REGULATORY AUDIT OF PACIFIC BELL FOR THE YEARS *1997*, *1998* AND *1999*

Prepared for:

California Public Utilities Commission

SUPPLEMENTAL REPORT:

Chapter 7 – Employee Benefits

Chapter 9 – Income Taxes

By:

Overland Consulting
10801 Mastin, Suite 420
Overland Park, KS 66210

(913) 599-3323

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REGULATORY AUDIT OF PACIFIC BELL
SUPPLEMENTAL REPORT
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Chapter 7 - Employee Benefits
Supplemental Report

This supplemental chapter addresses the data responses Pacific Bell provided after December 31, 2001 concerning employee benefits. The findings included in this supplemental chapter are listed below.

- Intrastate regulated operating expenses are overstated by $69 million because of Pacific Bell's failure to properly account for the December 1999 withdrawal of funds from its pension trust.

- Pacific Bell withdrew $180 million from its PBOP trusts in December 1999. That withdrawal violated the restrictions on the use of PBOP trust fund assets adopted in D.92-12-015. Pacific Bell should be required to refund $136 million to customers pursuant to Ordering Paragraph 3 of D.92-12-015.

- The pension correction recommended in the Audit Report should be revised to properly reflect prepaid pension balances in the aggregate cost method calculation of pension costs. The pension correction recommended in the Audit Report decreased recorded intrastate regulated pension costs by $357 million. The revised corrections reduces recorded intrastate regulated pension costs by $325 million.

- Pacific Bell's CPUC basis FAS 106 transition benefit obligation ("TBO") is overstated because Pacific Bell failed to properly account for the contributions it made to its PBOP trust funds prior to the adoption of FAS 106 in 1993. The overstatement of the FAS 106 TBO did not impact intrastate regulated operating expense during the audit period, because under the CPUC's PBOP policy, PBOP costs are limited to the amount of tax deductible contributions to PBOP trusts.

I. Pension Trust Fund Withdrawal

Pacific Bell withdrew $99 million from its management pension plan in December 1999. The funds were transferred to Pacific Bell as cash available for unrestricted general corporate use.

The pension fund withdrawal is discussed on pages 7-28 of through 7-31 of the Audit Report. The Audit Report notes that Pacific Bell had not yet responded to Data Request OC-1264 and concludes "[w]e will determine the proper accounting treatment for the $99 million pension trust fund withdrawal after Pacific Bell responds to Data Request OC-1264." Pacific Bell responded to that request on January 3, 2002, with supplemental responses on January 28, 2002 and February 25, 2002. In addition Pacific Bell supplemented the response to Data Request OC-959 on January 26, 2002. The section reflects the response to OC-1264 and the supplemental response to OC-959. In addition, this section reflects the revision to the treatment of prepaid pension assets under the ACM described in Section III of this Supplemental Chapter.

Flow of Funds

The pension trust withdrawal was implemented in a three step process. First, the pension trust agreement was amended to create a new retiree health benefit account within the master pension trust.[1] Second, the funds were transferred from the general pension fund account to the new retiree health benefit account.[2] No funds actually left the pension master trust in the second step. The funds were just transferred between sub-accounts of the master pension trust. The third step was the transfer of the funds from the pension master trust to Pacific Bell's unrestricted cash account.[3]

Pacific Bell Accounting

Pacific Bell accounted for the withdrawal as a negative contribution to its pension trust. Specifically, Pacific Bell accounted for the withdrawal by increasing cash and decreasing its prepaid pension asset account.[4] Pacific Bell did not decrease its pension expenses to reflect the withdrawal. Pacific Bell's accounting did not change operating expenses or net income.

Pacific Bell Characterization

The pension trust withdrawal was implemented pursuant to IRC Section 420.[5] IRC Section 420 permits the withdrawal of assets from pension trusts only to the extent that the assets are used to pay qualified current retiree health benefits for the current tax year. In order to satisfy that requirement, Pacific Bell characterized the pension trust withdrawal as "reimbursement of post-retirement medical and dental benefits paid in the calender year 1999." That characterization reflects the provisions of IRC Section 420 rather than the actual substance of the transaction. The actual substance of the transaction was a direct transfer of assets from the pension trust to Pacific Bell's cash account as funds available for unrestricted general corporate use.

Pacific Bell's own accounting is consistent with the substance of the transaction. Pacific Bell did not account for the pension trust withdrawal as a reimbursement of PBOP costs paid in 1999. Pacific Bell accounted for the transaction as a negative contribution to its pension trust.

Pacific Bell characterized the withdrawal as a reimbursement of PBOP benefits paid in 1999 for IRC §420 purposes. However, the PBOP benefits used to justify the withdrawal

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[1] OC-1264

[2] OC-959

[3] OC-959

[4] OC-959

[5] OC-1264

were paid by Pacific Bell’s PBOP trusts. The money withdrawn from the pension trust was never deposited in the PBOP trust. The pension trust assets were not actually used to reimburse “post-retirement medical and dental benefits paid in calendar year 1999" as Pacific Bell claims because those benefits were paid by the PBOP trusts and the pension assets never reached the PBOP trusts.

Pacific Bell contributed $99.6 million to its PBOP trusts in January through November 1999.[6] Pacific Bell withdrew $98.9 million from its Pension Trust in December 1999. The assets taken from the pension trust could be viewed as reimbursing Pacific Bell for the contributions it made to its PBOP trusts in 1999. That position is apparently the basis for Pacific Bell’s characterization of the pension trust withdrawal.

The net result of the transaction is clear: (1) the pension trust assets decreased by $99 million; (2) Pacific Bell’s unrestricted cash account increased by $99 million; and (3) the assets held by the PBOP trust did not change. Therefore, the actual substance of the transaction was a direct transfer of funds from Pacific Bell’s pension trust to Pacific Bell’s cash account as funds available for unrestricted general corporate use.

Income Tax Treatment

The withdrawal of the pension assets increased Pacific Bell’s taxable income.[7] The withdrawal of assets from the pension trust is not taxable under IRC Section 420. However, IRC Section 420 prohibits the employer from making contributions to the qualified trust with respect to the qualified retiree health benefits that are paid for with the funds. Since, Pacific Bell claimed the funds were used to reimburse itself for contributions made to its PBOP trusts, those prior contributions were no longer tax deductible under IRC Section 420. The decrease in the tax deduction available for 1999 PBOP trust contributions increased Pacific Bell’s taxable income by $99 million.

Impact On Future Pension Expense

The removal of the assets from the pension trust will not impact Pacific Bell’s pension expenses if the aggregate cost method is properly applied. Under the ACM, the annual pension accrual reflects the amortization of the present value of future normal costs. That value reflects the difference between the present value of projected benefits and the value of the trust fund assets. The value of the trust fund assets used in the ACM equals the actuarial value of the assets less any recorded prepaid pension costs. Pacific Bell accounted for the withdrawal as a negative pension contribution by increasing cash and decreasing prepaid pension assets. If the aggregate cost method is properly

[6] OC-797

[7] OC-797 and OC-812

applied, the reduction in the actuarial value of the pension trust assets will be offset by the decrease in prepaid pension assets and the total value of trust fund assets used in the ACM calculation will not change. However, the prepaid pension asset included in rate base will be reduced. The reduction in rate base will reduce revenue requirements to reflect the reduction in Pacific Bell's investment in providing telephone service resulting from the pension fund withdrawal.

As noted in this Supplemental Chapter and the Audit Report, Pacific Bell did not correctly apply the ACM method during the audit period. Instead, Pacific Bell arbitrarily set its pension costs equal to zero during the audit period.

CPUC Policy Concerning Pension Trust Withdrawals

The CPUC's PBOP policy was adopted in D.92-12-015. That decision includes the following discussion of pension fund withdrawals made under IRC Section 420.

