Access Lines for Revenues Forecasts</u>

DRA also suggests that non-switched access lines (private lines) be included with switched access lines in determining the growth factors for access lines and revenue per access line.

Pacific states, "Advice Letter 15343 applies the <u>same</u> attrition formula and methodology approved by the Commission in connection with Pacific's 1987 attrition filing. Indeed, the DRA's protest does not even allege any inconsistency with Pacific's 1987 attrition filing...The DRA's protest improperly seeks to modify the approved attrition formula." Pacific further defends its attrition filing by citing portions of D. 87-10-075 and alleging that DRA ignores the clear mandate of that decision in recommending different methodology for Pacific's attrition filing.

CACD's investigation reveals that historical non-switched access line data prior to mid-1985 is not reliable. Pre and post divestiture non-switched access line data are incompatible. Therefore, for Pacific, we will use switched access line data, consistent with the methodology in Resolution T-12007. The issue of total versus switched access lines should be discussed in an appropriate future proceeding in which attrition is re-examined.

4. Summary of Our Handling of DRA's Protest

With respect to DRA's protest, we have corrected the factual error reqarding growth factors and have considered its recommendations. To that extent, DRA's protest is granted.

DISCUSSION

Operational Attrition

Pacific's 1988 operational attrition is generally consistent with the required methodology. The filing includes the adopted separation factors and productivity factor, which were developed in Phase II Results of Operations D. 87-12-067 of A. 85-01-034. We make several relatively minor corrections to Pacific's filing.

The factors for growth in access lines and growth in revenue per access line were corrected to use forecasted data only in the factor determinations as a result of DRA's protest. The factor for growth in access lines is changed from 1.0273 to 1.0306] and the factor for growth in revenue per access line is changed from 1.0353 to 1.0370. The correction of the factors results in a further reduction in revenue requirement of $4.718 million.

Pacific's determination of expenses for Labor and Labor Overheads is consistent with Resolution T-12007 and D. 87-10-075. The calculation used the 2.9% productivity factor set forth in Phase II, D. 87-12-067. The factor for growth in composite salaries and wages was determined by methods used in the 1987 attrition filing. Once again the factor was determined from weighted relative growth of (1) salaries and wages, (2) team incentive plan, (3) benefit plans, and (4) payroll taxes. While this is consistent with Resolution T-12007, neither the team incentive plan nor the benefit plans are specifically mentioned in the attrition formula for labor expense. Inclusion of team incentive plan and benefits plan should be reviewed in a future appropriate proceeding in which the attrition mechanism will be re-examined.

We will correct Pacific's federal and state income tax calculation by including the interest resulting from the increase in the 1988 attrition year rate base over the 1987 attrition year rate base. We also correct a transcriptional error. The result of these corrections is a further reduction in revenue requirement of $1.843 million.

Financial Attrition

Pacific includes financial attrition in Advice Letter No. 15343 in compliance with D. 87-10-075. Pacific's embedded cost of debt decreased from 9.25% in December 31, 1986 to 9.17% on December 31, 1987. The reduction is due to long-term debt retirement and redemption activity. This resolution does not change the capital structure or the 15% return on equity which we found reasonable in D. 86-01-026. The rate of return on intrastate rate base decreases by 4 basis points from 12.16% adopted in Resolution T-12007 to 12.12%. Consistent with Resolution T-12007 and

D. 87-10-075, preferred stock is imputed in the capital structure. We will correct rounding errors which results in a financial attrition revenue requirement reduction of $4.075 million compared to Pacific's estimate of $5.143.

Other Adjustments

Pacific's 1988 attrition filing includes revenue requirement of $40.049 million from Advice Letters for new or revised services implemented during 1987. This amount is reduced to $38.292 million to reflect the removal of $1.757 million for DCA/DI Advice Letter No. 15070 as directed by Resolution T-12075.

Ordering Paragraph No. 1 of D. 87-12-048 permitted the inclusion of ELG impact in this filing. Our review shows that plant categories subject to ELG treatment were capped at the same growth rate used for the attrition year telephone plant in service and additions to plant were made to ELG plant while retirements were made in Vintage Group. This is in compliance with D. 87-12-048. Pacific included this adjustment as a "Section M" filing as provided for in D. 86-12-099, page 25. Pacific calculated the ELG revenue requirement impact to be $16.740 million.

In I. 87-11-033 we indicated our intention that Pacific's revenue requirement changes occurring after the Phase II Decision would be accumulated in a memorandum account. Thus, we direct Pacific to accumulate its 1988 attrition year revenue requirement reduction beginning January 1, 1988 with interest accrued at the three month commercial paper rate in a memorandum account.

FINDINGS OF FACT

1. Decision No. 87-10-075 directs Pacific to use the adopted attrition methodology (D. 85-03-042, as modified by D. 86-12-099) as implemented in Resolution T-12007.

2. Pacific Bell's Advice Letter No. 15343 generally follows the methodology it used in its 1987 attrition.

3. Pacific developed its factors for growth in access lines and growth in revenue per access lines by comparing actual data with forecasted data.

4. The attrition formula for the factors for growth in access lines and growth in revenue per access line states, "Growth rates shall be calculated from the regression equation, not by comparison of predicted attrition year access lines or revenues to recorded results." (D. 86-12-099, Appendix C, Page 1)

5. It is appropriate to correct the growth factor methodology used by Pacific to agree with the attrition formula as stated above in Finding of Fact No. 4.

6. Using 60 or 66 months of recorded data and/or data points in revenue growth forecasting is a matter of interpretation that should be addressed in a future proceeding which will re-examine the attrition mechanism. Until such time, the method used by Pacific in its 1987 attrition filing is appropriate.

7. The attrition mechanism is silent on the use of compounded growth rates.

8. Considering the revenue requirement effects of Billing and Collection Advice Letter No. 15091 in this attrition filing is consistent with Resolution T-12007 and D. 86-12-099.

9. The team incentive plan and benefits plan, while not specifically mentioned in the attrition formula for Labor and Labor Overhead set forth on Page 2 of Appendix B of D. 86-12-099, should be included in this filing because they are part of the labor contract and because it is specifically allowed in Resolution T-12007.

10. The inclusion of team incentive plan and benefits plan in attrition should be reviewed in a future proceeding in which the attrition mechanism will be re-examined.

11. Pacific's attrition filing for 1988 uses the 2.9% productivity factor adopted in D. 87-12-067.

12. The actual productivity factor will not be known until after the end of the year. Therefore it is appropriate to implement the sharing of the productivity savings on or before January 31, 1989.

13. On or before January 31 of the year, Pacific should file its 1988 actual productivity factor with CACD for review. It should use the Productivity Sharing Plan adopted in D. 87-12-067. If there is a productivity sharing, Pacific should file an advice letter to flow-through the ratepayers' share of the savings at the time it files its actual productivity factor.

14. The productivity sharing plan as modified and adopted in D. 87-12-067 was litigated at length in Pacific's A. 85-01-034. Revisions to the methodology should not be made in this Resolution, but are more appropriately raised in a Petition for Modification of D. 87-12-067.

15. Represcription is not allowed in the attrition mechanism as set forth in D. 86-12-099 or Resolution T-12007.

16. To keep this attrition filing open until the 1988 represcription effect is known is not reasonable. At the time that this Commission adopts Pacific's represcription rates, CACD should recommend the appropriate method to deal with any flow-through in the event of a change in revenue requirement.

