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Decision 97-04-043 April 9, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the matter of post-retirement benefits other than pensions.	I.90-07-037 (Filed July 18, 1990)
Application of Pacific Gas and Electric Company for authority among other things, to increase its rates and charges for electric and gas service. (Electric and Gas) (U-39-M)	Application 88-12-005 (Filed December 5, 1988)
And Related Matter.	I.89-03-033 (Filed March 20, 1989)

Subject **Page**

INTERIM OPINION 2

I. Introduction 2

II. Procedural Background 3

III. Does the PBOP Z-Factor Meet NRF Z-Factor Eligibility Criteria? 7
A. Positions of Parties 7
TURN 11
ORA 12
MCI 15
CCLTC 16
B. Discussion 17
1. Introduction 17
2. Controllability of PBOP Expenses 19
3. Controllability of PBOP Trust Funding 24
4. Normal Cost of Business 26
5. Effects of PBOP Costs On NRF Inflation Index 28
6. Conclusion 29

Findings of Fact 32

Conclusions of Law 38

INTERIM ORDER 39

INTERIM OPINION

I. Introduction

Interim Decision (D.) 94-10-037 reopened the issue decided in D.92-12-015 concerning the right of Pacific Bell (Pacific) and GTE California Incorporated (GTEC) to recover in rates through z-factor adjustments the costs associated with the adoption of new accounting standards for post-retirement benefits other than pensions (PBOPs). PBOPs represent those nonpension benefits which employees receive upon retirement, including medical and dental care, life insurance, and legal services. D.94-10-037 also made the portion of Pacific's and GTEC's rates associated with the accounting change subject to refund[1] pending the outcome of the reopened proceeding. In the event the Commission were to conclude that the z-factor treatment given to PBOP costs in D.92-12-015 is not proper, D.94-10-037 directed that a broad range of options be considered as to what ratemaking changes to order related to the recovery of PBOP costs.

In D.92-12-015, the Commission approved Statement on Financial Account Standards (SFAS) 106 for ratemaking and accounting purposes, which required that the accounting for PBOP costs be changed from a cash basis to an accrual basis.[2] Prior

1 By D.95-10-018, we denied Pacific's application for rehearing of D.94-10-037 wherein Pacific alleged that the subject-to-refund provisions violated the rule against retroactive ratemaking. As noted in D.95-10-018, refund provisions, if any, that might be adopted as a result of the reopening of this proceeding would apply only from the date D.94-10-037 was issued.

2 Cash accounting for PBOP is also referred to as "pay-as-you-go" or "pay-go" accounting.

to SFAS 106, employers generally accounted for PBOPs on a cash basis whereby PBOP expense was only recognized as cash disbursements were made to current retirees. SFAS 106 required that employers recognize the cost of providing PBOP to their employees by accruing these costs in the employers' financial statements as they are earned during the employees' years of service instead of waiting until the employees' retirement. The PBOP accrual comprised two separate components: (1) the prospective accrual of PBOPs earned by current employees in each accounting period and (2) the amortization of cumulative prior period PBOP earnings of past employees prior to January 1, 1993 which were not previously recognized as an expense for accounting purposes. The FASB defined PBOP as those benefits other than pensions that employees receive upon their retirement from work. These benefits include medical and dental care, life insurance and legal services.

Based upon our reconsideration of this issue, we conclude that z-factor treatment for the effects of SFAS 106 adopted in D.92-12-015 is appropriate, and affirm the findings and conclusions of D.92-12-015 supporting the z-factor recovery of costs associated with the SFAS 106 accounting change for PBOP costs.

II. Procedural Background

On July 18, 1990, the Commission issued Order Instituting Investigation (I.) 90-07-037 to analyze the potential ratemaking impacts on regulated utilities of implementing the FASB Statement 106, which would change the accounting treatment of PBOPs from a cash to an accrual basis. The FASB formally adopted SFAS 106 in December 1990.

I.90-07-037 was bifurcated into two phases. Phase I examined whether prefunding of the PBOP liability was in the best interest of ratepayers. The Phase I issues were decided in D.91-07-006, modified by D.91-10-024, which allowed recovery of

costs associated with prefunding PBOPs liability for utilities not under the New Regulatory Framework (NRF) incentive regulation. D.91-10-024 further authorized GTEC and Pacific to establish memorandum accounts to track prefunded PBOP contributions to tax deductible vehicles but deferred consideration of the recovery of prefunded amounts for GTEC and Pacific to Phase II of the proceeding.

In Phase II, the Commission investigated several issues related to SFAS 106: revenue requirement effects of adopting SFAS 106, accounting and ratemaking treatment, the effects of legislation on SFAS 106 costs, and Z-factor treatment.

On December 3, 1992, the Commission issued D.92-12-015 (Re Investigation of Post-retirement Benefits Other Than Pensions (1992) 46 CPUC2d 499) approving SFAS 106 for ratemaking and accounting purposes and establishing procedures for the recovery of PBOP costs associated with the SFAS 106 accounting changes. Pacific and GTEC were allowed to recover such costs via z-factor adjustments in their annual NRF price cap filings on a prospective basis subject to specified limitations. They were not allowed to recover their prefunded PBOP contributions made prior to the adoption of SFAS 106. Prospective z-factor treatment was limited to the difference between what is required by accrual accounting and what their pay-as-you-go costs otherwise would have been.

On January 11, 1993, TURN filed what is now its Petition for Modification of the PBOP Decision (see Re Investigation of Post retirement Benefits Other Than Pensions (1993) D.93-03-028, 48 CPUC2d 418, 420). In D.94-10-037 (PBOP Reopening Decision), the Commission agreed to "reexamine whether the treatment given to PBOP costs in D.92-12-015 justifies z factor recovery for PBOP costs" (D.94-10-037, mimeo., p. 10 at COL. 4) and ordered "[f]urther proceedings...to determine whether the treatment afforded PBOP costs in D.92-12-015 justifies z factor recovery and, if not, what ratemaking changes should be ordered." (Id., p. 10 at Ordering

Paragraph (OP) 3.) The Commission ordered that rates authorized for recovery of PBOP be recorded subject to refund, pending further order of the Commission (Id., p. 11 at OP 6). D.95-10-018 prescribed that any refunds which might be ordered pursuant to the reopening of the PBOP z-factor issue could only cover the period subsequent to October 1994. We are therefore precluded from making any ratemaking adjustments to the z-factor adopted for 1993 in any event, but could adjust the PBOP z-factor carried forward beginning October 1994 and for subsequent years.

D.94-10-037 asked parties to comment on alternative ratemaking changes that would be necessary if the Commission concluded that current z-factor treatment for PBOPs granted in D.92-12-015 was not justified. The decision stated that the Commission intends to consider a broad range of alternative ratemaking options and listed three specific options:

1. A simple reduction in the NRF utilities' rates to reflect the elimination of the PBOP z-factor currently in rates.

2. An order requiring the NRF utilities to fund independent trusts to provide PBOP benefits (thereby justifying z-factor treatment of the amounts they are required to fund). Under this option, the amount the utilities would be required to fund could be:

   a. the tax-deductible amount;

   b. only the amount required to amortize the TBO;

   c. the full amount necessary to reflect PBOP costs (i.e., not just the tax-deductible portion).

3. A recalculation of the NRF utilities' startup revenue requirements to in some way reflect additional PBOP costs revealed by accrual accounting.

Since we have concluded that the PBOP z-factor does satisfy the NRF criteria for z-factor eligibility, as discussed below, we do not need to consider alternative ratemaking options as called for in D.94-10-037.