> Excess pension assets are another potential source of funding for PBOP...The method of utilizing the pension fund as a source of PBOP funding was created by the passage of the Omnibus Budget Reconciliation Act of 1980. This allows employees to transfer annually a certain portion of excess pension assets to an Internal Revenue Code (IRC) § 401(h) retiree medical account. The primary disadvantage of this method is that IRC § 420 provides for limited transfers of excess pension assets to a § 401(h) account...and only if the pension plan...exceeds 125 percent of the current liability.
>
> * * * * *
>
> DRA has recommended that PBOP costs be used only to pay for PBOP. If DRA's recommendation is to prevail, consistency should prevail. Similar to restricting PBOP costs to pay for only PBOP, pension costs should be restricted to pay only pension benefits. Surplus pension assets, as they occur, should be investigated and, if necessary, adjusted in the GRC or other rate proceedings. The use of surplus assets is not a viable alternative source of funding for PBOP at this time. However, we do not want to preclude utilities from using surplus pension assets to fund PBOP expenses. Therefore, to the extent that the IRS lifts its restrictions and the employee unions agree to the use of surplus pension assets to fund PBOP expense we fully expect the utilities to do so.
>
> Ordering paragraph 2(g) of Decision 92-12-015 states:
>
>> The utilities shall, to the extent allowed by the Internal Revenue Service (IRS) and employee unions, apply surplus pension assets (as defined by the IRS) to fund their PBOP expense.

Decision 92-12-015 is somewhat contradictory. It suggests pension trust assets should be used only for paying pension benefits. It also orders utilities to use surplus pension assets to fund their PBOP expenses. However, D.92-12-015 clearly does not condone simply withdrawing assets from pension trusts to provide cash for unrestricted general corporate use.

Pacific Bell withdrew $99 million from its pension trusts in December 1999. The substance of the transaction was a direct withdrawal of assets from the pension trust to provide cash for unrestricted general corporate use. Pacific Bell did not use the assets withdrawn from its pension trust to fund PBOP expenses. Therefore, Pacific Bell clearly violated the policy established in D.92-12-015 concerning the withdrawal of assets from pension trusts.

Conclusion

Understanding the correct accounting for the pension trust withdrawal requires separating the accounting into its two components. The first component is normal pension accounting. The second component is accounting for the CPUC's policy concerning pension trust withdrawals established in D.92-12-015.

Pension Accounting Conclusion

If the ACM is properly applied, Pacific Bell's accounting for the pension trust withdrawal will result in the recognition of reasonable pension expenses. Pacific accounted for the transaction as a negative contribution to its pension trust. That accounting reflects the substance of the transaction and the proper application of the ACM incorporates that accounting.

Unfortunately, Pacific Bell does not correctly apply the ACM. Pension trusts assets are ratepayer funded assets and ratepayers are entitled to the benefit of those assets. Pacific Bell has violated those principles. It has withdrawn assets from its pension trust and has appropriated the value of those assets for its shareholders through the misapplication of the ACM.

Pacific Bell claims that under the ACM, annual pension costs are equal to the amount contributed to the pension trust. However, Pacific Bell's own accounting for the pension fund withdrawal is inconsistent with that claim. The withdrawal represents a negative contribution to Pacific Bell's pension trusts. However, Pacific Bell did not reduce its 1999 pension expense to reflect that negative contribution. If the CPUC adopts Pacific Bell's position that pension expense should equal funding, 1999 pension expenses should be reduced to reflect the negative contribution Pacific Bell made to its pension trusts.

D.92-12-015 Policy Accounting - Conclusion

Pacific Bell also violated the CPUC's policy for pension trust withdrawals established in D.92-12-015. The application of that policy has significant accounting implications.

Pacific Bell's current accounting ignores the CPUC's policy for pension trust withdrawals.

The CPUC's policy requires pension trust withdrawals to be used to fund PBOP costs. The CPUC's PBOP policy limits annual PBOP costs to the amount actually funded during the year. Therefore, the CPUC's policy requires using pension trust withdrawals to reduce PBOP costs in the year of withdrawal.

D.92-12-015 limits PBOP expenses to the amount of tax-deductible contributions made to PBOP trusts. The pension trust withdrawal directly reduced the amount of tax-deductible PBOP contributions Pacific Bell was able to claim on its 1999 income tax return. Therefore, the pension trust withdrawal also reduced the maximum amount of PBOP costs that Pacific Bell could recognize in 1999 under the CPUC's general PBOP policy.

- Intrastate regulated operating expenses are overstated by $69 million because of Pacific Bell's failure to properly account for the December 1999 withdrawal of funds from its pension trust.

Reducing PBOP costs by the amount of the pension trust withdrawal is required by Ordering Paragraph 2(g) of D.92-12-015 and the CPUC's general PBOP policy. For those reasons, we recommend accounting for the pension trust withdrawal as a reduction in 1999 PBOP costs.

Correction Amount

The $99 million pension trust withdrawal reduced Pacific Bell's maximum allowable 1999 intrastate regulated PBOP costs by $69 million, as calculated below.

Table 7S-1
Pension Fund Withdrawal
Correction to 1999 Operating Expenses
Intrastate Regulated
(Dollars in Thousands)

Source: OC-959 and Attachment 7-8

Description	Amount
Funding	(98,960)
Intrastate Factor	0.8043
Intrastate Portion	(79,594)
Regulated Factor	0.9409
Intrastate Regulated	(74,890)
Expense Factor	0.9180
Intrastate Regulated Expense	(68,749)

Post-Retirement Benefit Over-Funding

Pensions and PBOPs are the two primary post-retirement benefits offered by Pacific Bell. Ratepayers fund both benefits before the benefits are paid to retirees. Pacific Bell's pension plans have significant surpluses. Pacific Bell's PBOP liability exceeds the assets contained in the PBOP trusts. However, on a combined basis, the pension and PBOP plans are significantly over-funded. Specifically, the market value of the assets included in the pension and PBOP trusts exceeded the combined pension and PBOP projected benefit obligation by $2.2 billion as of January 1, 1998.[8] Using the surplus pension funds that Pacific Bell withdrew from its pension trust in 1999 to reduce the PBOP trust under-funding charged to ratepayers is required by Ordering Paragraph 2(g) of D.92-12-015.

Withdrawals Continued in 2000 and 2001

Pacific Bell apparently continued to withdraw funds from its pension trusts in 2000 and 2001. Pacific Bell's management pension plan merged with the SBC management cash balance plan on January 1, 1999. SBC's 2001 Annual Report To Shareholders includes the following discussion of pension trust fund withdrawals made in 2000 and 2001.

> In December 2001 and 2000, under the provisions of Section 420 of the internal Revenue Code, we transferred $286 (million) and $220 (million) in pension assets to a health care benefit account for reimbursement of certain retiree health care benefits paid to us.

The $99 million of pension assets received by Pacific Bell in 1999 represented 35% of a total of $280 million withdrawn from SBC's management cash balance plan in December 1999. Based on that percentage, we estimate that Pacific Bell's portion of the 2000 and 2001 pension trust withdrawals totaled $177 million. We estimate that Pacific Bell has withdrawn a total of $276 million from its pension trusts over the three year period 1999 to 2001.

II. PBOP Trust Fund Withdrawal

Pacific Bell withdrew $180 million from its PBOP VEBA 1 trust fund in December 1999. The funds were transferred to Pacific Bell as cash available for unrestricted general corporate use.

That PBOP trust withdrawal is described on pages 7-31 through 7-33 of the Audit Report. The Audit Report notes that Pacific Bell had not responded to several data requests concerning the PBOP trust fund withdrawal and concludes that:

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[8] OC-33. Data after 1/1/98 is not available because Pacific Bell no longer issues stand-alone Pacific Bell actuarial reports. PBOP obligation is EPBO.