17. Pacific's return on equity of 15% has been found reasonable through 1988. No finding of reasonableness for return on equity exists for 1989.

18. Pacific's year-end 1987 embedded cost of debt of 9.17%, a decrease from 9.25% adopted in Resolution T-12007, is reasonable and should be adopted.

19. We are not changing the capital structure or the 15% return on equity which were found reasonable in D. 86-01-026. Using the 9.17% embedded cost of debt, the attrition year return on rate base of 12.12% is reasonable.

20. A review of Pacific's capital structure and cost of capital for 1989, either as a benchmark for an alternative regulatory framework or for 1989 financial attrition, is necessary.

21. Resolution ALJ-160 directs Pacific to file a 1989 attrition year filing, using the advice letter format, in lieu of a test year 1989 general rate case.

22. Non-switched access line data is not reliable prior to mid-1985. Pre and post-divestiture non-switched access line data are not comparable.

23. Resolution T-12075 directs the $1.757 million effect of Advice Letter No. 15070 be excluded from this attrition filing.

24. The development of ELG effect of $16.740 million, included as "Section M" in this attrition, is in compliance with D. 87-12-048.

25. The 1988 Attrition year revenue requirement reduction of $64.911 million as set forth in Appendix A of this Resolution is reasonable and should be adopted.

26. Placing the $64.911 million revenue requirement reduction for 1988 attrition in a memorandum account is consistent with our intention in the alternative regulatory framework investigation, I. 87-11-033.

27. With respect to DRA's protest, we have corrected the factual error and have considered the recommendations. To that extent, DRA's protest is granted.

IT IS ORDERED THAT:

1) The 1988 attrition year intrastate results of operation and revenue requirement reduction of $64.911 million as set forth in Appendix A of this resolution are adopted.

2) Pacific shall place the revenue requirement reduction from January 1, 1988 into a memorandum account with interest accruing at the three-month commercial paper rate from January 1, 1988 until further order of the Commission.

3) Pacific shall file an application, testimony and exhibits for capital structure and cost of capital review for 1989 on or before July 15, 1988.

4) Pacific shall file an advice letter for 1989 operational attrition by October 1, 1988 using the adopted methodology (D. 85-03-042, as modified by D. 86-12-099) as implemented in this Resolution.

5) On or before January 31, 1989, Pacific shall file its 1988 actual realized productivity factor, with supporting workpapers, with CACD for review. If there is a productivity sharing, Pacific shall file an advice letter to flow-through the ratepayers' share of the savings at the time it files its 1988 actual realized productivity factor.

6) This resolution is effective today.

I certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting on April 13, 1988. The following Commissioners approved it:

STANLEY W. HULETT
President
FREDERICK R. DUDA
G. MITCHELL WILK
JOHN B. OHANIAN
Commissioners

Victor Weisser

Executive Director

APPENDIX A

Pacific Bell 1988 Attrition Year
Gross revenue requirement
$(000)

	Pacific 1988 Attrition	Adopted 1988 Attrition
1. INTRASTATE REVENUES	7,366,140	7,374,734
2. LABOR AND LABOR OVERHEADS	2,608,102	2,610,640
3. MATERIALS RENTS & SERVICES	1,372,178	1,373,514
4. DEPRECIATION EXPENSE	1,184,566	1,184,566
5. FEDERAL AND STATE INCOME TAXES	748,862	750,381
6. AD VALOREM TAXES	160,486	160,486
7. OTHER TAXES	7,400	7,400
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8. BALANCE NET REVENUE	1,284,546	1,287,746
RATE BASE COMPONENTS		
9. TELEPHONE PLANT IN SERVICE	16,744,663	16,744,663
10. PROPERTY HELD FOR FUTURE USE	11,468	11,468
11. WORKING CASH	268,784	269,056
12. MATERIALS AND SUPPLIES	76,908	76,908
13. less: DEPRECIATION RESERVE	4,582,684	4,582,684
14. less TAX RESERVE	2,443,812	2,443,812
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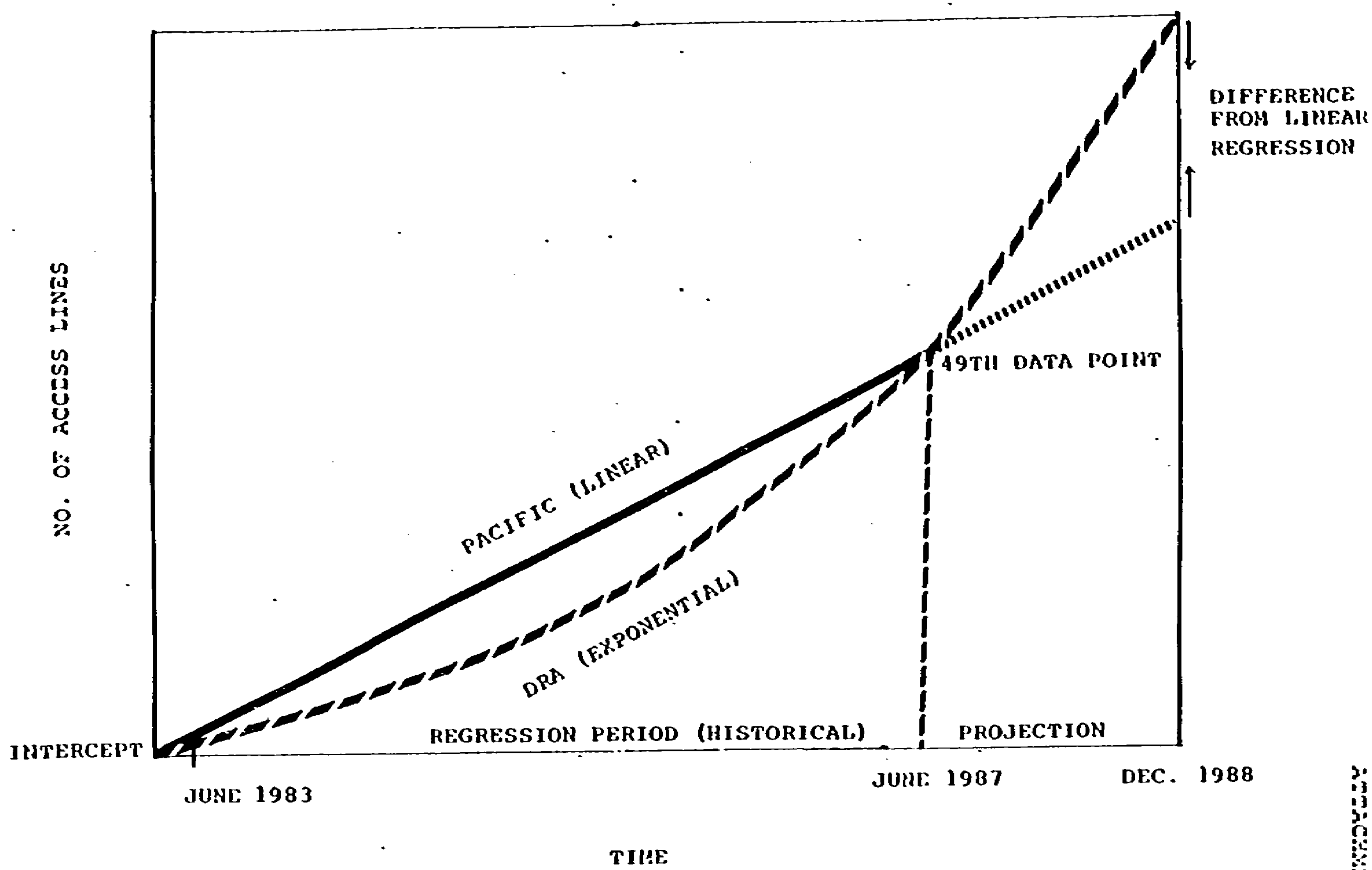
15. NET RATE BASE	10,075,327	10,075,599
REVENUE REQUIREMENT CALULATION		
16. NET RATE BASE	10,075,327	10,075,599
17. times: RATE OF RETURN	0.1216	0.1216
	-----------	-----------
18. RETURN ON RATE BASE	1,225,160	1,225,193
19. less: BALANCE NET REVENUE	1,284,546	1,287,746
	-----------	-----------
20. NET REVENUE REQUIREMENT	(59,386)	(62,554)
21. times: NET TO GROSS MULTIPLIER	2.07131	2.07131
	-----------	-----------
22. GROSS REVENUE REQUIREMENT	(123,007)	(129,568)
ADJUSTMENTS		
23. TECH. UPDATE(87) or ELG IMPACT(88)	16,740	16,740
24. CPE PHASEOUT	13,700	13,700
25. ADVICE LETTERS	40,049	38,292
	-----------	-----------
26. TOTAL ADJUSTMENTS	70,489	68,732
	-----------	-----------
27. FINANCIAL ATTRITION	(5,143)	(4,075)
	-----------	-----------
28. ADJUSTED GROSS REVENUE REQUIREMENT	(57,661)	(64,911)
	==========	==========