A prehearing conference (PHC) was held on February 6, 1995 to determine a schedule for the reopening of the proceeding. All parties at the PHC, except Pacific, agreed that there was no need to hold hearings on these issues since the Phase II hearings provided a complete record with regard to the issues which the Commission wished to review again. Subsequently, by motion dated March 28, 1995 Pacific withdrew its request for hearings. Accordingly, no evidentiary hearings were scheduled. Parties filed opening briefs on June 9, 1995 and reply briefs on August 4, 1995. The rehearing will be decided based upon parties' arguments in briefs.

Comments advocating modification of D.92-12-015 to order the denial of z-factor treatment of PBOP costs were filed by The Utility Reform Network (TURN), the Commission's Division of Ratepayer Advocates (DRA)[3], MCI Telecommunications Corporation (MCI), and the California Committee for Large Telecommunications Consumers (CCLTC). Comments were filed by Pacific Bell and GTEC opposing modification of the decision and supporting the Commission's D.92-12-015 in its z-factor treatment of PBOP costs.

3 Since the filing of comments, the Commission has undergone a major reorganization. DRA has been superseded by the Office of Ratepayer Advocates (ORA). All subsequent references in this decision to the positions of the former DRA shall apply to the ORA.

III. Does the PBOP Z-Factor Meet NRF Z-Factor Eligibility Criteria?

A. Positions of Parties

Pacific argues that there is no new evidence supporting any change in D.92-12-015, and there is no legal basis to warrant modification of the prior decision. Both Pacific and GTEC contend D.92-12-015 correctly decided that z-factor treatment should be allowed for the change in PBOP costs caused by the adoption of SFAS 106, and that no modification in the decision is called for. Pacific focuses its comments on the two questions raised in the PBOP Reopening Decision regarding PBOP costs under SFAS 106 z-factor criteria. The decision questioned whether PBOP cost increases associated with the adoption of SFAS 106 are (1) within utility management control, and (2) are simply normal costs of doing business.

Pacific acknowledges that it has some ability to control PBOP costs for retirees, but argues that its ongoing management of PBOP costs is separate and distinct from the one-time effect on costs resulting from the adoption of SFAS 106. Under SFAS 106, utilities must account for PBOP expenses under the accrual basis of accounting instead of the cash basis previously used. Under accrual accounting, PBOP expenses are recognized for financial reporting purposes in the same period which employees earn them. Pacific argues that this one-time accounting change was exactly the type of adjustment contemplated for z-factor treatment by the NRF decision. SFAS 106 required all entities to record as a liability the cost of all PBOP benefits earned prior to January 1, 1993. D.92-12-015 required Pacific and GTEC to amortize this liability, known as the "transition benefit obligation" (TBO) over 20 years. The bulk of the z-factor for PBOP costs was due to the required 20-year amortization of the TBO and the related interest. Pacific argues that those TBO costs were beyond its control because the benefits were earned prior to the adoption of SFAS 106.

Pacific states that it has requested recovery in this proceeding only of the difference between what its books would have reflected in 1993 with and without SFAS 106. Pacific has not sought recovery of subsequent increases in the SFAS 106 PBOP expense accruals after 1993 as a result of ongoing increases in the costs of employee benefit programs.

Although the Commission "clarified" and "refined" its z-factor analysis in D.94-06-011 (the NRF Review Decision), Pacific does not believe the Commission intended to change the underlying z-factor requirements. Pacific believes that language in D.94-06-011 is consistent with D.92-12-015 regarding the definition of the control criterion for determining z-factor eligibility. The Commission cited Resolution T-15160 to support its definition of the "control test" in D.94-06-011. Since Resolution T-15160 was issued at virtually the same time as D.92-12-015, Pacific reasons that the Commission must have applied the same "control" criterion to both of these virtually contemporaneous decisions. Accordingly, Pacific believes that SFAS 106 costs meet the Commission's "control" criterion in D.94-06-011.

Pacific believes an interpretation of the "control" test which precluded recovery of SFAS 106 costs would eliminate z-factors altogether. Drawing upon the examples of other qualifying z-factors such as mandated jurisdictional separations, Pacific argues that while it cannot control separations rules, it can control the costs being separated. By analogy, Pacific argues that it cannot control the change in accounting rules required under SFAS 106 even though PBOP costs subject to the accounting change are within management control.

Pacific claims that it would unfairly distort the incentives of NRF if z-factor treatment of SFAS 106 costs were eliminated. Absent a symmetrical z-factor mechanism, Pacific argues that it would be unfairly penalized by the downward pressure

on rates due to the productivity factor.[4] Pacific further claims the asymmetry would create uneconomic price signals which would frustrate the Commission's goal of a competitively efficient market for telecommunications services.

Pacific disagrees that the z-factor control test should be judged by its ability to control the manner in which it funds PBOP obligations. Pacific distinguishes between the PBOP obligation which is incurred under SFAS 106 and how that PBOP obligation is funded. Whether money is set aside each quarter or paid out of ongoing cash flows as needed, the underlying PBOP obligation does not change. Since it cannot control the PBOP obligation which results from SFAS 106, Pacific argues that the manner of funding is irrelevant to the issue of z-factor recovery.

Pacific denies that SFAS 106 costs are a normal cost of doing business. Pacific characterizes the cost impact of SFAS 106 as a one-time event which produced a substantial increase in PBOP expense to account for the build up of a historical liability that resulted from cash accounting in the past. (Exh. 53, p. 4.) Pacific asserts that while the applicability of SFAS 106 applied to nonregulated businesses, it did not change the way in which nonregulated businesses price their services. According to Pacific, nonregulated businesses already priced their goods and services in recognition of the full economic costs of PBOPs even prior to the enactment of SFAS 106. By contrast, Pacific states that it was not permitted to reflect the full economic cost of PBOP in its rates prior to SFAS 106.

4 Pacific's description of the NRF productivity factor is correct for 1993 (the period addressed in this order). In D.95-12-052 dated December 20, 1995, however, the Commission froze the NRF price caps for three years beginning January 1, 1996 for Category I and II services.

Pacific believes that a recalculation of the startup adjustment would be a workable alternative recovery vehicle. To this end, Pacific worked with an independent actuarial firm to estimate the PBOP accrual that would have occurred in 1989 if SFAS 106 had been in effect. The declaration of Gregory S. Schlappich, Senior Actuary at Pacific Telesis Group (Exhibit A), of Pacific's comments and explains how he and the actuarial firm estimated the accrual. The SFAS 106 accrual for 1989 was estimated to be $318 million. The declaration of Brian E. Thorne, Pacific Bell Director of Technical and Regulatory Accounting, explains how the revenue requirement for this accrual was calculated (See Pacific's comments, Exhibit B). The incremental revenue requirement is calculated to be $151,835,000. Pacific claims its rates would need to reflect that amount if the current z-factor were eliminated and the startup revenue requirement adjusted.

GTEC notes that the PBOP portion of the z-factor adjustment does not include any pay-as-you-go (PAYGO) component, but only the incremental costs associated with the SFAS 106 accounting change. GTEC states that it must assume the risk of managing its PBOP costs beyond the PAYGO amount included in its 1989 startup revenue requirement. GTEC did not request or receive authority to recover the expected increase in PAYGO costs over time, which amount to approximately $515 million over the next 20 years (Exh. 66, Tr. 786). GTEC argues that the SFAS 106 accounting change is an exogenous event not subject to management control and thus the resulting change in PBOP costs meets the z-factor eligibility criteria regardless to what extent the PBOP costs themselves are within management control. GTEC references the analysis of Dr. Mark Schankerman, an expert on the NRF price cap mechanism and its indices, in support of its arguments concerning whether SFAS 106 accounting changes represent a controllable event. In Phase II of this proceeding, Schankerman illustrated the principle of PBOP z-factor eligibility with respect

to payroll tax changes. Schankerman noted that the "issue is not whether wages are in the control of management, but whether the payroll is exogenously increased as a consequence of this change." (Tr. 1198.)