> If Pacific Bell retains the $180 million PBOP funding reimbursement, the reimbursement should be accounted for as negative PBOP contributions. That accounting would require a correction to reduce 1999 PBOP costs to reflect the intrastate regulated portion of the $180 million withdrawal. The restrictions on the use of PBOP trust fund assets adopted in D.92-12-015 may support ordering Pacific Bell to: (1) return the $180 million to its PBOP trusts; or (2) refund the $180 million directly to ratepayers. An adjustment to PBOP costs would not be necessary if Pacific Bell returns the funds to the PBOP trusts or refunds the funds to ratepayers.
>
> Data requests OC-960, OC-1266 and OC-1296 are currently outstanding. We will determine the proper accounting and ratemaking treatment for the $180 million PBOP trust withdrawal after Pacific Bell responds to those data requests.

Pacific Bell responded to those data requests in late January and early February 2002.

Flow of Funds

The PBOP trust funds were withdrawn from Pacific Bell's VEBA 1 Trust. The withdrawal was implemented in a two step process. First, the VEBA 1 trust agreement was amended to allow payment of active employee health benefits.[9] Second, the trust transferred $180 million to Pacific Bell's unrestricted cash account in December 1999.

The VEBA 1 Trust

The VEBA 1 trust funds PBOP life insurance benefits provided to employees. The VEBA 1 trust was largely funded prior to the implementation of FAS 106 on January 1, 1993. The contributions Pacific Bell made to the VEBA 1 trust were charged to regulated operating expense accounts as they were made and the resulting operating expenses were included in rates. [10]

Pacific Bell Accounting

Pacific Bell accounted for the withdrawal as a negative contribution to its PBOP trusts. Specifically, Pacific Bell accounted for the withdrawal by increasing cash and increasing its PBOP accrued liability account. Pacific Bell did not decrease its PBOP expenses to

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[9] OC-960

[10] OC-1295

reflect the withdrawal. Pacific Bell's accounting did not change operating expenses or net income.[11]

Pacific Bell Characterization

The VEBA 1 trust agreement was amended to allow trust assets to be used to pay health care costs of active Pacific Bell employees. Pacific Bell characterized the PBOP trust fund withdrawal as "reimbursement of...active employees' 1999 medical, dental and vision claims...and HMO premium expense."[12] Pacific Bell had paid those expenses during prior months of 1999. However, Pacific Bell did not account for the PBOP withdrawal as a reimbursement of those costs. Instead, Pacific Bell accounted for the withdrawal as a negative contribution to its VEBA 1 trust.

Pacific Bell provided its PBOP actuarial report for the year 2000 in response to Data Request OC-600 on January 24, 2002. The PBOP actuarial report shows the $180 million withdrawal as negative "1999 VEBA Contributions." Attachment S7-1 is the page from Pacific Bell's 2000 PBOP actuarial report showing the negative 1999 PBOP contribution of $180 million.

Pacific Bell characterized the PBOP trust fund withdrawal as a reimbursement of active employee health care costs because that characterization was required by the VEBA 1 trust agreement. However, the actual substance of the transaction was a direct transfer of assets from the VEBA 1 trust to Pacific Bell's cash account as funds available for unrestricted general corporate use.

Income Tax Treatment

The withdrawal of the PBOP assets increased Pacific Bell's taxable income in 1999. The withdrawal was treated as a negative contribution to Pacific Bell's PBOP trusts for income tax purposes.[13]

CPUC Policy For PBOP Trust Fund Withdrawals

The CPUC's policy for PBOP Trust Fund Withdrawals was established in D.92-12-015. Ordering Paragraph 3 of D.92-12-015 states:

> To the extent that PBOP trust assets cannot or are not used for PBOP obligations, then those assets shall be returned to ratepayers as allowable by law. Utility rates are hereby made subject to refund, but only to the

[11] OC-960

[12] OC-1266

[13] OC-812 and OC-797

> extent necessary to allow such a return to ratepayers of any PBOP assets that cannot be used for PBOP purposes or that have been used for other purposes.

The CPUC's policy recognizes that PBOP trust assets are ratepayer funded assets and the benefits of those assets should accrue to ratepayers.

The PBOP trust withdrawal transferred assets from the PBOP trusts to Pacific Bell's cash accounts for unrestricted general corporate use. Pacific Bell itself characterizes the withdrawal as reimbursement of non-PBOP costs. Clearly, the assets withdrawn from the PBOP trust were not used for PBOP obligations.

Data Request OC-1296 asked Pacific Bell to explain how the $180 million withdrawal from its PBOP trusts was consistent with the CPUC's policy of requiring PBOP trust assets to be used for paying PBOP benefits. Pacific Bell's response to that request states:

> The Commission does not have a "policy" concerning the disposition of PBOP trust assets. However, it did make the rate increases it authorized in D.92-12-015 conditional. The decision allowed utilities to recover their costs of adopting FAS 106 (namely, the incremental costs of changing from cash to accrual accounting). But in order to qualify for this recovery, the utilities were required to place the proceeds of their D.92-12-015 rate increases into independent trusts. Additionally, they were prohibited from using the assets in those trusts for anything except the payment of PBOP. Pacific established two independent trusts (VEBA 4 and VEBA 5) to comply with the above-mentioned provisions of the decision. All of the revenue granted for recovery of incremental PBOP costs was deposited into these two trusts, and the VEBA 4 and VEBA 5 trusts have not been used for any purpose other than to pay for PBOP. The surplus assets in VEBA 1 did not arise from recovery of the incremental cost of adopting FAS 106; therefore, the $180 million withdrawal did not violate the ratemaking conditions stipulated in D.92-12-015.

Conclusion

The PBOP trust fund withdrawal removed $180 million in assets from Pacific Bell's PBOP trusts. Pacific Bell did not use that $180 million to pay PBOP benefits. Therefore, the intrastate regulated portion of the $180 million should be refunded to ratepayers, as required by Ordering Paragraph 3 of D.92-12-015.

Pacific Bell claims the PBOP assets included in its VEBA 1 trust are not subject to Ordering Paragraph 3 of D.92-12-015 because VEBA 1 was funded prior to the adoption of D.92-12-015. Pacific Bell's position is not supported by D.92-12-015. Ordering Paragraph 3 does not make any distinction between PBOP trusts funded prior to the decision and PBOP trusts funded after the decision. Moreover, there is no reason to apply a different policy to PBOP trusts funded prior to the decision. The CPUC placed restrictions on the use of PBOP trust fund assets to assure that ratepayer funded contributions to PBOP trusts were actually used to fund PBOP benefits. Pacific Bell admits that the contributions it made to the VEBA 1 trust were funded by ratepayers prior to the adoption of FAS 106. Therefore, the policy reasons supporting the restrictions on PBOP trust fund assets adopted in D.92-12-015 are equally applicable to PBOP trusts funded before and after the date of the decision.

C Pacific Bell withdrew $180 million from its PBOP trusts in December 1999. That withdrawal violated the restrictions on the use of PBOP trust fund assets adopted in D.92-12-015. Pacific Bell should be required to refund $136 million to customers pursuant to Ordering Paragraph 3 of D.92-12-015.

The provisions of Ordering Paragraph 3 of D.92-12-015 are directly applicable to the $180 million PBOP trust fund withdrawal that occurred in December 1999. Therefore, Pacific Bell should refund the intrastate regulated portion of the assets withdrawn from the PBOP trust to ratepayers.

Refund Calculation

The calculation of the refund required by Ordering Paragraph 3 of D.92-12-015 is shown below.