(Red Figure)

ILLUSTRATIVE GRAPH

CONSTANT ABSOLUTE GROWTH VS CONSTANT GROWTH RATE
(LINEAR) (EXPONENTIAL)



NOTE: NOT DRAWN TO SCALE

ATTACHMENT 3

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STATE OF CALIFORNIA GEORGE DEUKMEJIAN, Governor

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102 3298

February 18, 1988

Victor Weisser
Executive Director
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Dear Mr. Weisser:

Re: Protest of the Division of Ratepayer Advocates to Pacific Bell's Advice Letter No. 15343

Pursuant to General Order 96A (III H), the California Public Utilities Commission's Division of Ratepayer Advocates ("DRA") hereby protests Pacific Bell's ("Pacific") Advice Letter No. 15343 dated January 29, 1988. As explained more fully below, Pacific's Advice Letter filing incorrectly applies the Commission's attrition methodology and when corrected should result in revenue requirement reduction of approximately $239 million.

BACKGROUND

On December 22, 1986, the Commission issued D.86-12-099 which resolved certain outstanding questions regarding the attrition methodology adopted for Pacific and General Telephone Company of California. D.86-12-099 contains the basic attrition mechanism applicable to this filing.

In D.87-10-075, the Commission ordered Pacific to file a 1988 attrition year advice letter on or before January 20, 1988, in order to address operational and financial attrition. The Commission ordered Pacific to follow the attrition formula adopted in D.85-03-042 as modified by D.86-12-099 with two exceptions: (1) Pacific should use the Phase 2 decision's results of operations; and (2) Pacific should incorporate the technical update/depreciation findings of A.87-04-049. The Commission also required Pacific to identify all financings and refinancings from January 1, 1987 through December 31, 1987.

Pacific filed Advice Letter No. 15343 on or around January 29, 1988, in compliance with Ordering Paragraph 1 of D.87-10-0075.

PROTEST

DRA's protest is based on Pacific's incorrect interpretation of the attrition methodology/formulae. Pacific has used essentially the same defective interpretation of the methodology for 1988 as it used in its 1987 attrition filing. For 1987, DRA filed a limited protest based on a limited evaluation of Pacific's 1987 attrition filing. Pacific's defective interpretation was not based on DRA's limited review. Unfortunately, the Commission adopted the filing by default.

Adoption of Pacific's defective interpretation in the 1988 attrition filing would result in the adoption of a revised methodology without benefit of a full review by all parties. DRA proposes that the Commission objectively apply the cookbook attrition methodology/formulae as set forth in D.86-12-099.

DRA has four specific areas of protest to Pacific's 1988 attrition Advice Letter. Approximate revenue requirement effects for each item are in parentheses. The total approximate revenue requirement is $(239M) for DRA's calculations versus $(58M) as calculated by Pacific.

1. <u>The AT&T Billing and Collections Adjustment Is Inappropriate At This Time</u> (-41M)

The Commission is investigating the revenue requirement impact on local exchange carriers of AT&T Communications of California's billing and collections takeback in OII 88-01-007, dated January 13, 1988. An attrition adjustment for billing and collections at this time would only complicate ultimate resolution of the revenue requirement issue, because an eventual true-up with the OII decision is inevitable.

DRA believes the appropriate forum for revenue requirement adjustment for AT&T's billing and collections is the OII specifically designated to investigate that issue. The current timetable for OII 88-01-007 calls for a decision by May. That timetable permits accounting for the revenue requirement effect in the supplementary rate design envisioned in OII 87-11-033, the investigation into intraLATA regulation.

2. <u>The Access Line Growth Forecast is Incorrect</u> (-39M)

The forecasting methodology used by Pacific is not in compliance with the attrition methodology adopted in D.86-12-099. That decision requires that growth in access lines be forecast with a linear least squares regression model using "(f)ive years of recorded data, including six months of recorded test year data." (Appendix C, p. 1). Five years of recorded data is 60 months of data. Pacific incorrectly uses 77 months of data.

Additionally, Pacific's data is based on a twelve month moving average. Using 60 months of data as a base, a twelve month moving average results in 49 data points. Therefore, the correct regression forecast would use data from July, 1982 through June, 1987, resulting in twelve month moving average data points from June, 1983 through June, 1987. Pacific incorrectly uses 66 data points, relying on data as far back as January, 1981.

By using more data than specified in the attrition decision, Pacific is allowing older, less relevant data to affect the attrition revenue requirement.

Pacific's method for determining the growth rate is also inconsistent with D.86-12-099. D.86-12-099 specifies how growth rates are to be determined:

> "Growth rates shall be calculated from the regression equation, not by a comparison of predicted attrition year access lines or revenues to recorded results."

(Appendix C, p. 1).

A comparison of predicted results to recorded results is expressly prohibited, but Pacific has done exactly that. To determine switched access line growth, Pacific forecasts the results for the last half of 1987 and for all of 1988. Pacific then calculates an average number of switched access lines for both years. The calculation of average switched access lines for 1987 includes <u>actual</u> 1987 results through June. This calculation is contrary to the attrition formula.

Pacific does not calculate growth rates from the regression equation. First, it forecasts 1988 results. Growth rates are then based on the change of 1988 over 1987. DRA calculates growth rates from the regression equation, as the Commission ordered. Using the direct output from the regression equation, which is the slope and intercept of the regression line, DRA calculates the compound annual growth rate over the relevant time span.