GTEC also denies that the cost effects due to adoption of SFAS 106 represents a normal cost of business for GTEC. In support of its position, GTEC refers to the Godwins study which was submitted in Phase II of this proceeding. The Godwins study documents that 73% of the economy (measured in terms of number of employees) is not subject to SFAS 106 because many private firms do not offer any PBOPs.

TURN

TURN reiterates its previous claim that PBOP expenses do not satisfy the criteria for z-factor adjustment set forth in D.94-06-011, but leaves it to other parties to present the substantive arguments for this claim. TURN does, however, claim that the Commission's treatment of an exogenous change in Pacific's cost of capital in D.94-06-011 compels the conclusion that PBOP expenses should not qualify for a z-factor adjustment. Although the Commission had found that "an important downward shift " had occurred in the financial markets which sharply reduced Pacific's cost of capital, the Commission did not reflect this change in reduced rates. The Commission noted that: "The price cap index itself automatically adjusts for changes in the cost of capital as it does changes in any particular input price." (Decision at 59, emphasis added.) TURN draws the analogy that PBOP costs likewise are already captured in the price cap index and that a z-factor adjustment for PBOP cost changes would therefore constitute double recovery. TURN believes the only way to reconcile its PBOP treatment with the sizable rate decrease it refused to order in D.94-06-011 is to deny z-factor treatment for PBOP costs.

ORA

ORA recommends that D.92-12-015 be modified to deny z-factor treatment for the effects of SFAS 106 and to order a refund to customers of the z-factor allowance. ORA believes that PBOP costs fail to qualify for z-factor treatment under at least three of the nine z-factor criteria set forth in D.94-06-011, the NRF Review Decision. In D.94-06-011, the Commission built on the policy refinements which had been made since the inception of NRF in D.89-10-031 to arrive at "a relatively comprehensive framework for z-factor analysis."[5] . Nine sequential criteria for z-factor treatment were adopted in D.94-06-011. Before any cost item can qualify for z-factor treatment, the item must pass all nine of the tests. ORA limited its comments to evaluating PBOP costs against three of the nine criteria since failing even one would mean that PBOPs are not eligible for z-factor treatment. Since ORA believes that PBOP costs fail all three of the selected criteria, ORA felt it was uneconomic to perform further analyses. ORA contends that the following three criteria for z-factor treatment prescribed by D.94-06-011 are not satisfied by PBOP costs:

1. Costs must be the result of an exogenous event.
2. Costs must be beyond management control.
3. Costs must be outside the ordinary cost of doing business.

ORA previously agreed that the FASB's promulgation of SFAS 106 is an exogenous event (ORA Exhibit 75, pp. 67-68). ORA now argues, however that while the effect of SFAS 106 is exogenous, it is an event without any impacts on the utility's true "economic costs. ORA does not believe that the accounting changes required

5 D.94-06-011, mimeo., page 71.

under SFAS 106 constitute an exogenous event resulting in a change in the true economic costs of providing PBOPs to utility employees. Since SFAS 106 does not change the employer/employee contracts governing PBOP obligations and benefits, ORA does not believe any exogenous event is triggered which impacts PBOP costs. Moreover, since SFAS 106 does not dictate the manner by which PBOP obligations are to be funded, the utility has discretion over the funding of PBOP obligations. Because of this discretion over funding, ORA believes that PBOP accounting changes under SFAS 106 do not qualify as an exogenous event eligible for z-factor treatment.

ORA likewise does not believe that SFAS 106 resulted in a change in costs which was beyond the control of management. ORA states that the utility can choose to pay for PBOP costs on a cash basis, resulting in no change in existing funding. In ORA's opinion, such control over funding means that management has clear control over PBOP costs, themselves. ORA also observes that management can control the various factors that determine PBOP costs, such as staffing levels, medical coverage terms, and even whether to terminate PBOP benefits altogether. By controlling these factors, ORA argues that Pacific and GTEC can mitigate the cost impacts of SFAS 106. ORA believes the effects resulting from SFAS 106 are analogous to the sort of cost changes described in D.94-06-011 which were not to be allowed z-factor treatment. In that decision, we stated:

> "The clear cut distinction between the exogenous cost-causing event and management actions after the event does not always exist...there will be circumstances in which an outside event requires the utility to take some action, but does not impose specific objectively determinable cost or wholly limit the utility's response to the event. In these circumstances, the utility may have the ability to respond to the event in a manner which limits the financial impact of the event. In sum, the utility may be able to control, and thus

> lessen, the adverse impact...By not allowing Z factor treatment for events which, while imposing costs, are within management's control, we encourage economic efficiency." (D.94-06-011, pp. 74-75, footnote omitted.)

As an example of the utilities' control over PBOP costs, ORA cites GTEC's 1993 Annual Shareholders' Report indicating a net reduction of $132.7 million in its accumulated PBOP obligation as a result of various changes in its management of postretirement health care and life insurance benefits. As further evidence of utility control over PBOP costs, ORA cites the large one-time write-off of SFAS 106-related costs which the parent companies of GTEC and Pacific took during 1992 and 1993. ORA believe these examples demonstrate that utility management can absorb the entire cost of the TBO and fund the annual cost of the accruals without additional rate recovery.

ORA also contends that the TBO is not completely beyond the control of the utilities. As noted by ORA, both Pacific's and GTEC's contracts with employees contain clauses that reserve management's rights to unilaterally terminate or reduce PBOPs. Since these reservation clauses apply to all past, present, and future PBOPs, ORA contends this discretion permits management to control the TBO prospectively.

ORA further argues that the effects of SFAS 106 constitutes a normal cost of doing business which disqualifies it from z-factor eligibility. Since SFAS 106 applies to all businesses and is not limited exclusively to utilities or telecommunications service providers, ORA concludes that the effects of SFAS 106 qualify as a normal cost of doing business.

ORA objects to Pacific's recalculation of the startup revenue requirement. ORA claims that computing a revised startup revenue requirement contradicts the prohibition against granting z-factor recovery for normal, endogenous costs subject to management's control. ORA further argues that an increased startup

revenue requirement would be unfair to ratepayers who would bear the upfront costs of PBOP funding while investors would reap the long term benefits as accrual amounts are expected to decline over time. ORA criticizes Pacific's calculation for failing to provide a mechanism for rates to be reduced when the 20-year TBO amortization is completed.

ORA claims it would be impractical to go all the way back to 1989 to recompute the startup revenue requirement as this would violate the prohibition against retroactive ratemaking.

ORA further claims that Pacific's $152 million incremental startup revenue requirement increase would exceed the 1% annual cap imposed by OP 2(f) of D.92-12-015. ORA argues that the first year's incremental revenue requirement could not exceed $100 million (based on a $100 million revenue base as of year-end 1994).

ORA further argues that recomputing a startup revenue requirement entails too much speculation and uncertainty regarding micro and macro impacts on the labor force, compensation packages, and the tax code. Accordingly, ORA finds this result to be incompatible with criterion "h" of D.94-06-011 which requires the z-factor "costs be determined with reasonable certainty and minimal controversy."