Table 7S-2
PBOP Trust Fund Withdrawal
Refund Liability
Intrastate Regulated
(Dollars in Thousands)

Source: OC-1266 and Attachment 7-8

Description	Amount
PBOP Trust Fund Withdrawal	180,000
Intrastate Factor	0.8043
Intrastate Portion	144,774
Regulated Factor	0.9409
Intrastate Regulated Refund Liability	136,218

Accounting for the PBOP Withdrawal and Refund Accrual

This section describes the proper accounting for the withdrawal and the required customer refund. Pacific Bell characterized the withdrawal as a reimbursement of active employee medical costs. However, Pacific Bell did not reduce its active employee medial expenses to reflect that reimbursement. Instead, Pacific Bell accounted for the reimbursement as a negative PBOP contribution by increasing cash and increasing its PBOP accrued liability account. The CPUC's PBOP policy limits PBOP expenses to the amount of tax-deductible contributions. However, Pacific Bell did not reduce its PBOP expenses to reflect the PBOP withdrawal.

The PBOP trust fund withdrawal represented a negative contribution to Pacific Bell's PBOP trusts. That negative contribution reduces Pacific Bell's 1999 PBOP expenses under the CPUC's PBOP accounting policy. However, the accrual of the refund obligation reduces revenues by the same amount. As a result, the combined accounting for the PBOP trust fund withdrawal and refund obligation does not change net operating income compared to Pacific Bell's improper accounting.

The proper accounting for the PBOP trust fund withdrawal and refund obligation consists of three entries. The first entry records the withdrawal by increasing cash and Pacific Bell's accrued PBOP liability. The second entry reduces PBOP costs to reflect the reduction in the maximum 1999 PBOP cost allowed by D.92-12-015. That entry increases the PBOP regulatory asset and decreases PBOP expense. The third entry accrues the refund obligation. That entry reduces revenues and increases Pacific Bell's accrued refund liability account.

Pacific Bell claims the VEBA 1 trust is not covered by the restrictions adopted in Ordering Paragraph 3 of D.92-12-015. If Pacific Bell does not refund the money it withdrew from its PBOP trusts, the third accounting entry described above would not be recorded. As a result, if no refund is made, PBOP operating expenses should be reduced by $136 million to treat the withdrawal as a negative contribution to Pacific Bell's PBOP trusts.

D.92-12-015 Ordering Paragraph 2(g)

Ordering Paragraph 2(g) of Decision 92-12-015 states:

> The utilities shall, to the extent allowed by the Internal Revenue Service (IRS) and employee unions, apply surplus pension assets (as defined by the IRS) to fund their PBOP expense.

Pacific Bell's pension trusts hold assets funded by ratepayers to pay post-retirement benefits as they come due. The VEBA 1 trust holds assets funded by ratepayers to pay post-retirement benefits as they come due. Therefore, the VEBA 1 assets are very similar in concept to pension trust assets. D.92-12-015 orders California utilities to use surplus pension fund assets to fund PBOP costs. Therefore, if Pacific Bell is not required to refund the $136 million to ratepayers, Ordering Paragraph 2(g) provides an additional basis for requiring Pacific Bell to reduce its 1999 PBOP expenses to reflect the withdrawal of assets from the VEBA 1 trust.

Additional Withdrawals in 2000 and 2001

Pacific Bell may have withdrawn additional funds from its PBOP trusts in 2000 and 2001. The response to Data Request OC-1266 includes a document which states that additional withdrawals in 2000 are contingent on the December 2000 VEBA 1 trust asset value.

III. Revision to Pension Correction

The Aggregate Cost Method spreads the previously unrecognized present value of future pension benefit costs over the remaining employment service period of the active participants in the plan. The previously unrecognized present value of future benefit costs is referred to as the present value of future normal costs.

Under the Aggregate Cost Method the present value of future normal costs is calculated by subtracting pension assets from the present value of future benefits. Prepaid pension assets represent pension trust assets that have not been recognized in cumulative ACM accruals. Therefore, the asset value used to calculate the present value of future normal should be reduced by the amount of the prepaid pension asset balance.

C The pension correction recommended in the Audit Report should be revised to properly reflect prepaid pension balances in the aggregate cost method calculation of pension costs. The pension correction recommended in the Audit Report decreased recorded intrastate pension costs by $457 million. The revised correction reduces recorded intrastate regulated pension costs by $325 million.

The pension correction recommended in the Audit Report did not reflect the impact of prepaid pension assets on the present value of future normalcosts and the resulting annual ACM pension accruals. As a result, the correction recommended in the audit report was overstated by $32 million. The calculation of the revised pension correction is shown on Attachment 7S-2.

IV. SFAS 106 Pre-Funding

Pacific Bell made contributions to its to its PBOP health care trust prior to the adoption of FAS 106 in 1993. D.92-12-015 contains the following description of those contributions.

> Pacific Bell pre-funded PBOP contributions of $117 million in 1989 and $91 million in 1990. However, it discontinued making further pre-funded contributions in 1991 and 1992 because of the uncertainty that it would recover in rates its pre-funded contributions in a timely manner and because of the many demands for its capital resources.

The CPUC's ratemaking treatment of the pre-funded contributions and Pacific Bell's accounting for those contributions are described on pages 7-17 to 7-19 of the Audit Report.

Data Requests OC-1276 and OC-1277 addressed Pacific Bell's accounting for the contributions it made to its PBOP health care trusts prior to the adoption of FAS 106. Pacific Bell responded to those requests on February 11, 2002.

Pacific Bell charged the pre-funded health care contributions to prepaid PBOP expense for CPUC purposes. The prepaid PBOP expense balance was rolled into the transition benefit obligation ("TBO") when FAS 106 was adopted for CPUC purposes effective January 1, 1993.[14] Under FAS 106, prepaid pension costs increase the TBO.[15] D.92-12-015 requires a 20 year amortization period for the TBO. The amortization of the TBO increases PBOP costs under FAS 106.

Pacific Bell charged the pre-funded health care PBOP contributions to expense for FCC purposes.[16] As a result, Pacific Bell's FCC basis TBO is lower than its CPUC basis TBO.

Under the CPUC's PBOP policy existing prior to the adoption of FAS 106, Pacific Bell should have charged the 1989 and 1990 PBOP contributions to expense. Pacific Bell also made contributions to its PBOP life insurance trust prior to the adoption of FAS 106. Pacific Bell charged those contributions to expense. [17] The contributions made to Pacific Bell's health care PBOP trusts should have been accounted for in the same manner as the contributions made to the life insurance PBOP trust.

Pacific Bell sought a Z-factor surcharge to recover the 1989 and 1990 "pre-funded" contributions it made to its PBOP health care trusts over a 12 month surcharge period.[18] Z-factor recovery is only allowed for costs that can be legitimately recognized under the CPUC's accounting policies during the surcharge period. The fact that Pacific Bell sought Z-factor recovery of the contributions over a 12 month surcharge period represents an admission that the contributions were properly charged to expense when made.

The CPUC denied Pacific Bell's request for Z-factor recovery in D.92-12-015. However, the CPUC did not deny recovery on the basis that the contributions were not properly recognizable as an expense. Instead, the CPUC rejected Z-Factor recovery because the amount and timing of the contributions were under management's control.

Page 3 of D.92-12-015 states:

> Utilities under the new incentive regulation shall not be allowed recovery of their PBOP contributions made prior to adoption of the Statement as a Z factor adjustment.

The contributions were made prior to the adoption of FAS 106. The CPUC accounting policy in affect when the contributions were made required the contributions to be charged to expense. The CPUC did not implement any rate adjustment designed to

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[14] OC-1276

[15] See page 7-19 of the Audit Report for a description of the TBO.

[16] OC-1276

[17] OC-1295

[18] D.91-07-006

collect the previously incurred cost of those contributions. Therefore, no accounting basis existed for deferring the cost of the contributions as a prepaid pension asset.