3. <u>The Revenue Growth Per Access Line Forecast Is Also Incorrect</u> (-66M)

This forecast is incorrect for the same reasons, discussed above, as the growth in access line forecast is incorrect. Again, Pacific does not adhere to the specified attrition formulae; DRA's forecast does.

4. Growth in Composite Salaries and Wages Forecast (~35M)

D.86-12-099 permits adjustment to labor and labor overhead expense to reflect changes to wage agreements. (Appendix B, p. 2). It does not permit adjustment to reflect actual wage expense, nor does it allow new estimates. (Appendix B, p. 2). Pacific has included adjustments for actual and forecasted changes to wage expenses which go far beyond changes to wage agreements. The specific items are:

* Pacific forecasts an increase in the number of employees taking advantage of the Pacific savings plan;

* Pacific increases benefit expenses by the amount that actual 1987 benefit expenses exceeded the expense included in the 1987 attrition award;

* Pacific further increases benefit expenses by including an inflation factor which is not included in the wage agreement nor is it a part of the attrition cookbook formula; and

* Pacific decreases pension expense due to a change in estimate.

All of these adjustments are external to and not directly included in Pacific's wage agreements. Therefore, these adjustments cannot be included in Pacific's attrition filing.

ADDITIONAL RECOMMENDATIONS AND COMMENTS

DRA also recommends that the productivity mechanism be specified and that represcription be incorporated in the attrition resolution. DRA also comments on the cost of capital and the use of switched access lines as the base for growth estimates.

1. The Productivity Sharing Mechanism Should Be Specified

D.87-12-067 calls for an equal sharing of productivity gains above the 2.9% which is imputed in Pacific's labor and labor overhead expense. DRA has estimated Pacific's end of 1988 productivity using the methodology accepted in the above referenced decision. Because DRA anticipates additional productivity improvements in Pacific's operation above 2.9%, the revenue requirement should further decrease by about $80 million. DRA also anticipates that Pacific's shareholders will receive approximately $80 million as a result of this sharing.

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To minimize controversy, DRA believes the specific mechanism for determining productivity be explicitly spelled out. DRA recommends the following:

1. Average employee levels and average switched access lines should be calculated as an average of actual January through December end of month figures. The same procedure should be used for both 1987 and 1988.

2. The revenue requirement calculation should be done exactly the same as is accepted by the Commission in this attrition filing, because this sharing is part of the 1988 attrition filing. The calculation should be done using a 2.9% productivity factor and again using the actual productivity factor. The difference in gross revenue requirement should be split evenly between Pacific and Pacific's ratepayers.

Because this true-up won't occur until sometime in 1989, Pacific's rates must be subject to refund pending this outcome.

2. <u>The Commission Should Incorporate the Impact of Depreciation Represcription</u>

1988 is a represcription review year for resetting basic depreciation lives and salvage for all accounts. Commission action should be concluded by mid-year. The revenue requirement impact of this represcription should be incorporated in the 1988 attrition resolution under section M provisions of D.86-12-099.

3. <u>The 1988 Attrition Capital Structure Should Be Evaluated In 1989</u>

DRA accepts that the current attrition proceeding does not permit a reevaluation of Pacific's cost of equity capital, even though Pacific's return on equity at 15% is far above returns authorized for any other major California utility. However, the Commission has stated that a 15% return on equity was reasonable only through 1988. (D.86-12-099, p. 6). DRA urges that Pacific's cost of capital be reevaluated in Pacific's 1989 attrition filing.

4. <u>The Use Of Switched Access Lines Rather Than Total Access Lines Biases Towards A Larger Revenue Requirement</u>

Using switched access lines in the access line growth formula and the revenue per access line growth formula is inaccurate. The unswitched access line market, which includes private lines and special access, has been rapidly growing. While the number of unswitched access lines has declined, the revenue per unswitched access lines has soared.

Pacific claims not to know how many unswitched access lines it had before 1984. Therefore, Pacific contends that the attrition formulae, which require 60 months of data, cannot rely on switched and unswitched access lines. As a result, Pacific only uses switched access lines.

DRA believes this interpretation of the attrition methodology introduces a serious error in the revenue requirement calculations. By omitting unswitched access line data, the formulae does not capture an important driver of Pacific's financial performance. This omission will cost ratepayers about $30 million in 1988. DRA believes that future attrition filings should be based on total access line data, not just on switched access line data.

CONCLUSION

DRA requests that Pacific's Advice Letter No. 15343 be rejected insofar as Pacific fails to correctly apply the attrition mechanism/formulae ordered by the Commission. DRA's proposed $239 million revenue requirement reduction for 1988 reflects proper application of the previously adopted attrition methodology. DRA further requests consideration of its recommendations and comments on the productivity sharing mechanism, depreciation represcription, 1989 capital structure and the use of switched access lines.

Respectfully submitted,

Rufus G. Thayer
Staff Counsel

RGT:JG:bjk

cc: All Respondent Telephone Utilities - I.85-03-078
All Parties - A.85-01-034

STATE OF CALIFORNIA GEORGE DEUKMEJIAN, Governor

PUBLIC UTILITIES COMMISSION
50[illegible] NESS AVENUE
SA[illegible]NCISCO, CA 94102-3298

March 3, 1988

Victor Weisser
Executive Director
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Dear Mr. Weisser:

Re: Amendment to Protest of the Division of Ratepayer Advocates to Pacific Bell's Advice Letter No. 15343

By letter dated February 18, 1988 the Division of Ratepayer Advocates (DRA) logged its protest to Advice Letter No. 15343 dated January 29, 1988 submitted by Pacific Bell (Pac Bell). The DRA protest indicated that corrections to the Advice Letter should result in a revenue requirement reduction of approximately $239 million. Upon further review of the advice letter methodology the staff hereby amends the amount of revenue requirement reduction to approximately $167 million as explained more fully below.

The original DRA calculation with respect to taxable income did not account for year-to-year changes. The DRA calculation was based strictly on the attrition formula in the Appendices to D.86-12-099. Resolution T-12007, the 1987 Pac Bell attrition resolution, did not amend those formulae. However, the 1987 attrition resolution adopted without comment an adjustment to income taxes due to changes in taxable income (Resolution T-12007 Finding of Fact 2).

Upon further examination of this issue the DRA believes that an adjustment to income taxes due to changes in taxable income is appropriate. Accordingly, the DRA recommends that the Commission explicitly adopt a formula to calculate this effect in order to avoid ambiguity in the future. It should be emphasized that this correction in methodology does not change the issues upon which the DRA protest of the Pac Bell attrition filing was made. The numerical estimates do change. The following Table shows both the original and revised DRA estimates:

	Original Filing	Revised Filing
AT&T Billing and Collection	-$41M	-$41M
Access Line Growth	-$39M	-$19M
Revenue per Access Line Growth	-$66M	-$32M
Wages and Benefits Growth	-$35M	-$17M
Pacific Bell base	-$58M	-$58M
TOTAL	-$239M	-$167M

An additional comment is necessary to the portion of the DRA discussion in its February 18 letter at page 4 with respect to the productivity sharing mechanism. While D-87-12-067 determines how the savings from the performance above the 2.9 percent benchmark productivity factor should be split, it is silent on whether those funds should be refunded with interest. Clearly the savings should be refunded to ratepayers and shareholders with interest because Pac Bell will have the use of the money until refunded.