MCI

MCI claims that the Commission drew no distinctions between those utilities under traditional regulation and telecommunications firms subject to NRF in determining the ratemaking/accounting treatment for PBOP costs in D.92-12-015. MCI states that the intent of NRF, however, is to detach rates from costs and to allow the utility to manage its own costs in order to provide it with the incentive to achieve higher returns. MCI believes that the risk in fluctuations in costs under local exchange carrier (LEC) control was shifted from ratepayers to shareholders. MCI believes that PBOP costs are under LEC control.

MCI notes that D.91-07-006 stated that Pacific and GTEC were "required to demonstrate that funding of the total PBOPs liability is in the ratepayers best interest." MCI asserts that neither Pacific nor GTEC have presented such compelling evidence.

MCI contends that the purported exogenous event of the accounting change resulting from release of SFAS 106 cannot be considered separately from the controllability of PBOP costs. MCI contends that PBOP costs are wholly within management control and thus, no portion of PBOP costs, including those impacted by SFAS 106, qualify for z-factor treatment. MCI further contends that PBOP costs are a normal cost of doing business, further warranting the rejection of z-factor treatment. Finally, MCI believes D.92-12-015 constitutes a violation of Public Utilities Code Section 454 by imposing a rate increase on NRF-regulated LEC ratepayers without making a clear finding identfying a compelling basis for NRF LEC to receive such a rate increase.

CCLTC

CCLTC supports a modification in the PBOP decision to disallow z-factor treatment for PBOP expenses related to SFAS 106. CCLTC argues that PBOPs do not qualify as a z-factor because such PBOP costs are within management control, are a normal expense of doing business, do not disproportionately affect the LECs, and are included in the inflation index used in the NRF price cap formulas.

The SFAS 106 accounting change requires corporations to make elections regarding future health benefits for its employees. CCLTC states that these are the same types of decisions that have to be made by LECs under NRF. CCLTC further views the LECs' exercise discretionary control in deciding whether to fund PBOP obligations as further evidence that the costs are under the control of the LECs.

CCLTC argues that it is "fairly certain" that the costs associated with SFAS 106 were reflected in the inflation factor used in the NRF price cap index applicable to the LECs. CCLTC

claims that the inflation factor reflects U.S. corporate write-offs associated with SFAS 106. Accordingly, CCLTC believes that the NRF inflation factor has already compensated the LECs for the effects of SFAS 106, and that no z-factor treatment should be allowed.

B. Discussion

1. Introduction

The question before us is whether D.92-12-015 constitutes legal or factual error in authorizing z-factor treatment for the effects on PBOP costs resulting from adoption of SFAS 106. Although D.94-10-037 granted reconsideration of the issue of z-factor treatment of costs related to SFAS-106, no party requested hearings or challenged the completeness of the evidentiary record underlying D.92-12-015.[6] Accordingly, no additional hearings were held as a result of the reopening of this proceeding regarding the merits of z-factor eligibility. Therefore, the question of z-factor treatment shall be decided based upon the previously existing record and parties' filed comments.

As a basis for reconsidering whether z-factor treatment was appropriately ordered, it is useful to review how the z-factor was established, and the required criteria for its use. D.89-10-031, 33 CPUC2d 43 (1989), established a NRF for GTEC and Pacific. The NRF centered around a price cap indexing mechanism

6 In its March 28, 1995 Motion to Withdraw its request for hearings, Pacific argued that while there are certain factual issues raised by D.94-10-037 that are not addressed in the current I.90-07-037 record, Pacific agreed to address these factual issues in written declarations attached to its filed comments. Accordingly, Pacific attached to its opening comments two declarations, under penalty of perjury: One of the declarations provides an estimate of the 1989 PBOP accrual that would have existed if Pacific had adopted SFAS 106 in 1989, instead of 1993. The second declaration explained how the 1993 SFAS 106 TBO was calculated.

designed to protect both ratepayers and shareholders from risks that the indexing method may over- or underestimate revenue changes needed to keep the utilities financially healthy. At the same time, the price cap indexing mechanism placed on GTEC's and Pacific's management more responsibility to control their expenses and assume more risks in exchange for simplified regulation and an opportunity to earn higher rates of return.

The z-factor was established as the component of the price cap mechanism to protect both the ratepayers and shareholders against exogenous events which affect utility costs but are not reflected in an economy-wide inflation factor. The NRF decision concluded that only exogenous factors which are not reflected in the economy-wide inflation factor and which are clearly beyond the utility's control should be reflected in the z-factor in the price cap index (22 CPUC 2d at 228). That decision also recognized that the range of exogenous factors which could affect utility costs to an extent warranting explicit z-factor rate adjustments could not be foreseen completely.

We concluded in D.92-12-015 that the change in PBOP costs resulting from adoption of SFAS 106 represented an exogenous event qualifying for z-factor treatment. In granting the request of TURN to reconsider the issue of z-factor eligibility in D.94-10-037, we raised two questions to be considered, namely, whether PBOP costs recovered through the z-factor pursuant to D.92-12-015 were within management control, and whether those costs were normal costs of doing business. We shall address these questions below.

In arguing against z-factor treatment of PBOP costs, various parties also cited D.94-06-011 in which we refined the definition of exogenous costs and z-factor eligibility. We shall consider parties' arguments as to whether PBOP costs satisfy the refinement of z-factor criteria as elaborated in D.94-06-011. In D.94-06-011, we provided clarification as to the required criteria for z-factor eligibility. We stated that the utility must

demonstrate that a cost meets nine criteria before the cost is eligible for z-factor treatment. These criteria are: (1) the cost is the result of an exogenous event; (2) the event occurred after implementation of NRF; (3) the cost is clearly beyond management's control; (4) the cost is not a normal cost of doing business; (5)the event disproportionately impacts telephone utilities; (6) the cost is not reflected in the economy wide inflation factor; (7) the time has a major impact on the utility's costs; (8) actual costs can be used to measure the impact of the change, or the impact can be measured with reasonable certainty and minimal controversy; and (9) the costs proposed for z-factor treatment are reasonable.

If a cost fails to satisfy any single criteria listed above, we must disqualify it from z-factor treatment. In the following discussion, we limit our review to the z-factor criteria which were challenged by parties in their filed comments. We conclude that the SFAS 106 accounting change resulted in exogenous costs properly satisfying z-factor criteria, and that the PBOP z-factor adopted in D.92-12-015 was limited to the effects of the accounting change. For this reason, we conclude that the PBOP z-factor meets our criteria set forth in D.94-06-011, including the criterion that the cost clearly be beyond management control. Since we uphold the adopted PBOP z-factor, we need not consider alternative ratemaking options as outlined in D.94-10-037.

2. Controllability of PBOP Expenses

We stated in D.94-10-037 that strong arguments can be made that PBOP costs are within the utilities' control. We have carefully evaluated those arguments as reflected in parties' filed comments. No party disputed that utility management can exercise control over the operational determinants of PBOP costs. Moreover, D.92-12-015 clearly acknowledged that the LECs have the ability to control the day-to-day management of PBOP costs. As noted in Pacific's Attachment 1 to its June 9, 1995 comments, these

controllable factors changed each year between 1989 (the year when NRF was initiated) and 1993 (the year when accrual accounting took effect). Management decisions regarding the levels of employees and earned benefits between 1989 and 1993 influenced the amount of expense in 1993. To the extent that the utilities were able to control the inputs such as the level of staffing and/or terms of benefit packages, the resulting PBOP costs were subject to some degree of management control between 1989 and 1993. Likewise, while the TBO amortization recovers the cumulative accruals covering PBOPs earned prior to adoption of SFAS 106, the TBO accruals include the cumulative effects of controllable costs related to periods between 1989 and 1993. To this extent, the TBO amortization could include operational cost changes beyond what would have been allowed if accrual accounting had been adopted in 1989. Moreover, management could prospectively change the terms of benefit plans covering PBOP amounts earned prior to January 1, 1993. Accordingly, we recognize that the TBO represented at least some costs which were subject to management control over time. Accordingly, we affirm for purposes of this order that management has the ability to influence the day-to-day level of PBOP costs over time.