D.91-07-006 authorized the California Utilities subject to traditional regulation to recover the PBOP "pre-funding" over a short recovery period.[19] If the pre-funded contributions were not properly recognized as an expense, there would not have been any basis for allowing accelerated recovery of the contributions. Clearly, the 1989 and 1990 contributions should have been charged to expense prior to the implementation of FAS 106.

The proper accounting treatment for the 1989 and 1999 contributions is relevant to this audit because Overland has recommended deducting Pacific Bell's accrued PBOP liability (net of the PBOP regulatory asset) from rate base. Accepting Pacific Bell's accounting for the 1989 and 1999 PBOP health care contributions would increase rate base. However, the amount of that increase cannot be determined because Pacific Bell cannot locate the workpapers supporting its CPUC basis TBO or the "VEB" jurisdictional adjustment to its Accrued PBOP liability account.[20]

Pacific Bell's accounting for PBOP costs has been a matter of controversy for many years. The CPUC deferred PBOP issues in its resolutions addressing Pacific Bell's 1997 and 1998 Price Cap filings because of a lack of information.[21] Pacific Bell's recent admissions that it cannot support its claimed CPUC basis FAS 106 TBO and the VEB jurisdictional adjustment are indicative of serious deficiencies in Pacific Bell's internal controls over regulatory accounting. The CPUC should order Pacific Bell to provide a detailed accounting analysis supporting its claimed TBO and VEB jurisdictional adjustment balances.

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[19] D.91-07-006, Ordering Paragraph 4

[20] OC-1277, OC-590 and representation by Dennis Wells in 3/29/02 data response status meeting.

[21] Resolutions No. T-15976 and No. 16102.

PREPAID/(ACCRUED) POSTRETIREMENT LIFE INSURANCE COST

Development by Plan	SBC	PTG	SNET	AIT	Total
1. Prepaid/(accrued) postretirement life insurance cost at January 1, 1999	($386,288,000)	$48,984,000	($18,392,000)	$44,203,000	($311,493,000)
2. 1999 postretirement (cost)/income	(32,688,000)	6,856,000	1,125,000	(4,843,000)	(29,550,000)
3. 1999 VEBA contributions	0	(180,000,000)	0	0	(180,000,000)
4. Claims paid from company funds	2,897,000	0	0	0	2,897,000
5. RFA transfer	(8,603,000)	0	0	0	(8,603,000)
6. Adjustments	0	153,000	0	0	153,000
7. Prepaid/(accrued) postretirement life insurance cost at January 1, 2000	($424,682,000)	($124,007,000)	($17,267,000)	$39,360,000	($526,596,000)

Attachment S7-1

CHICAGO CONSULTING ACTUARIES

PBA 152393

ATTACHMENT S7-2

PACIFIC BELL
REVISED CORRECTION TO INTRASTATE PENSION COSTS
TO REFLECT AGGREGATE COST METHOD

	1997	1998	1999
MANAGEMENT PLAN - PACIFIC TELESIS TOTAL			
PRESENT VALUE OF PROJECTED BENEFITS	4,384,553,625	4,528,520,000	NOT AVAIL
ACTUARIAL VALUE OF ASSETS	4,791,304,000	5,202,616,000	NOT AVAIL
PREPAID PENSION COST	0	(36,555,862)	
ADJUSTED VALUE OF ASSETS	4,791,304,000	5,166,060,138	0
PRESENT VALUE OF FUTURE NORMAL COSTS	(406,750,375)	(637,540,138)	NOT AVAIL
PRESENT VALUE OF FUTURE COMPENSATION	9,602,988,204	13,070,174,000	NOT AVAIL
ACCRUAL RATE	(0.0424)	(0.0488)	NOT AVAIL
VALUATION (CURRENT) COMPENSTATION	863,049,007	1,106,049,000	NOT AVAIL
NORMAL COST (NOTE 1)	(36,555,862)	(53,951,128)	(53,951,128)
PVFC/NORMAL COST	11.1	11.8	NOT AVAIL
NON-MANAGEMENT PLAN - PACIFIC TELESIS TOTAL			
PRESENT VALUE OF PROJECTED BENEFITS	3,287,713,625	3,672,034,000	3,989,951,000
ACTUARIAL VALUE OF ASSETS	4,272,493,600	4,853,226,000	5,248,886,000
PREPAID PENSION COST	0	(125,240,705)	(250,994,892)
ADJUSTED VALUE OF ASSETS	4,272,493,600	4,727,985,295	4,997,891,108
PRESENT VALUE OF FUTURE NORMAL COSTS	(984,779,975)	(1,055,951,295)	(1,007,940,108)
PRESENT VALUE OF FUTURE SERVICE	258,405	308,084	296,162
ACCRUAL RATE PER EMPLOYEE	(3,811)	(3,427)	(3,403)
NUMBER OF EMPLOYEES	32,863	36,690	37,048
NORMAL COST	(125,240,705)	(125,754,187)	(126,086,956)
PVFC/NORMAL COST	7.9	8.4	8.0
TOTAL PACIFIC TELESIS NORMAL COST	**(161,796,566)**	**(179,705,315)**	**(180,038,084)**
ALLOCATE TO PACIFIC BELL	0.9372	0.9327	0.9410
PACIFIC BELL NORMAL COST	**(151,635,742)**	**(167,611,148)**	**(169,415,837)**
EXPENSE RATIO	0.9032	0.9162	0.9153
NORMAL COST EXPENSE	(136,957,402)	(153,565,334)	(155,066,316)
LESS: BELOW THE LINE	2,250,384	12,763,375	12,689,681
LESS: INTERSTATE	29,426,926	32,027,582	31,880,171
INTRASTATE REGULATED EXPENSE	**(105,280,092)**	**(108,774,377)**	**(110,496,464)**
TOTAL FOR THREE YEAR AUDIT PERIOD			**(324,550,932)**

NOTE 1 : 1999 MANAGEMENT PLAN DATA NOT AVAILABLE. 1999 NORMAL COST SET EQUAL TO 1998 NORMAL COST

SOURCE: OC-33

NOTE: THIS PAGE REVISES ATTACHMENT 7-4

Chapter 9 - Income Taxes
Supplemental Report

This supplemental chapter addresses the data responses Pacific Bell provided after December 31, 2001 concerning income taxes. The findings included in this supplemental chapter are listed below.

- The income tax normalization correction recommended in the audit report should be revised to reflect normalization of the State Income Tax Cash Basis federal temporary difference and to correct a math error. Those revisions decrease corrected intrastate regulated deferred income tax expense by $17 million.

- The income tax normalization correction presented in the Audit Report excluded certain plant related temporary differences. Pacific Bell does not have the information needed to reflect the proper tax treatment of those temporary differences. However, based on the limited available information, providing flow-through treatment to those items would not have a large impact on audit period income tax expense.

- The excess deferred income tax amortization correction recommended in the Audit Report should be revised to reflect the response to OC-1195. The correction recommended in the Audit Report reduced intrastate regulated deferred income tax expense by $51.2 million. The revised correction reduces intrastate regulated deferred income tax expense by $59.3 million.

I. Income Tax Normalization Policy

Pacific Bell responded to several data requests concerning its income tax normalization accounting policy subsequent to December 31, 2001. Those responses are discussed below.

- The response to Data Request OC-956 admits that the CPUC had only authorized income tax normalization accounting for two temporary differences prior to the adoption of Resolution F-634 in January 1995. Those two temporary differences were federal accelerated depreciation and the California Franchise Tax (CCFT) accrual versus payment temporary difference. As noted on page 9-15 of the Audit Report, Resolution F-634 did not modify the Commission's policy of requiring flow-through treatment for temporary differences to the extent permitted by tax regulations.

- The response to Data Request OC-1292 admits that the federal accelerated depreciation temporary difference is the only temporary difference that must be normalized pursuant to tax regulations.