Respectfully submitted,

Rufus G. Thayer

Rufus G. Thayer
Staff Counsel

RGT:bjk

cc: All Respondent Telephone Utilities - I.85-03-078
All Parties A.85-01-034

Appendix C

Thomas J. Ballo
Attorney
Legal Department

140 New Montgomery Street
San Francisco, California 94105

PACIFIC BELL.
A Pacific Telesis Company

March 7, 1988

Victor Weisser
Executive Director
California Public Utilities Commission
505 Van Ness Ave.
San Francisco, CA 94102

Re: Response of Pacific Bell (U 1001 C) to Protest of the Division of Ratepayer Advocates to Pacific Bell's Advice Letter No. 15343

Dear Mr. Weisser:

Pacific Bell ("Pacific") hereby responds, pursuant to General Order No. 96-A (III H), to the Division of Ratepayer Advocate's ("DRA's") February 18, 1988 protest, as amended on March 3, 1988, to Pacific's Advice Letter No. ("AL") 15343. The DRA's protest seeks to change the revenue requirement reduction associated with 1988 attrition from the approximately $58 million set forth in AL 15343 to approximately $167 million as calculated by the DRA.

For the reasons set forth below, Pacific respectfully submits that the DRA's protest should be denied. AL 15343 applies the same attrition formula and methodology approved by the Commission in connection with Pacific's 1987 attrition filing. Indeed, the DRA's protest does not even allege any inconsistency with Pacific's 1987 attrition filing. For purposes of comparison, Pacific has attached to this response a synopsis demonstrating the consistency between its 1987 and 1988 attrition advice letter filings for each issue raised by the DRA in its protest (see Attachment A).

The DRA's protest improperly seeks to modify the approved attrition formula. The DRA's proposed modifications are highlighted on Attachment A. In light of the Commission's stated goal of making attrition proceedings as straightforward and noncontroversial as reasonably possible, the attrition methodology approved for Pacific's 1987 attrition filing should also be approved for use in 1988.

I. GENERAL COMMENTS APPLICABLE TO THE DRA'S ENTIRE PROTEST

A. AL 15343 Applies The Same Methodology Approved By The Commission In Connection With Pacific's 1987 Attrition Filing.

The DRA argues that Pacific "incorrectly applies the Commission's attrition methodology" (DRA Protest, p. 1) and that AL 15343 is based on an "incorrect interpretation of the attrition methodology/formulae" (Id. at 2). However, in compliance with Decision No. 87-10-075, Pacific has applied in AL 15343 the very same attrition methodology reviewed and found "reasonable" by the Commission in connection with Pacific's 1987 attrition filing (see Resolution No. T-12007, Finding of Fact No. 17). In Decision No. 87-10-075, the Commission stated:

> Accordingly we will order Pacific Bell to file for 1988 attrition using the adopted methodology (D.85-03-042, as modified by D.86-12-099), as implemented in Resolution T-12007, and allow only the few specific changes to the methodology which may be adopted in other related decisions to be issued before the end of 1987 (D.87-10-075, mimeo p. 14).

Since AL 15343 uses the attrition methodology specified and implemented by the above decisions, Pacific has in fact complied with Decision No. 87-10-075. Ignoring the clear mandate of the Commission's decision, the DRA in its protest recommends that Pacific use a methodology different than that implemented in Resolution No. T-12007.

The DRA's claim (DRA protest, p. 2) that in 1987 it filed a "limited protest based on a limited evaluation of Pacific's 1987 attrition filing" should be disregarded. Pacific submits that there was an extensive review of Pacific's 1987 attrition filing (AL 15215). The DRA filed a lengthy protest to Pacific's AL 15215 that raised a number of issues and sought to reduce Pacific's attrition-year revenue requirement by an unspecified amount, which Pacific later determined to be approximately $80 million. Later, the DRA filed a second protest based on a "further review" of AL 15215, seeking to reduce Pacific's attrition-year revenues by an additional $36 million. The DRA took nearly a month to review AL 15215 and although it certainly had ample opportunity to do so, it never indicated, until now, that its protests or review were "limited." Nor was DRA the only party to review and protest AL 15215. Toward Utility Rate Normalization ("TURN") similarly filed two protests to AL 15215, raising several additional issues.

In Resolution No. T-12007, the Commission analyzed each issue raised by the multiple DRA and TURN protests. In addition, the Commission conducted an independent review of Pacific's filing and made several adjustments on its own initiative (e.g., labor escalation factor; non-labor escalation factor; advice letters for new services; intrastate separation factor for the Attrition Year

1987 Telephone Plant in Service formula; and tax effects resulting from a change in taxable income). The result was the Commission's adoption of an attrition year revenue requirement reduction of approximately $191 million, which was approximately a $115 million larger reduction than that originally filed by Pacific. Later, the Commission granted a limited rehearing on the issues of depreciation technical update and the non-labor escalation factor. During that rehearing, testimony was filed by the DRA and Pacific, hearings were held, and a later decision (D.87-12-048) was issued by the Commission. Given the detailed review of AL 15215 described above, the DRA's claim that the Commission "unfortunately adopted [AL 15215] by default" obviously is incorrect (DRA protest, p. 2). Therefore, AL 15343, which applies the same attrition methodology approved after the extensive review of AL 15215, is based upon a <u>correct</u> application of the Commission's attrition methodology and complies with the specific mandate of Decision No. 87-10-075 requiring the application of such methodology.

B. <u>The DRA Inappropriately Attempts To Change The Approved Attrition Formula</u>.

The DRA's claim that Pacific has incorrectly interpreted the attrition methodology/formulae is essentially a claim that the <u>Commission</u> has incorrectly interpreted the attrition formula, since Pacific has strictly adhered to the same procedures the Commission found "reasonable" last year and that Pacific was in fact required to use this year. Undeniably, the DRA is attempting to change the approved attrition methodology. However, the Commission has indicated several times that the generic attrition methodology should not be reviewed in connection with attrition advice letter filings. Rather, it "should be reviewed in a future proceeding in which the attrition mechanism will be re-examined" (<u>see</u>, <u>e.g.</u>, Resolution No. T-12007, p. 5). Since that time, the Commission has indicated that attrition is an issue that will be addressed in the Commission's Alternative Regulatory Framework OII No. 87-11-033 (<u>see</u> D.87-10-075, mimeo p. 14; <u>see</u> <u>also</u> D.87-12-067, mimeo p. 147).

As discussed more fully below, it is inappropriate for the DRA in this proceeding to propose changes to the approved attrition methodology. As the Commission is aware, Pacific itself has concerns about the attrition formula and methodology; however, Pacific understands that this attrition advice letter filing is not the proper forum to address that issue. If the DRA desires to change the adopted attrition methodology, it should first propose doing so in OII No. 87-11-033.

II. SPECIFIC RESPONSES TO THE DRA'S "AREAS OF PROTEST"

A. Inclusion Of The AT&T-C Advice Letter Effect Is Entirely Proper.

The DRA contests the inclusion of the effect of Pacific's advice letter concerning the provision of billing and collections services to AT&T Communications of California ("AT&T-C"). The DRA argues that such effects should be considered instead in OII No. 88-01-007, which is addressing the issue of AT&T-C billing and collections takeback. The DRA alleges that "the current timetable for OII 88-01-007 calls for a decision by May" (DRA protest, p. 2). The DRA's protest on this issue should be denied.