While we agree that the LECs exercise control over day-to-day changes in PBOP costs, such day-to-day changes are driven by operational factors separate and distinct from the accounting measurement change resulting from the adoption of SFAS 106 over which the LECs had no control. The fact that controllable factors are among the inputs to PBOP costs does not defeat z-factor eligibility, as long as changes in those controllable factors are excluded from the z-factor. We find no persuasive reason to reverse the finding of D.92-12-015 that the effects of SFAS 106 on PBOP costs constitute an exogenous event. The adoption of SFAS 106 was determined by external forces over which neither LEC was able to exercise management control.

Moreover, the choice of accounting measurement methodology causes no change in the underlying controllable factors which determine PBOP obligations. Whatever level of operational inputs are assumed, the means by which those inputs are measured for accounting purposes does not change the underlying inputs, themselves. Accordingly, assuming no change in controllable factors of production used to determine PBOP costs, the change to the SFAS 106 accounting methodology would still cause a change in PBOP costs merely due to differences in the manner in which cost inputs are measured for accounting purposes. Thus the argument that management controls the operational inputs which determine PBOP obligations--while true--does not mean that the cost change merely due to the use of a different measurement methodology is subject to management control.

We conclude, therefore, that the change in costs due to the change in accounting methodology under SFAS 106 were not subject to management control. We also conclude that there were separate costs explicitly attributable to the change in accounting measurement. This change in cost was due to the use of a different set of input assumptions required to measure a PBOP accrual as opposed to PBOP costs on a pay-as-you-go basis. The use of different input assumptions, however, does not change the values assigned to the relevant input assumptions.

We therefore conclude that as long as z-factor treatment is limited only to the effects of the accounting change and excludes controllable changes in operational factors of production, the z-factor control test is satisfied. We described the characteristics of a controllable event in D.94-06-011, pp. 74-75:

> "there will be circumstances in which an outside event requires the utility to take some action, but does not impose specific objectively determinable cost or wholly limit the utility's response to the event. In these circumstances, the utility may have the ability to respond on the event in a manner which limits the financial impact of the even. In sum, the

> utility may be able to control, and thus lessen, the adverse impact...By not allowing the Z factor treatment for events which, while imposing costs, are within management's control, we encourage economic efficiency." (Decision at 74-75.)

The effects of the SFAS 106 accounting change do satisfy the z-factor criteria cited above in that the accounting change is objectively determinable based on explicit FASB instructions regarding the manner in which PBOP costs are to be measured and accounted for. While the utility may exercise control to limit the financial effects of PBOP costs irrespective of accounting methodology, the utility cannot control how the PBOP costs are measured for accounting purposes for any given set of operational inputs. Thus, when applied strictly to the effects of the accounting change in this manner, the z-factor controllability criteria is satisfied.

We have made a similar distinction between controllable and uncontrollable cost effects with respect to other qualifying z-factor items. For example, D.89-10-031 listed "mandated jurisdictional separations" as a z-factor. Jurisdictional separation rules determine what portion of LECs' costs are considered intrastate versus interstate. While the LECs cannot control what separations rules apply to them, they can control the costs that are being separated. Accordingly, the z-factor "control test" applied to cost changes produced by new or changed separations rules, rather than to the underlying costs being separated. Under NRF procedures, the LECs are allowed a z-factor adjustment only for the effects of the cost change resulting from changes in the separations rules, but not for mere day-to-day changes in the underlying operating costs. Similarly, the z-factor control test for PBOP costs rightly applies to control over PBOP cost changes produced by the accounting rule change resulting from adoption of SFAS 106. Moreover, our NRF policy established in

D.89-10-031 for qualifying z-factor criteria explicitly include "[c]hanges to...accounting procedures adopted by this Commission." (46 CPUC2d at 526.)

The more essential question, however, is whether the actual costs captured in the z-factor adopted by D.92-12-015 were in fact properly limited solely to the exogenous change in accounting measurement methodology. As explained below, we conclude the z-factor was properly limited to the change due to accounting differences. To understand why this is so, we must review how the change in PBOP costs used to determine the z-factor adopted in D.92-12-015 was computed. The z-factor reflected the difference in PBOP costs using 1993 data under (1) an accrual method versus (2) a pay-as-you-go method.

We agree with Pacific and GTEC that the transition from cash-basis to accrual accounting was a one-time event, and we captured this discrete event in our z-factor. In quantifying the z-factor for PBOP costs as adopted in D.92-12-015, we acknowledged the need to exclude the effects of ongoing controllable activity level increases underlying PBOP expenses from the z-factor. In measuring this exclusion, however, we had no adopted ratemaking allowance reflecting the operating inputs required under PBOP accrual accounting (since accrual accounting was not in effect in 1989, the year we established the NRF startup revenue requirement.) Thus, we had no adopted startup revenue requirement benchmark for segregating the pure accounting change while holding controllable operational assumptions constant between 1989 and 1993. While assumptions regarding controllable factors of production were incorporated into NRF rates in the process of establishing the PBOP startup revenue requirement in 1989, the inputs used were those required to compute pay-as-you-go costs.

Therefore, to avoid capturing any ongoing controllable increase in PBOP costs in the z-factor, we limited the z-factor strictly to the difference between what was required under accrual

accounting and what the pay-as-you-go costs otherwise would have been for actual 1993 operations. As the starting point for determining any PBOP cost change attributable to SFAS 106, we therefore used the level of pay-as-you go costs for the year 1993. The resulting z-factor only captured the incremental change in costs due to substituting accrual accounting instead of pay-as-you-go as the algorithm for computing accounting expenses. By starting the calculation with 1993 cost levels, we effectively excluded the effects of any changes in PBOP operational costs which occurred between 1989 (the year when NRF was initiated) and 1993 (the year the PBOP z-factor took effect). By limiting the z-factor only to the difference between these two accounting methods as a one-time change while holding all other controllable factors constant, we effectively excluded from the rate adjustment the effects of controllable factors underlying PBOP costs incurred between 1989 and 1993 from the PBOP z-factor due to any factor other than the SFAS 106 accounting change.

We conclude that the 1993 z-factor is the best quantification of the accounting change since it is based on contemporaneous 1993 information. It would be speculative at best to try to precisely recreate a 1989 PBOP accrual. Moreover, we stated in D.92-12-015 that the difference between pay-as-you-go versus accrual accounting may decrease over time. To the extent this is so, any z-factor allowance would be less over time than an adjustment for SFAS 106 in the original 1989 startup revenue requirement. In any event, the 1993 z-factor did not pass on controllable cost increases to ratepayers. We therefore conclude that the computed z-factor was a reasonable measure of the SFAS 106 accounting change, exclusive of controllable factors.

3. <u>Controllability of PBOP Trust Funding</u>

In D.94-10-037, we also raised the question of whether the NRF utilities' discretion over whether to fund PBOP trusts was an indicator of control over PBOP costs. Although NRF utilities

are not required to make any contributions to PBOP trusts, the NRF utilities were authorized z-factor recovery to the extent they make certain tax-deductible contributions to those trusts.