- The response to Data Request OC-1178 admits that Pacific Bell accounts for state depreciation temporary differences on a flow-through basis because the

CPUC has not authorized normalization accounting for state depreciation temporary differences.

- Pacific Bell does not deduct accumulated deferred state income taxes from rate base. The response to Data Request OC-1070 admits the basis for not deducting state accumulated deferred income taxes from rate base "is what is recognized for ratemaking purposes per D.84-05-036." The response states:

  > The California Commission recognizes federal primary deferred taxes related to plant for ratemaking purposes per CPUC D.84-05-036. The federal primary tax reserve is used...[for the rate base deduction] because that excludes the effect of state income taxes.

- The response to Data Request OC-1143 admits that Pacific Bell is not required to normalize the Universal Service Fund temporary difference. The response indicates "[T]here are no normalization requirements that apply. Flow-through ratemaking treatment of this item would not cause a change in the tax treatment of [Universal Service Fund] receipts." As noted on Page 9-21 of the Audit Report, the impact of the income tax normalization issue on audit period earnings is concentrated in two specific temporary differences, universal service fund and pension. There are no IRS normalization requirements that apply to those temporary differences.

- The response to Data Request OC-1197 admits that Pacific Bell accounts for the interest during construction ("IDC") jurisdictional adjustment on a flow-through basis because the CPUC has not authorized normalization accounting for IDC.

The additional data responses illustrate the fundemental inconsistency in Pacific Bell's income tax normalization policy. Pacific Bell claims, incorrectly, that Resolution F-634 changed the CPUC's income tax flow-through policy to one of full normalization. However, Pacific Bell itself continues to give flow-through treatment to state depreciation in its rate base calculations. Pacific Bell also continues to provide flow-through treatment to selected temporary differences, including interest during construction and vacation pay accrual. The treatment Pacific Bell itself has given to state depreciation, interest during construction and vacation pay accruals, directly contradicts its claim that Resolution F-634 required normalization treatment for all temporary differences. Pacific Bell cannot explain how it decides which temporary differences should be given flow-through accounting treatment and which should be given normalization accounting treatment. Pacific Bell has not provided a coherent explanation of its income tax normalization policy.

II. State Income Tax Cash Basis Temporary Difference

The response to Data Request OC-956 notes that the CPUC authorized normalization accounting for the California Corporate Franchise Tax (CCFT) accrual versus payment temporary difference in D.90-12-034. State income taxes are a deductible expense for federal income tax purposes. The temporary difference reflects a difference in the timing of CCFT expense recognition for book accounting and federal income tax purposes.

CCFT expense is accrued on the books during the year in which the liability is incurred. CCFT expense is deducted for federal income tax purposes in the following year when the tax is paid. The Audit Report refers to the temporary difference as the State Income Tax Cash Basis temporary difference.

The normalization correction presented in the audit report provided flow-through treatment to the recorded State Income Tax Cash Basis temporary difference. D.90-12-034 permits normalization of the State Income Tax Cash Basis temporary difference. Therefore, a revision to the correction is required to reflect normalization treatment.

The income tax normalization correction recommended in the audit report contains a math error which overstated 1997 deferred income tax expense by $2.4 million.[1] Therefore, a revision is also required to correct that error.

- The income tax normalization correction recommended in the audit report should be revised to reflect normalization of the State Income Tax Cash Basis federal temporary difference and to correct a math error. Those revisions decrease corrected intrastate regulated deferred income tax expense by $17 million.

The calculation of the revised income tax normalization correction is shown on Attachment S9-1. The income tax normalization correction, before consideration of the impact of other audit adjustments, recommended in the audit report increased recorded intrastate deferred income tax expense by $54 million. The revised correction increases recorded intrastate deferred income tax expense by $37 million. Thus, the revision reduced intrastate expense by $17 million.

The revision reflects the reinstatement of Pacific Bell's recorded deferred income tax expense for the State Income Tax Cash Basis temporary difference. Several of the other audit corrections recommended in the Audit Report impact current state income tax expense. However, we did not adjust the State Income Tax Cash Basis temporary difference to reflect the impact of those corrections. As a result, we effectively normalized the State Income Tax Cash Basis temporary differences arising from those corrections in the Audit Report. Therefore, the revision to the tax normalization correction is properly limited to a reinstatement of the recorded deferred income tax expense.

III. Property Related Flow-Through Temporary Differences

The CPUC's income tax policy is to provide flow-through treatment to temporary differences to the extent permitted by tax regulations. Tax regulations require normalization of depreciation method and life temporary differences. Tax regulations do

[1] The 1997 FCC accounting basis state correction of $1.538 million was posted in the wrong direction on Attachment 9-6, page 1. The correction should have reduced deferred tax expense instead of increasing deferred tax expense. The error overstated intrastate deferred income tax expense by $2.4 million ($1.538 million times two times 77.741% intrastate factor).

not require normalization of basis differences.[2] The Depreciation temporary difference reported by Pacific Bell includes method, life and basis differences.

Page 9-19 of the Audit Report notes:

> Pacific Bell has not provided the information needed to divide its depreciation temporary difference into flow-through and normalization categories. As a result, the correction shown above does not include the following temporary differences: (1) construction overheads; (2) cost of removal; (3) gains and losses on the retirement of plant; (4) interest during construction; (5) contributions in aid of construction; and (6) leases (capital versus operating). We will revise our recommended correction when we receive the information required to calculate the revision.

Data Request OC-1293 asked Pacific Bell to provide the adjustments needed to reflect flow-through of all plant-related temporary differences not required to be normalized by tax regulations on an FCC accounting basis. Pacific Bell's response states:

> The adjustments cannot be provided for the recorded MR (FCC) basis deferred income tax expense since Pacific does not separately maintain property related deferred taxes on life, method and basis differences. Thus, the requested information is not available.

Tax regulations require the normalization of depreciation method and life differences. The total method and life depreciation temporary differences in a given period should equal the difference between tax depreciation and book depreciation of tax basis. Pacific Bell provided 1998 and 1999 FCC basis tax depreciation and book depreciation of tax basis in response to Data Requests OC-1283 and OC-1284. The following table compares the deferred income tax expense based on those amounts to the deferred income tax expense recognized in the income tax normalization correction recommended in the Audit Report.

[2] OC-1292

Table S9-1 Estimated Deferred Income Tax Expense Compared to Level Recommended In Audit Report Intrastate Federal Accelerated Depreciation Years 1998 and 1999 (Dollars in Thousands)		
Source: OC-1283, OC-1284 and Attachment 9-6		
Description	1998	1999
Book Depreciation on Tax Basis	1,987,814	1,840,087
Tax Depreciation	(1,881,382)	(1,974,231)
Method and Life Temporary Difference	106,432	(134,144)
Tax Rate	0.35	0.35
Required Deferred Income Tax Expense	(37,251)	46,950
Required Expense per Attachment 9-6	(41,313)	20,724
Difference - Total FCC Basis	4,062	26,226
Intrastate Factor	0.77130	0.77253
Difference - Intrastate	3,133	20,261

Data Requests OCSUP-5 and OCSUP-6, submitted on March 29, 2002, requested book depreciation of tax basis and tax depreciation for 1997. Pacific Bell objected to providing that information on the basis that the request was burdensome and oppressive.

- The income tax normalization correction presented in the Audit Report excluded certain plant related temporary differences. Pacific Bell does not have the information needed to reflect the proper tax treatment of those temporary differences. However, based on the limited available information, providing flow-through treatment to those items would not have a large impact on audit period income tax expense.

The income tax normalization correction recommended in the Audit Report excluded certain plant related temporary differences. Pacific Bell has not tracked the data needed to reflect flow-through treatment for those temporary differences. Pacific Bell provided summary depreciation data for 1998 and 1999. That data indicates that providing flow-through treatment to those plant-related temporary differences would not have a large impact on audit period income tax expense.