First, the attrition adjustment relative to the AT&T-C advice letter is specific to the application of the attrition mechanism and independent of OII No. 88-01-007. In fact, in Resolution No. T-12007 the Commission approved the inclusion of the advice letter effects of declining revenues from AT&T-C billings in connection with Pacific's 1987 attrition filing. The DRA is well aware of this fact, as evidenced by its very recent "Response of the Division of Ratepayer Advocates" (hereafter "DRA Response"), dated February 25, 1988, in OII NO. 88-01-007:

> Resolution T-11049 has delineated the revenue impact of such billing rate changes on Pacific. The Commission has provided, in both the 1986 rate case test year, and in the 1987 attrition award, for recovery of reduced levels of Pacific's contribution margins earned on these services" (DRA Response, p. 11).

Since it is clear that the DRA previously acknowledged the appropriateness of the revenue effect of AT&T-C billing and collections and that the Commission approved Pacific's recovery of such reduced revenue in its 1987 attrition proceeding, the Commission should do the same in 1988.

Second, there is no assurance (or even an indication) that Pacific or any other local exchange carrier ("LEC") will be granted a revenue requirement increase arising out of OII 88-01-007. Although the Commission is interested in analyzing the revenue effect of the billing and collections takeback, the Commission has not stated that it intends to grant any LEC a revenue requirement change because of such analysis.

Third, one week after the DRA protested Pacific's AL 15343, the DRA requested a six-month extension of the current schedule in OII 88-01-007 (see DRA Response, p. 7). Thus, although the DRA claims in its protest that a decision is expected in OII 88-01-007 by "May," if the DRA's request is granted a decision may not occur until 1989. Certainly, this attrition proceeding should not be held open until for over a year to take into account something that has historically been included in attrition without protest.

Pacific has responded in OII 88-01-007 with the following statement: "Pacific opposes [the DRA's recommendation to have the AT&T-C advice letter impact issue decided in OII 88-01-007] and respectfully asks that attrition issues, such as the above-mentioned adjustment, be determined in its 1988 Attrition filing" (Pacific's Response, Feb. 25, 1988, p. 3). Pacific reiterates that response in this proceeding.

B. Pacific's Revenue Forecasting Methodology Complies With The Requirements Of D.86-12-099; The DRA's Methodology Does Not.

1. Pacific properly uses the linear regression model.

Pacific used its regression equation in AL 15343 in the same manner as it has done previously and as Decision No. 86-12-099 specifies. The order specifies, and Pacific followed, in essence, a two-step process using the linear regression equation. First, Pacific forecasted the level of 1988 access lines and revenue per access line (D.86-12-099, mimeo Appendix C, p. 1: "Growth in access lines and growth in revenue per access line are to be forecast from linear least squares regression models used to correlate access lines and revenue per access line with time" (emphasis added)). Second, Pacific calculated the appropriate growth rates for use in the attrition formula from the forecasted levels of growth (Id.: "Growth rates shall be calculated from the regression equation ...."

On the other hand, the DRA did not follow either of these two required steps. The DRA did not use the regression equation to forecast 1988 levels. As a result, the DRA obviously could not calculate the attrition formula growth rates from those levels, as required by Decision No. 86-12-099, since the DRA did not forecast those levels in the first place.

Instead, the DRA created an entirely new methodology, which has no precedent at all. The DRA derived a growth rate in only one step. It arbitrarily compared the first and 49th fitted data points from the regression equation to derive a historical, compound growth rate. The use of such a compound growth rate is not specified in D.86-12-099. In addition, the DRA's 49th data point does not even address 1988; instead, it coincides with June 1987.

The error of the DRA's methodology is demonstrated by plotting the estimations of growth in access lines and growth in revenue per access lines generated by use of the DRA's compound growth rate. Such plotted points produce a curve, rather than a straight line (as a proper use of the regression equation would produce). Conversely, Pacific's model forecasts that the absolute number of Pacific's access lines will grow by steady, constant amounts. When plotted, these amounts properly form a straight line.[1]

The error in the DRA's methodology is that it assumes a constant growth rate, rather than constant absolute growth required by Decision No. 86-12-099. (See DRA protest, p. 3: "DRA calculates the compound annual growth rate over the [allegedly] relevant time span" (emphasis added)).[2] In effect, the DRA assumes that an estimated, historical rate of growth (from June 1983 to June 1987) will continue into 1988. However, the use of such an assumption does not comply with Decision No. 86-12-099's requirement that "growth in access lines . . . [is] to be forecast from linear least squares regression models" (emphasis added).

2. Pacific relies upon the proper amount of data.

The DRA argues that "Pacific incorrectly uses 77 months of data" (DRA protest, p. 2) and that "Pacific incorrectly uses 66 data points" (Id. at 3). It is undeniable, however, that Pacific used the same methodology in its 1987 attrition filing. Moreover, the amount of data relied upon by Pacific for its regression analysis would have been obvious even under the most cursory review of Pacific's 1987 attrition workpapers. Thus, to the extent the DRA has a concern with the amount of data analyzed, the DRA could and should have raised this issue over a year ago in connection with Pacific's 1987 attrition filing. Pacific's approach to forecasting access line growth and revenue growth per access line was reviewed extensively and the attrition year revenue forecast generated by Pacific's calculations was found "reasonable" by the Commission.

Further, Pacific's use of 66 data points in the regression equation complies with the requirements of Decision No. 86-12-099. That decision states that, in calculating growth in access lines and revenues per access line, Pacific shall use "five years of recorded data, including six months of [attrition year 1987] data" (D.86-12-099, mimeo Appendix C, p. 1). The words "five years of recorded data" mean five full calendar years of recorded data. In accordance with this requirement, Pacific's 66 data points represent five full calendar years of recorded data (1982-1986) plus the additional half-year of attrition year 1987 data required by Decision No. 86-12-099.

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[1]For ease of understanding, the DRA's improper approach is graphically represented in "Attachment B" to this response.

[2]In any situation where the growth rate is constant, the absolute amount of growth will increase in larger and larger increments (in other words, exponentially). For example, if a collection of marbles is increased at a constant growth rate (e.g., by repeatedly doubling its size), the absolute number of marbles will rapidly increase by ever-larger increments (e.g., 2, 4, 8, 16).

As noted above, the DRA argues that "Pacific incorrectly uses 77 months of data" (DRA protest, p. 2). Again, it should be emphasized that Pacific employed the same methodology in its 1988 attrition filing that it did in its approved 1987 attrition filing. The DRA essentially argues that Pacific's use of moving averages for its data points means that Pacific is using data from a period beyond the five-year limitation imposed by Decision No. 86-12-099. The DRA's argument is without support or merit.

First, using moving averages for data points makes the forecasting methodology more statistically reliable because it "smooths" out seasonal irregularities. The DRA's protest recognizes the appropriateness of using moving averages; in fact, the DRA uses them itself (see DRA protest, p. 3). However, the DRA's interpretation of Decision No. 86-12-099 generates a less statistically reliable model because it relies on fewer moving averages.

Second, Pacific's use of moving averages does not mean that Pacific uses more than the 66 data points required by Decision No. 86-12-099. In fact, only 66 data points were used for the linear regression analysis. Thus, Pacific's use of moving averages employs the exact number of data points required by Decision No. 86-12-099.