ORA and others argue that because the utility's method of funding its PBOP obligation is not mandated by SFAS 106, the cost of the PBOP obligation is within management's control. We find a distinction, however, between the funding of the obligation and the incurrence of the obligation. The cost of the PBOP obligation as determined by accrual accounting under SFAS 106 must not be confused with the financing of that cost. The total cost of the PBOP obligation is not changed by the manner in which a utility may choose to finance that obligation during a given accounting period. If a utility reduces its current PBOP funding, it must correspondingly increase its liability for unfunded PBOP costs. Thus, there is no net change in the total PBOP expense or liability as a result of funding decisions.

We conclude that while management has the discretion to fund PBOP costs on a pay-as-you-go basis, this discretion does not enable management to control the level of PBOP obligation, itself. The control over the financing of PBOP costs relates to how the PBOP obligation is paid for, not what the PBOP obligation amount is. Financing is a wholly separate activity from the incurrence of the cost, itself. The accrued PBOP expenses required under SFAS 106 cannot be diminished merely by refraining from providing current funding for them. The test for z-factor eligibility involves control over the level of expenses, not control over the level of financing.

While the manner of funding does not control the magnitude of PBOP obligations or current PBOP expenses, it does relate to the level of PBOP expenses which may be recouped as a z-factor adjustment. In D.92-12-015, we limited z-factor recovery only to PBOP amounts invested in a Voluntary Employee Benefit Association (VEBA). The relationship between PBOP funding and

eligibility for ratepayer reimbursement, however, has been externally imposed by the Commission's own rules. The Commission's rules limiting z-factor recovery to VEBA-funded PBOP costs do not enable the utilities to control the total level of PBOP expenses or obligations, themselves, as determined under SFAS 106.

Rather, the restriction enabled the Commission to control the portion of PBOP costs which the utilities may recover as determined by Commission rules concerning PBOP funding, and to limit recovery only to that portion of those costs for which funding is made.

As explained in D.92-12-015, this restriction was adopted to prevent the utilities from recovering any controllable costs through the z-factor and to preserve the same risks and incentives that previously existed under the "pay go" accounting rules. As we stated:

> "...if we retained pay-as-you-go accounting, any increase in pay-as-you-go costs would not be entitled to Z factor treatment. Therefore, the NRF utilities' additional recovery for PBOP costs through the Z factor should be limited to the difference between what is required by accrual accounting and what their pay-as-you-go costs otherwise would have been."

The decision of the utility as to whether to fund PBOP has no effect on the magnitude of PBOP costs incurred. The determination of accrued PBOP expenses is separate and independent of the manner in which future PBOP obligations are financed. PBOP expenses cannot be controlled by reducing the amount of currently funded PBOP expenses. Accordingly, we conclude that control over PBOP Trust Funding does not disqualify the SFAS 106 cost change from z-factor treatment.

4. Normal Cost of Business

In our order granting rehearing, we stated that strong arguments can be made that the shift to accrual accounting for PBOP are simply normal costs of doing business. These arguments involve

the fact that all businesses which offer post-retirement employee benefit plans are affected by the accounting changes required under SFAS 106. If we find that the effects of SFAS 106 are merely part of the "normal costs of doing business," then they are not eligible for z-factor treatment. While all companies, not just telephone utilities, have switched to accrual accounting for PBOP costs, this fact alone does not persuade us that the "normal cost of doing business" test has been satisfied. Industries generally are free to adjust their prices to reflect economic costs of doing business, regulated industries such as the telephone utilities are constrained in their ability to adjust prices to recognize economic costs.

We are persuaded by the testimony of Pacific witness Taylor (in Exhibit 52, p.11) that for unregulated firms, the supply curve reflects the economic cost of PBOPs regardless of their accounting treatment. Thus, it is reasonable to conclude that the effects of the SFAS 106 PBOP accrual were already generally taken into account in market prices for unregulated competitive firms. Merely because a business does not establish a separately identified fund to finance the payment of future employee benefits, there is no factual basis to necessarily infer that the business is unaware of that cost or has failed to incorporate the expected cost of those future obligations in its current prices. Accordingly, because there was no effect generally on prices of unregulated firms, the effects of SFAS 106 was a normal cost of business for such firms.

Pacific and GTEC, unlike the unregulated business sector, is subject to NRF price regulation by this Commission. While the NRF procedure involved a departure from strict reliance on accounting-driven costs as the determinant of LEC prices, NRF incorporated a startup revenue requirement which did not immediately or completely decouple LEC prices from accounting costs. Moreover, as noted previously, when we established the

initial startup revenue requirement under the NRF in 1989, we explicitly denied Pacific's request to reflect pending changes in accounting rules related to PBOP because the change had not yet been mandated by the FASB.

Thus, unlike unregulated firms which were not prohibited by a regulatory authority from incorporating the economic costs of PBOPs in its prices, the LECs, even under NRF, were still subject to setting their startup revenue requirement based upon recorded costs which were based on pay-as-you-go accounting. Unlike unregulated firms, the LECs were unable to adjust their prices to reflect the true economic costs of PBOPs either before or after the effective date of SFAS 106 absent authorization from this Commission. Accordingly, the distinction in pricing flexibility between the regulated LECs versus unregulated competitive firms indicates that the effects of SFAS 106 was outside of the normal course of business for the LECs.

5. <u>Effects Of PBOP Costs On NRF Inflation Index</u>

Although CCLTC claims that the NRF price cap inflation index reflects the increased costs associated with the adoption of SFAS 106, it provides no citation to the evidentiary record. We find no support for CCLTC's claim in the evidentiary record. CCLTC claims that corporate write-offs relating to SFAS 106 are measured in the GDPPI. The GDPPI measures firms output prices, not their reported expenses (Exh. 51, Att. p. 8). Since unregulated firms with PBOP costs already reflected the economic cost of PBOPs in their output prices prior to SFAS 106, there is no basis to expect a significant change in GDPPI as a result of SFAS 106. Consequently, we found no basis to change the findings on this issue in D.92-12-015.

Our analysis of the evidence already presented in the prior hearings in this proceeding led us to conclude that the GDPPI will be impacted minimally. (Dr. Taylor (for Pacific) Exh. 52, pp. 22-27; Mr. McLeish (for GTEC) Exh. 68, pp. 3-7; Dr. Abel (for GTEC)

Exh. 69, pp. 3-7; Dr. Shankerman (for GTEC) Exh. 91, pp. 12-15). This analysis of the evidence also leads us to conclude that the recovery of the accrual required by adopting [SFAS 106] with modification through the z-factor will not provide the utilities with any measurable double recovery through the GDPPI adjustment (46 CAL PUC2d at 528).

Likewise, TURN's claimed analogy between our treatment of the cost of capital in the 1992 Review with the treatment of SFAS 106 costs in this proceeding involves an inconsistent comparison. We did not decrease rates to reflect cost of capital changes in the 1992 review proceeding because cost of capital is an input price that affects the output prices of all companies in the economy. Consequently, changes in the cost of capital are reflected in the NRF price cap inflation index. By contrast, the inflation index did not reflect SFAS 106 costs for the reasons discussed above.

6. Conclusion

Based on our analysis of z-factor criteria above, we conclude that the z-factor allowances for PBOP accounting changes granted in D.92-12-015 were consistent with our NRF framework and should be upheld. We must balance two countervailing principles underlying NRF rules. On the one hand, NRF is intended to hold utility management financially responsible for costs over which they exercise control. Consequently, the utility is at risk for changes in costs which may not be recoverable as a rate adjustment. On the other hand, NRF is intended to allow for limited rate adjustments to allow rates to generally conform to economic reality. As we stated D.89-10-031, in designing NRF, we intended that "rates to which the [NRF] index is applied form a reasonable starting point for determining rates for the upcoming year..." (33 CPUC2d at 190).