Pacific Bell has objected to providing the comparable summary data for 1997. Pacific Bell has not tracked the data needed to test the reasonableness of the 1998 and 1999 summary data. Based on the circumstances described above, Overland concluded that revising the correction recommended in the audit report to reflect the summary data provided in Data Responses OC-1283 and OC-1284 was not appropriate.

IV. Excess Deferred Income Tax Amortization

Page 9-20 of the Audit Report recommends a correction to correct Pacific Bell's failure to amortize excess deferred income taxes in 1998 and 1999. The recommended correction amount was an estimate based on 1997 data. Page 9-20 states:

> Data Request OC-1195, submitted on September 25, 2001, asked Pacific Bell to provide the entry it recorded in 2000 to correct its failure to amortize [excess] deferred income taxes. Overland will adjust the amount of the audit correction after Pacific Bell responds to that request.

Pacific Bell responded to Data Request OC-1195 on February 4, 2002 with a supplemental response on April 1, 2002. The response to Data Request OC-1195 indicates Pacific Bell reduced deferred income tax expense by $76.8 million in November 2000 to correct its failure to amortize excess deferred income taxes in 1998 and 1999. The response does not separate the $76.8 million correcting entry by year.

C The excess deferred income tax amortization correction recommended in the Audit Report should be revised to reflect the response to OC-1195. The correction recommended in the Audit Report reduced intrastate regulated deferred income tax expense by $51.2 million. The revised correction reduces intrastate regulated deferred income tax expense by $59.3 million.

The following table shows the revised correction to reflect amortization of excess deferred income taxes in 1998 and 1999.

Table S9-2
Amortization of Excess Deferred Income Taxes
Correction to 1998 and 1999 Deferred Income Tax Expense
Intrastate Regulated
(Dollars in Thousands)

Source: OC- 1195 and Attachment 9-6

Description	1998	1999	Total
November 2000 Correcting Entry	(38,408)	(38,408)	(76,816)
Intrastate Factor	0.77130	0.77253	
Intrastate Correction	(29,624)	(29,671)	(59,295)

The original correction recommended in the audit report reduced intrastate regulated deferred income tax expense by $51.2 million. The revised correction reduces intrastate regulated deferred income tax expense by $59.3 million, a change of $8 million.

V. True-up of Prior Year Accruals

Pacific Bell records tax credits and true-ups of provisions recorded in prior years as adjusting journal entries (AJE's) to current income tax expense. The provision true ups reflect the difference between amounts included in book accruals and the income and deductions actually report on the tax return for that year.

The audit period AJEs are shown as "adjusting journal entries" on Attachment 9-1. The AJEs reduced audit period federal and state current tax expense by $51.7 million.

The response to Data Request OC-1180, received on January 24, 2002, provided support for the AJEs recorded in 1998 and 1999. The response to Data Request OC-812 provided support for the AJEs recorded in 1997 and for the 1999 true-up recorded in 2000.

The AJEs include both tax credits and true-ups of taxable income. The actual Research and Experimentation and Los Angeles Revitalization Zone tax credits applicable to the audit period totaled $47 million.[3] The AJEs recorded during the audit period reduced current income tax expense by $52 million. Thus, the AJEs can be viewed as largely reflecting tax credits properly used to reduce audit period income tax expense.

Overland analyzed the 1996, 1997 and 1998 true-ups recorded during the audit period and the 1999 true-up recorded in 2000 and concluded that audit period recorded current income tax expense exceeded actual current income tax expense by $14 million (before other audit period corrections). Our conclusion reflects two adjustments to the recorded true-ups.

- Pacific Bell included the temporary difference arising from the abandonment of the Advanced Communications Network in operating taxable income in its 1997 true up. We reclassified the ACN temporary difference to non-operating taxable income.

- Pacific Bell included the taxable income created by the December 1999 Pension trust and PBOP trust withdrawals in operating taxable income in the 1999 true-up recorded in 2000. We eliminated those items from the 1999 true-up because they are addressed separately in Chapter 7.

A variance of $14 million between recorded current income tax provisions and actual current income tax liabilities represents a normal accounting estimating variance. Normal ongoing corrections of accounting estimates are expected and are not necessarily the result of accounting error. Accordingly, we do not recommend a correction to true-up the audit period current income tax provisions to reflect the actual income and deductions reported on Pacific Bell's income tax returns.

[3] OC-1176, OC-1180 and OC-812

PACIFIC BELL
INCOME TAX NORMALIZATION CORRECTION
(AMOUNTS IN 000s)

		1997	1998	1999	TOTAL
FCC ACCOUNTING BASIS					
	FEDERAL	(1,527)	(158,833)	(170,750)	(331,110)
	STATE	(1,538)	(39,378)	(20,204)	(61,120)
	TOTAL	(3,065)	(198,211)	(190,954)	(392,230)
	ESTIMATED SEPARATIONS FACTOR	0.77741	0.77130	0.77253	
	ESTIMATED INTRASTATE CORRECTION	(2,383)	(152,880)	(147,518)	(302,781)
JURISDICTIONAL ADJUSTMENTS (PAGE 2)		133,159	(18,499)	72,917	187,577
IEMR RATEMAKING ADJUSTMENTS					
	GAAP NORMALIZE	1,491	0	74	1,565
	HAZARDOUS WASTE	(1,887)	0	0	(1,887)
	SFAS 106	22,423	162,985	0	185,408
	RESTRUCTURING RESERVE	35,943	0	0	35,943
	MERGER REFUND	(80,253)	11,437	13,810	(55,006)
	COMMUNITY PARTNERSHIP	(16,295)	2,527	(548)	(14,316)
	TOTAL	(38,578)	176,949	13,336	151,707
TOTAL CORRECTION TO INTRASTATE		**92,198**	**5,570**	**(61,265)**	**36,503**

Note: This page revises page 1 of Attachment 9-6

PACIFIC BELL
INCOME TAX NORMALIZATION CORRECTION
FEDERAL INCOME TAX
FCC ACCOUNTING BASIS
YEAR 1997
(AMOUNTS IN 000s)

TEMPORARY DIFFERENCE	RECORDED PROVISION	REQUIRED PROVISION	DIFFERENCE
DEPRECIATION	(7,046)	(7,046)	0
BOOK DEPRECIATION -FLOW THRU VINTAGES	0	0	0
EXCESS DEFERRED INCOME TAX	(29,992)	(29,992)	0
ADV. COMM. NETWORK	17,910		(17,910)
CAPITAL LEASE PRE 88	0		0
MCI FIBER OPTIC RENTAL	0		0
SOFTWARE RTU & SEC 481 ADJ	(5,421)		5,421
MERGER PENSION EXPENSE ACCRUE	(12,629)		12,629
PENSION ERO (FAS 88)	83,412		(83,412)
PENSION EXPENSE ACCRUAL	61,403		(61,403)
SFAS 106 ACCRUAL	(98,876)		98,876
SFAS 106 FUNDING	69,402		(69,402)
SFAS 112 W/O WORKERS COMP	(455)		455
TEAM AWARD	(1,416)		1,416
VACATION PAY ACCRUAL	(22,179)		22,179
UNCOLLECTIBLE ACCOUNTS ACCRUAL	(6,890)		6,890
BELLCORE SALE	6,897		(6,897)
BOND REDEMPTION	(1,913)		1,913
STATE INCOME TAX CASH BASIS	17,769	17,769	0
COMMUNITY PARTNERSHIP	(15,931)		15,931
MERGER REFUND	(64,783)		64,783
FICA ACCRUAL	66		(66)
ISSC SERVICE CONTRACT PREPAYMENT	(7,361)		7,361
PB EXTRA AWARDS/POINTS	(4,908)		4,908
PENDING AND UNREPORTED CLAIMS	787		(787)
PROPERTY TAX ACCRUAL	1,159		(1,159)
RESERVE 1996 USOAR TURNAROUND	(5,533)		5,533
RESTRUCTURING RESERVE	1,389		(1,389)
SSPP/VISB ACCR/PAYBACK	0		0
SUPERFUND TAX	0		0
PRIOR YEAR TRUE UP	13,073		(13,073)
TRANSFER PRICING FCC VS CPUC	(4,394)		4,394
VARIOUS SMALL LINE ITEMS	(1,282)		1,282
FEDERAL DEFERRED INCOME TAX ADJUSTMENT	**(17,742)**	**(19,269)**	**(1,527)**