Finally, the DRA alleges that Pacific's use of "actual 1987 results through June ... is contrary to the attrition formula" (DRA protest, p. 3). However, as above, it must be stressed that in this regard AL 15343 follows the same procedures that were followed in Pacific's 1987 attrition filing. In addition, Decision No. 86-12-099 requires the use of "six months of recorded test year data" (D.86-12-099, Appendix C. p. 1). Accordingly, in its filing Pacific used actual 1987 results through June. The DRA's proposal to change the approved attrition methodology should not be adopted.

C. Pacific Properly Calculates Growth In Composite Salaries And Wages.

1. Pacific employed the same approach it followed in 1987.

The DRA alleges that Pacific has improperly forecasted growth in benefits in connection with the composite salaries and wages forecast. The DRA is incorrect for the reasons set forth below. First, in AL 15343 Pacific employed the same method it did in its 1987 attrition filing. Second, Pacific's approach complies with Resolution No. T-12007, which adopted Pacific's benefits plan expense for attrition purposes. If the DRA wants to change the attrition formula, it should raise its concerns in OII No. 87-11-033 (see D.87-10-075, mimeo p. 14; see also D.87-12-067, mimeo p. 147). Until that time, the approach adopted by the Commission in 1987 should remain the accepted approach.

2. The nature of the approved methodology used by Pacific.

Pacific employs a four-step process to forecast growth in composite benefits. First, Pacific separates these expenses into four primary categories: medical/dental/vision; pension; savings plan; and "other benefit" expenses. Second, Pacific forecasts attrition year expenses-per-employee for each category. In order to do so, Pacific takes into account a number of factors to ensure the accuracy of the forecast, including contractual changes, inflation, consultant reports of industry-specific expense increases, and estimates of employee claims and participation levels. Third, in order to arrive at a forecasted growth rate for each category, Pacific compares the forecasted expense-per-employee to the expense-per-employee level inherent in Pacific's 1987 attrition filing as adopted by Resolution No. T-12007 . Fourth, Pacific weights these growth rates and combines them into the overall labor and labor overheads attrition equation.

3. The crux of the DRA's concern.

The DRA's only expressed concern relates to the second step of Pacific's methodology outlined above, in which Pacific forecasts the attrition year expense-per-employee for the various categories. For example, the DRA asserts that Pacific should not be able to take into account such items as increased employee participation due to an improved savings plan package for employees. Similarly, the DRA protests Pacific's method of taking into account inflation in determining its 1988 benefit expense-per-employee. The DRA bases its protest on the argument that items such as "increased employee participation levels" and "inflation factors" are not expressly provided for in Pacific's wage agreements. It should be emphasized that the DRA does not protest the validity or accuracy of Pacific's component inputs (e.g., the forecasted inflation rate); instead, the DRA seeks to modify the adopted, accepted methodology.

4. Pacific's response.

The DRA's argument is inconsistent with Resolution No. T-12007. In that decision, the Commission held that Pacific's benefits plan expenses are properly includable in the attrition process (Resolution T-12007, Finding of Fact No. 5, mimeo p. 9). The basis for the Commission's decision was the fact that these items "are part of the labor contract" (Id.). However, various determinants of these expenses, although not expressly provided for in the contract, are directly related to the contract. For example, the vision care plan reimbursement to employees increased by 31% (1988 over 1987) pursuant to contract. This would also logically increase the number of employees that participate in the reimbursement. To ensure the accuracy of its forecasts, Pacific's calculations took these kinds of effects into account. In addition, non-salaried employees were contractually granted an increased "Company-match" for savings plan contributions. For attrition purposes, Pacific estimated that a higher percentage of employees would take advantage of this benefit during 1988. Other benefit expenses, such as medical, were revised because of factors such as inflation or anticipated industry-specific expense increases. As a result, Pacific's estimate for expense-per-employee reflects these factors. The DRA's argument that such revised forecasts are not permissible is without merit.

It should also be emphasized that Pacific employed the same methodology in connection with its 1987 attrition advice letter filing. Such methodology was specifically reviewed and approved by the Commission (see Resolution T-12007, mimeo pp. 4-5). In that 1987 attrition filing, Pacific's estimations of its benefits plan expense contained estimates of employee participation levels and forecasts of inflation and industry-wide expense trends. Thus, Pacific's methodology for 1988, which follows the same approach as that used and approved in 1987, should also be valid.

III. RESPONSE TO DRA'S ADDITIONAL RECOMMENDATIONS AND COMMENTS

A. The Productivity Sharing Mechanism.

Preliminarily, Pacific would like to reinforce its intention to comply with the productivity incentive mechanism adopted by the Commission in Decision No. 87-12-067. However, Pacific is concerned with the DRA's recommendations expressed in its protest.

1. Amounts to be shared will be based on recorded results.

DRA states that it estimates that Pacific's revenue requirement for 1988 "should further decrease by about $80 million" (DRA protest, p. 4). However, the amount by which Pacific's revenue requirement may be reduced due to the productivity sharing mechanism will be determined by referencing actual, recorded results for 1988, not by the DRA's "anticipated" or "estimated" results. See Decision No. 87-12-067, which states: "The labor attrition formula should be recomputed after the attrition year using the actual realized productivity factor" (Ordering Paragraph No. 13, mimeo p. 330-331 (emphasis added)). The DRA's estimate is premature and out of context in this proceeding. It should be disregarded.

2. The productivity sharing mechanism is already specified.

The DRA argues that "to minimize controversy . . . the specific mechanism for determining productivity be explicitly spelled out" (DRA protest, p. 5). The DRA's concern is misplaced, however, as the Commission has already adopted a specific methodology for determining productivity. In Decision No. 87-12-067, the Commission adopted the DRA's own recommended methodology for determining productivity. Nevertheless, in its protest the DRA now proposes a new methodology. It recommends that "average employee levels and average switched access lines should be calculatd as an average of actual January through December end of month figures. The same procedure should be used for both 1987 and 1988" (DRA protest, p. 5).

The DRA's proposed methodology, which examines average levels, rather than end-of-period ("EOP") levels, conflicts with Decision No. 87-12-067's adopted procedure. There, the Commission adopted DRA's own incentive mechanism (D.87-12-067, mimeo p. 146). Later in the same decision, the Commission adopted the DRA's suggested access lines per employee index (Id. at mimeo p. 148). To fully understand the precise mechanism proposed by the DRA and adopted by the Commission, it is necessary to examine evidence received in that proceeding (Application No. 85-01-034). Such evidence makes clear that, under the DRA's own mechanism, employee and access line levels are to be determined from EOP data. The DRA did not at any time recommend that average levels of access lines or employees should be the proper measure.

For example, in a key chart supporting its productivity testimony, the DRA set forth end-of-year (in other words, EOP) access line data when testifying as to "recorded productivity at PacBell from 1974 to 1983" (Exh. 518, p. 4-1). Moreover, the numbers under the "Employees" heading of the same chart exactly correspond to data found in a chart entitled "Employees End of Year" included in Exhibit 1 of that proceeding (Exh. 1, p. 2-11 (emphasis added)). Elsewhere in its testimony, the DRA states that the "final tally" of the productivity factor for Pacific is 156 access lines per employee (Id. at p. 3-6). In a footnote, the DRA states that the "156" figure is "per PacTel's internal report" (Id.). Examination of that "internal report" reveals that the "156" figure represents "Access Lines per Employee (EOP)" (emphasis added). These examples clearly demonstrate that the DRA's productivity incentive plan is based on EOP access line and employee levels, not average levels.