Economically realistic price signals are important in promoting economically efficient behavior particularly in a competitive market. Consequently, it is appropriate to authorize

an adjustment for the effects of SFAS 106 through the z-factor. Failure to do so would ignore the reality of accrual accounting for ratemaking purposes. We disagree with ORA that the change in costs due to SFAS 106 adoption has no impact on the utility's economic costs merely because the SFAS 106 accounting change had no impact on employee/employer PBOP contracts. The economic effects of SFAS 106 were particularly felt because we explicitly precluded the NRF utilities from reflecting the economic costs related to PBOP accrual accounting in their 1989 startup revenue requirements.

We used cash-basis accounting rules in our determination of the LECs' 1989 startup revenue requirement for PBOPs when NRF was initiated. Although Pacific requested that the 1989 startup revenue requirement reflect the change from cash to accrual accounting for PBOP costs, we rejected the request for two reasons: (1) it was not an adjustment to 1989 results and (2) since the FASB has not yet mandated the change, it did not meet the criteria as an exogenous factor for inclusion in the 1990 price cap indexing mechanism.

Our stated reasons for denial of Pacific's 1989 request had to do with the artifact of regulatory timing of NRF implementation. We gave no indication that the change in PBOP accrual accounting would be economically inconsequential or ineligible for recovery once SFAS 106 became effective. If such were the case, the question of timing would have been moot.

We recognized the importance of generally accepted accounting principles as a relevant measure of ratemaking costs for NRF utilities in our original NRF decision (D.89-10-031). We explicitly included "[c]hanges to...accounting procedures adopted by this Commission" as a qualifying z-factor adjustment. (46 CPUC2d at 526). In D.94-10-037, we found the accounting effects of SFAS 106 significant enough to adopt its provisions for NRF utilities. We stated in D.94-10-037 that "failure to recognize PBOP liabilities as they are incurred would be misleading. In short,

because we agree with the FASB that accrual accounting for PBOP costs more accurately reflects financial reality, we conclude that it should be adopted for NRF utilities." (Decision at 6.) If we were to ignore the accounting effects of SFAS 106 for ratemaking purposes even while mandating its adoption for accounting purposes, we would create an anomaly between our own adopted accounting and ratemaking policies as applied to the LECs.

Accordingly, we conclude that NRF rates should reflect the effects of PBOP accrual accounting for both ratemaking and accounting purposes. It is consistent with the principles underlying NRF to provide rate recognition of the effects of the SFAS 106 accounting change as long as we preserve management's incentive to control costs and adhere to our adopted z-factor criteria. We, therefore, affirm the order in D.92-12-015 authorizing a z-factor for the effects of the SFAS 106 accounting change, and deny the request of TURN to modify the decision.

We also stated in D.92-12-015 that we would consider revising the PBOP z-factor after 1993 to avoid the possibility of utilities earning windfalls from declining PBOP accrual funding requirements. We provided explicitly for subsequent annual z-factor adjustments to capture anticipated declines in the PBOP accrual requirements and to pass the savings to ratepayers over time. As we noted in D.92-12-015:

> "It appears that the difference between the amount required for PBOP costs under accrual accounting and the amount required under pay-as-you-go accounting may decrease over time. Indeed, we have earlier noted evidence that the cost of an accrual plan would eventually be less expensive than a pay-as-you-go plan. Therefore, we should not authorize NRF utilities to recover as a permanent z-factor the increase in rates for PBOP necessary during the first year. Accordingly, it appears that yearly adjustments to the z-factor for PBOP costs will be required. Our decision today will order such annual adjustments." (Id. 528.)

We indicated that we would determine the simplest method for annually revising the amount of PBOP recovery without extensive litigation. We shall consider how to address this matter further by separate order.

Findings of Fact

1. D.92-12-015 approved SFAS 106 for ratemaking and accounting purposes for utilities generally.

2. SFAS 106 required that the accounting for PBOP costs be changed from a cash to an accrual basis.

3. The startup revenue requirement adopted for the NRF utilities in 1989 included a provision for PBOP costs based only upon the cash basis of accounting for such costs.

4. D.92-12-015 also authorized the recovery by Pacific and GTEC of costs associated with SFAS 106 accounting changes as a z-factor under NRF.

5. D.92-12-015 concluded that the change in PBOP costs resulting from adoption of SFAS 106 represented an exogenous event beyond management control which qualified for z-factor treatment.

6. D.94-10-037 reopened the proceeding to reconsider whether the change in PBOP costs associated with the adoption of SFAS 106 accounting standards met the requisite criteria for z-factor treatment as found by D.92-12-015.

7. D.94-10-037 directed that reconsideration of z-factor treatment should specifically address whether the PBOP cost changes associated with SFAS 106 are (1) within utility management control, and (2) are simply normal costs of doing business.

8. In the event the Commission were to conclude that the treatment given to PBOP costs in D.92-12-015 does not justify z-factor treatment, D.94-10-037 directed that a range of options be considered as to what ratemaking changes to order.

9. The criteria for z-factor eligibility under NRF were originally set forth in D.89-10-031 and were subsequently elaborated upon in D.94-06-011 (the 1992 NRF Review Decision).

10. D.94-06-011 adopted nine criteria determining z-factor treatment which essentially clarified the general principles underlying z-factor treatment adopted in D.89-10-031.

11. ORA evaluated only the following three of the nine criteria for z-factor eligibility set forth in D.94-06-011 since failing to satisfy even one would constitute ineligibility for z-factor treatment:

a. Costs must be the result of an exogenous event.

b. Costs must be beyond management control.

c. Costs must be outside the ordinary cost of doing business.

12. NRF is designed to require the utility to manage its own costs in order to provide it with the incentive to achieve higher returns while compensating for costs beyond utility control to keep rates aligned with costs.

13. Z-factor treatment of the SFAS 106 accounting change is consistent with the Commission's "control" criterion articulated in the 1992 NRF Review Decision.

14. The change of accounting methodology under SFAS 106 causes no change in the underlying controllable factors which impact PBOP obligations.

15. While management controls the operational inputs which impact PBOP obligations, it could not control the PBOP cost change merely due to the change in accounting methodology under SFAS 106.

16. There were higher costs due to the change from pay-as-you-go to accrual accounting in 1993 even when controllable costs are held constant due to the use of a different set of input assumptions.

17. The LECs' ability to control day-to-day changes in PBOP costs can be distinguished from the lack of control over the specific change in costs resulting from the adoption of SFAS 106.

18. Under PBOP accrual accounting, PBOP expense is composed

of: (1) the prospective PBOPs earned by current employees and (2) the amortization of the TBO.

19. The majority of the z-factor amount for PBOP costs was due to the required 20-year amortization of the TBO and the related interest which represented benefits earned but not accrued prior to the adoption of SFAS 106.

20. Both Pacific's and GTEC's employee contracts contain clauses that reserve management's rights to unilaterally terminate or reduce PBOPs applicable to all past, present, and future service.

21. Discretion over employee contracts permits management to control the TBO obligation both prospectively and retroactively.

22. The question of whether failure to recover a cost will produce a detrimental financial impact on the utility is not one of the adopted criteria for testing z-factor eligibility.