SOURCE: OC-797

NOTE: THIS PAGE REVISES ATTACHMENT 9-6 PAGE 3

PACIFIC BELL
INCOME TAX NORMALIZATION CORRECTION
FEDERAL INCOME TAX
FCC ACCOUNTING BASIS
YEAR 1998
(AMOUNTS IN 000s)

TEMPORARY DIFFERENCE	RECORDED PROVISION	REQUIRED PROVISION	DIFFERENCE
STATE INCOME TAX CASH BASIS	(12,981)	(12,981)	0
TAX RATE CHANGE	(3,708)	0	3,708
TAX RESERVE	4,362	0	(4,362)
DEPRECIATION	(41,313)	(41,313)	0
BOOK DEPRECIATION - FLOW THRU VINTAGES	0	0	0
ADV. COMMUN. NETWORK WRITE OFF	(1,351)	0	1,351
CAPITALIZED SOFTWARE	10,064	0	(10,064)
PENSION SFAS 88 GAINS AND LOSSES	(16,974)	0	16,974
PENSION ACCRUAL	46,552	0	(46,552)
SFAS 106 ACCRUAL	(64,057)	0	64,057
SFAS 106 FUNDING	71,255	0	(71,255)
SFAS 112 W/O WORKERS COMP	(34)	0	34
STOCK APPRECIATION RIGHTS	1,695	0	(1,695)
WORKERS COMPENSATION	(771)	0	771
TEAM AWARD	36,973	0	(36,973)
VACATION PAY ACCRUAL	215	0	(215)
95 INTERSTATE SHARABLE EARNINGS	(1,248)	0	1,248
AMORTIZATION OF BOND REDEMPTION	(2,087)	0	2,087
AT&T INTERSTATE USAGE REFUND	(770)	0	770
COMMUNITY PARTNERSHIP	2,125	0	(2,125)
MERGER REFUND	12,381	0	(12,381)
CONTINGENT IEC	(1,758)	0	1,758
FICA ACCRUAL	68	0	(68)
PROPERTY TAX ACCRUAL	3,843	0	(3,843)
FCC TARIFF FILINGS & ANNUAL ACCESS	(1,695)	0	1,695
INTERNET CONTESTED TRAFFIC	(17,717)	0	17,717
OTHER BILLING & COLLECTION	11,843	0	(11,843)
PENDING AND UNREPORTED CLAIMS	(258)	0	258
UNCOLLECTIBLE ACCOUNTS ACCRUAL	(3,231)	0	3,231
SALE OF BELLCORE	(2,057)	0	2,057
SALE OF BELLCORE - PRIOR YR TRUE UP	(4,363)	0	4,363
TRANSFER PRICING OPER.	(20,166)	0	20,166
UNIVERSAL SERVICE FUNDS	100,506	0	(100,506)
MISC. SMALL ITEMS	(804)	0	804
FEDERAL DEFERRED INCOME TAX	104,539	(54,294)	(158,833)

SOURCE: OC-797

NOTE: THIS PAGE REVISES ATTACHMENT 9-6 PAGE 5

PACIFIC BELL
INCOME TAX NORMALIZATION CORRECTION
FEDERAL INCOME TAX
FCC ACCOUNTING BASIS
YEAR 1999
(AMOUNTS IN 000s)

TEMPORARY DIFFERENCE	RECORDED PROVISION	REQUIRED PROVISION	DIFFERENCE
STATE INCOME TAX CASH BASIS	(23,991)	(23,991)	0
TAX RESERVE	19,011	0	(19,011)
DEPRECIATION	20,724	20,724	0
UNIVERSAL SERVICE FUND	103,885	0	(103,885)
BOOK DEPRECIATION - FLOW THRU VINTAGES	0	0	0
ADV. COMM. NETWORK WRITE-OFF	(49,865)	0	49,865
CAPITALIZED SOFTWARE	18,499	0	(18,499)
AIT MERGER SEVERANCE & ERB	(8,111)	0	8,111
PENSION ACCRUAL	181,445	0	(181,445)
SFAS 106 ACCRUAL	(89,788)	0	89,788
SFAS 106 FUNDING	55,347	0	(55,347)
SFAS 112 W/O WORKERS' COMP	(14,841)	0	14,841
SAVINGS PLAN CONTRIBUTION	(22,810)	0	22,810
EXECUTIVE DEFERRED COMP.	(2,142)	0	2,142
WORKERS COMPENSATION	(2,833)	0	2,833
TEAM AWARD	(25,551)	0	25,551
VACATION PAY ACCRUAL	(16,580)	0	16,580
911 SURCHARGE AUDIT	1,085	0	(1,085)
92-93 FEDERAL EMPLMT TAX AUDIT	638	0	(638)
MCI FIBER OPTIC RENTAL	0	0	0
AMORTIZATION OF BOND REDEMPTION	(2,274)	0	2,274
AT&T INTERSTATE USAGE REFUND	770	0	(770)
CA HIGH COST & TELECONNECT FD	652	0	(652)
COMMUNITY PARTNERSHIP	1,696	0	(1,696)
MERGER REFUND	22,303	0	(22,303)
CONTINGENT IEC	2,611	0	(2,611)
ENRON ENERGY CREDIT	(3,017)	0	3,017
PROPERTY TAX ACCRUAL	(5,755)	0	5,755
FICA ACCRUAL	284	0	(284)
INTER TARIFF FILINGS & ANNUAL ACC	1,696	0	(1,696)
INTERCO DEFERRED REVENUE	880	0	(880)
INTERNET CONTESTED TRAFFIC MOU	(18,895)	0	18,895
INTERSTATE SHARABLE EARNINGS	1,247	0	(1,247)
ISCP ALLIANCE & TELESIS VIDEO	(909)	0	909
LATE PAYMENT LIABILITY	1,665	0	(1,665)
OTHER BILLING AND COLLECTION	(12,036)	0	12,036
PB EXTRA AWARD POINTS	4,132	0	(4,132)
PBIS REBATES -T/C RBT	6,598	0	(6,598)
PREPAID INS & OTHER PREPAIDS	8,646	0	(8,646)
UNCOLLECTIBLE ACCOUNTS ACCRUAL	6,363	0	(6,363)
RESV FOR USOAR TURNAROUND	12,910	0	(12,910)
SALE OF BELLCORE	(1,424)	0	1,424
SALE OF LAND	(2,691)	0	2,691
SALES & USE TAX LIABILITY	3,560	0	(3,560)
SSCS SERVICE CONTRACT PREPAYMENT	(2,061)	0	2,061
TRANSFER PRICING OPER.	(10,847)	0	10,847
UNIVERSAL SERVICE FUND	3,092	0	(3,092)
WIRELESS EMPLOYEE STOCK OPTS	5,807	0	(5,807)
MISC. SMALL ITEMS	(1,274)	0	1,274
UNLOCATED DIFFERENCE	(368)	0	368
FEDERAL DEFERRED INCOME TAX	**167,483**	**(3,267)**	**(170,750)**

SOURCE: OC-797