Since the Commission adopted the "DRA's suggested access lines per employee index," (D.87-12-067, mimeo p. 148), and since that index uses EOP levels for those measures, the productivity measure used to calculate 1988 productivity for the sharing plan should also be based on EOP levels. The DRA's protest recommendation to use average employee and access line levels represents a significant departure from the DRA's proposal for productivity sharing adopted in Decision No. 87-12-067 and should not be considered here.[3]

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[3]Regardless of any modification to the productivity sharing mechanism at this time, Pacific submits that the Commission should ensure that significant, unique events affecting the productivity measurements do not skew the results.

3. Interest should not accrue until amounts are known.

In its amended protest, the DRA adds the additional comment that any realized productivity savings "should be refunded ... with interest" (Amended Protest, p. 2). However, the productivity sharing mechanism adopted by the Commission does not specify that interest is properly refundable. In any event, it would not be appropriate to begin accruing interest until at least January 1, 1989, when the actual amount, if any, to be refunded will become known.

B. Represcription Should Not Be Included In 1988 Attrition.

The DRA alleges that the revenue requirement effect of 1988 represcription will be determined "by mid-year" and "should be incorporated in the 1988 attrition resolution" (DRA protest, p. 5). While Pacific agrees that the revenue requirement effects associated with 1988 represcription must be recognized, it is inappropriate to hold the attrition proceeding open until mid-year to take these effects into account. Instead, these revenues should be put into memorandum balancing accounts to be considered at a later time. Such a procedure would be consistent with the Commission's decision in the USOAR proceeding (see D.87-12-063, Finding of Fact No. 55, mimeo p. 42).

Moreover, it is improper for the DRA to recommend that this proceeding be held open to account for represcription, since that issue was not resolved "before the end of 1987" (see D.87-10-075, mimeo p. 14). In Decision No. 87-10-075, the Commission rejected the notion of a pro forma filing, with subsequent update. The Commission stated that such a procedure would hamper the Commission Advisory and Compliance Division's ability to prepare a Resolution for the Commission's consideration, "by obviating the necessity of performing the multiple calculations associated with such updates" (D.87-10-075, mimeo pp. 11-12. As stated earlier, attrition is intended to take into account only those known changes which are finalized before the start of the attrition year (Id. at 11).

C. In Light Of OII No. 87-11-033, It Is Premature To Decide Whether To Review Pacific's Cost Of Capital In Connection With A 1989 Attrition Filing.

The DRA proposes that Pacific's cost of equity capital be reviewed in Pacific's 1989 attrition filing. Pacific submits that in light of OII No. 87-11-033, which will consider changes to the current regulatory framework (including regulatory processes and procedures), it would be premature to decide at this time the scope of future attrition proceedings. Moreover, it is not clear that a review of Pacific's capital structure and cost of equity is appropriate to be conducted within the context of a straightforward, noncontroversial advice letter proceeding (see, e.g., D.86-12-099, mimeo p. 25).

D. Switched Access Line Data Should Continue To Be The Measure Of Access Lines If A 1989 Attrition Advice Letter Is Filed.

The DRA alleges that "future attrition filings should be based on total (switched and unswitched) access line data, not just on switched access line data" (DRA protest, p. 6 (emphasis added)). However, Pacific's 1987 attrition filing was based on switched access line data, and no party objected to such methodology. Nor has the DRA protested the use of such methodology in Pacific's 1988 attrition filing. Thus, the DRA is again attempting to change the adopted methodology in this proceeding, in contravention of Decision No. 87-12-067's requirement that proposed changes to the attrition methodology should be addressed in OII 87-11-033. Moreover, the DRA's assertion that "the unswitched access line market ... has been rapidly growing" is wrong. Non-switched revenue growth over the past two years has been flat and non-switched access line growth has been declining.

Moreover, since Decision No. 86-12-099 states that five years of data must be used, and since five years of non-switched access line data is not available, implementation of the DRA's recommendation will conflict with Decision No. 86-12-099. Any attrition filing made prior to 1992 would not include five years of data and, hence, would not comply with Decision No. 86-12-099. In fact, without the availability of the necessary data, it is hard to understand how DRA made any estimate of the effect of using non-switched access lines in the formula, much less make an assertion about a $30 million cost to the ratepayers. Finally, it also not clear whether the DRA's $30 million estimate is subject to revision consistent with other changes filed in the DRA's amended protest.

IV. Conclusion

For all of the above reasons, Pacific submits that the DRA's protest to AL 15343 should be denied. Pacific has complied with the adopted methodology, whereas the DRA's protest arises out of a desire to change the attrition formula. If the attrition procedure is truly straightforward and noncontroversial, the DRA's protest is obviously misplaced. Pacific should be entitled to know that from year-to-year it can confidently rely on prior Commission precedent in calculating its attrition year revenue requirement.

Respectfully Submitted,

Thomas J. Ballo

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Attachments

cc: Service List for Advice Letter No. 15343
Bruno A. Davis, CACD

1988 Attrition

Summary of Pacific Bell and DRA Positions

	PACIFIC'S FILING - AL 15343	DRA PROTEST
■ **1988 ATTRITION ISSUES**		
AT&T Advice Letter	Consistent with Resolution T-12007 in which a revenue requirement effect was recognized by the Commission.	Inconsistent with Resolution T-12007, proposes to transfer this attrition-related adjustment to OII 88-01-007.
Revenue Growth Rate Forecasts	Uses linear regression model adopted in Resolution T-12007 (1987 Attrition decision) to forecast 1988 access lines and revenue per access line growth, consistent with Pacific's 1987 attrition filing.	Introduces new method which computes an historical compound growth rate which is inconsistent with Resolution T-12007.
Number of Data Points Used In Regression Model	Uses 66 data points in regression model consistent with the Commission's decision in Resolution T-12007.	Uses 49 data points which is new and inconsistent with Resolution T-12007.
Labor Escalation Factors	Uses the same methodology adopted in Resolution T-12007.	Contradicts the approach to forecasting growth in labor escalation factor adopted in Resolution T-12007.

■ **OTHER ISSUES RAISED BY DRA**	PACIFIC'S RESPONSE	DRA PROTEST
Productivity Sharing Mechanism	The productivity sharing mechanism has been established in D.87-12-067 and should not be modified.	Introduces a new methodology which is inconsistent with D.87-12-067 to calculate productivity results.
1988 Represcription	Proposes revenue requirement impact be reflected in a balancing account.	Proposes incorporating effects into 1988 Attrition even though represcription may not be concluded until mid-year.
Capital Structure/Cost of Equity	Premature to decide the scope of future attrition proceedings in light of OII 87-11-033 (Alternative Regulatory Frameworks)	Should be evaluated as part of 1989 attrition filing.
Use of Total Rather Than Switched Access Lines for Revenue Forecast	Uses switched access lines, consistent with the Commission's prior attrition decisions.	Introduces new method which is inconsistent with the Commission's prior attrition decisions.

ATTACHMENT 3

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