23. SFAS 106 applies to all businesses which offer employee benefit plans and is not limited exclusively to utilities or telecommunications service providers.

24. The z-factor treatment for SFAS 106 costs is analogous to the treatment of "mandated jurisdictional separations" as a z-factor.

25. While the LECs cannot control what separations rules apply to them, they can control the underlying costs that are being separated.

26. Similarly, the z-factor control test applies to PBOP cost changes resulting from adoption of SFAS 106, not the underlying PBOP costs to which SFAS 106 applies.

27. Established NRF criteria for qualifying z-factor treatment include changes to accounting procedures adopted by this Commission.

28. The economic impacts of SFAS 106 were significant enough to compel us to adopt SFAS 106 for accounting purposes for NRF utilities in D.94-10-037.

29. Accrual accounting for PBOP costs more accurately reflects financial reality than pay-as-you-go accounting, as found in D.94-10-037.

30. The SFAS 106 change in accounting rules applicable to PBOPs had a bearing on the economic condition of the LECs.

31. Although NRF utilities are not required to make any contributions to PBOP trusts, the NRF utilities were authorized z-factor recovery to the extent they do make certain tax-deductible contributions to those trusts.

32. The utility's method of funding its PBOP obligation is not mandated by SFAS 106.

33. The funding of the PBOP obligation and the incurrence of the accrued PBOP obligation are two independent actions.

34. The cost of the PBOP obligation is not changed by the manner in which a utility may finance that obligation.

35. While management has the discretion to fund PBOP costs on a pay-as-you-go basis, this discretion does not enable management to control the level of PBOP obligation, itself.

36. The test for z-factor eligibility involves control over expenses, not control over the level of financing.

37. While the manner of funding does not control the magnitude of PBOP obligations or expenses, it does relate to the level of PBOP expenses which may qualify as a z-factor.

38. D.92-12-015 limited z-factor recovery only to PBOP amounts invested in a VEBA.

39. The relationship between PBOP funding and eligibility for ratepayer reimbursement has been externally imposed by the Commission's own rules.

40. The Commission's rules limiting z-factor recovery to funded PBOP costs do not enable the utilities to control the total level of PBOP expenses or obligations, themselves.

41. If the effects of SFAS 106 were part of the normal costs of doing business, then they would not be eligible for z-factor treatment.

42. For competitive firms, the supply curve reflects the economic cost of PBOPs regardless of their accounting treatment.

43. While all businesses which offer post-retirement employee benefit plans are subject to the accounting rules under SFAS 106, the effect of the SFAS 106 PBOP accrual has already generally taken into account in market prices for competitive firms prior to its adoption.

44. It is not necessary for a business to establish a separately identified fund to finance the payment of future PBOPs to infer that the business has incorporated the expected cost of those future obligations in its current prices.

45. Pacific and GTEC, unlike the unregulated business sector, were subject to regulatory limitations on the amount of PBOP costs which it could recover under the NRF procedure adopted in 1989.

46. While the NRF procedure involved a departure from strict reliance on accounting-driven costs as the determinant of LEC prices, NRF did not immediately or completely decouple LEC prices from accounting costs.

47. The initial startup revenue requirement under the NRF in 1989, explicitly excluded pending changes in accounting rules related to PBOP because the change had not yet been mandated by the FASB.

48. CCLTC provides no citation to the evidentiary record for its claims that the NRF price cap inflation index reflects the increased costs associated with the adoption of SFAS 106.

49. The GDPPI measures firms output prices, not their reported expenses (Exh. 51, Att. p. 8).

50. Since unregulated firms with PBOP costs already reflected the economic cost of PBOPs in their output prices prior to SFAS

106, there is no basis to expect a significant change in GDPPI as a result of SFAS 106.

51. Changes in PBOP costs due to SFAS 106 are not already captured in the NRF price cap GDPPI index, thus a z-factor adjustment for such PBOP cost changes would not constitute double recovery.

52. TURN's claimed analogy between the Commission's treatment of the cost of capital in the 1992 Review with the treatment of SFAS 106 costs in this proceeding involves an inconsistent comparison.

53. The reason why rates were not decreased to reflect cost of capital changes in the 1992 review proceeding was because cost of capital is an input price that affects the output prices of all companies in the economy.

54. Changes in the cost of capital are reflected in the NRF price cap inflation index, unlike SFAS 106 costs.

55. The PBOP cost changes for which z-factor treatment was granted in D.92-12-015 reflected the difference between what would have been reflected on the LECs books in 1993 with and without SFAS 106.

56. The difference in PBOP cost between accrual and pay-as-you-go accounting would not necessarily be precisely the same in 1989 as in 1993, but still represents a reasonable measure of the effects of SFAS 106.

57. D.94-06-011 requires the z-factor costs be determined with reasonable certainty and minimal controversy.

58. While the NRF utilities incur upfront costs of PBOP funding, accrual amounts are expected to decline over time.

59. D.92-12-015 called for consideration of subsequent annual adjustments in the z-factor to guard against the utilities realizing any windfalls due to anticipated declines in PBOP accruals in future years.

Conclusions of Law

1. Parties were provided the opportunity to be heard and to present evidence in response to the reopening of this proceeding as directed in D.94-10-037.

2. Since all parties agreed that the record in Phase II of this proceeding was already complete regarding the merits of z-factor treatment for PBOP costs, no evidentiary hearings were necessary to dispose of the issues reopened pursuant to D.94-10-037.

3. If a cost fails to satisfy any single criteria listed in D.94-06-011, it does not qualify for z-factor treatment.

4. The fact that controllable factors impact PBOP costs does not defeat z-factor eligibility for SFAS 106 accounting changes as long as changes in controllable factors are excluded from the z-factor.

5. The PBOP z-factor should be limited to changes in the accounting measurement of PBOP costs.

6. The PBOP z-factor adopted in D.92-12-015 reasonably meets the criteria set forth in D.94-06-011.

7. In conformance with D.94-10-034, alternative ratemaking options should be considered only to the extent that the z-factor authorized in D.92-12-015 did not satisfy the adopted z-factor criteria.

8. It would be inconsistent with NRF to disallow SFAS 106 cost impacts since doing so would ignore the reality of accrual accounting for ratemaking purposes.

9. A rate allowance is appropriate to reflect the effects of PBOP accrual accounting for both ratemaking and accounting purposes.

10. It is consistent with NRF to provide rate recognition of the effects of the SFAS 106 accounting change as long as management's incentive to control costs is preserved and z-factor criteria are met.

11. Because D.95-10-018 prescribed that any refunds which might be ordered pursuant to the reopening of the PBOP z-factor issue could only cover the period subsequent to issuance of D.94-10-037, no ratemaking adjustments to the PBOP z-factor for prior periods may be adopted prior to that date in any case. As determined in D.95-10-018, any rate adjustments prior to this date would constitute retroactive ratemaking.

12. The rates to which the NRF index is applied should form a reasonable starting point for determining rates for the upcoming year.

13. Realistic price signals are important in promoting economically efficient behavior particularly in a competitive market.

14. Requiring the NRF utilities to fund independent trusts to provide PBOP benefits is neither appropriate nor necessary to satisfy z-factor criteria.

15. It would be unduly speculative to attempt to determine a recalculation of Pacific's and GTEC's 1989 startup revenue requirement.

INTERIM ORDER

IT IS ORDERED that:

1. The Petition for Modification of Decision 92-12-015 filed by The Utility Reform Network is hereby denied.

2. The z-factor allowance for the 1993 PBOP accounting change is hereby upheld.

This order is effective today.

Dated April 9, 1997, at San Francisco, California.

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