

Decision **ALTERNATE PROPOSED DECISION OF COMMISSIONER KENNEDY**  
(Mailed 8/29/03) (Revised September 23, 2004)

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking on the  
Commission’s Own Motion to Assess and Revise  
the New Regulatory Framework for Pacific Bell  
and Verizon California Incorporated.

Rulemaking 01-09-001  
(Filed September 6, 2001)

Order Instituting Investigation on the  
Commission’s Own Motion to Assess and Revise  
the New Regulatory Framework for Pacific Bell  
and Verizon California Incorporated.

Investigation 01-09-002  
(Filed September 6, 2001)

**INTERIM OPINION REGARDING PHASE 2B AUDIT ISSUES**

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**INTERIM OPINION REGARDING PHASE 2B ISSUES**

**I. Summary**

This decision acts on portions of an audit of Pacific Bell Telephone Company (Pacific)<sup>1</sup> that the Commission conducted as part of its oversight of the “New Regulatory Framework” (NRF). We find that a number of audit findings are justified and that in some instances Pacific over-reported expenses. In other situations, we find that Overland misinterprets Commission policies concerning the accounting treatment of Pacific’s expenses. Although we find evidence of accounting errors and misinterpretations of Commission policy, we do not find any evidence of fraudulent action by Pacific.

The NRF framework, implemented in 1990,<sup>2</sup> relaxed regulation of certain large telephone companies in California in exchange for assurances regarding service quality, protection of ratepayer funds, and other measures. This phase of the proceeding (Phase 2B) examined all but the four largest issues presented in that audit; Phase 2A examined those four issues and was the subject of a separate decision, D.04-02-063, issued previously.

Phase 2B examined 68 accounting issues identified by Overland for scrutiny in this proceeding. As a result of Overland’s review of these 68 issues,

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<sup>1</sup> Pacific has since changed its name to SBC. Because we discuss activities of SBC, Pacific’s parent company, in this decision, we use the name Pacific to identify the regulated telephone company for the sake of clarity.

<sup>2</sup> Decision (D.) 89-10-031, 1989 Cal. PUC LEXIS 576, 33 CPUC 2d 43 (1989), 107 PUR 4<sup>th</sup> 1 (1989).

Overland proposed adjustments in Pacific's revenues of \$625.3 million and adjustments in Pacific's ratebase of \$2134.7 million.

In 1997 and 1998, Pacific was under an obligation to share earnings above a certain threshold with ratepayers. Despite the errors identified here and in the Phase 2A of this proceeding, the adjusted earnings did not rise to a level that requires Pacific to share earnings with ratepayers in 1997 or 1998. The calculations that lead to the determination that no sharing takes place are contained in Appendix G.

Certain parties participating in this proceeding have asked that we reverse our decision to suspend sharing in 1999 on the ground that Pacific misled us into making it. We do not find sufficient evidence to support this allegation. Therefore, while we require Pacific to remedy its earnings reporting for 1999, the changes we order do not require ratepayer sharing in that year.

The audit errors that we find in this decision are summarized in Appendix H.<sup>3</sup> In addition, we require Pacific to prepare schedules that identify each of this decision's adopted errors and demonstrate that it has or will properly correct its reporting, consistent with GAAP procedures. In particular, unless otherwise

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<sup>3</sup> The parties also presented joint schedules of 1) the audit adjustments (disputed and undisputed) and 2) the issues in dispute in this proceeding, showing the parties' various positions on the issues resolved in this decision. These schedules appear as Appendix B ("Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997-1999") and Appendix C hereto. As to Appendix B, the amounts reported there may disagree with Appendices D and E to the Phase 2A decision, and Appendix A to this decision, to reflect the impact of taxation. Each Appendix is cross-referenced by issue number so parties can track issues across appendices.

noted, the timing of the adjustments should be made consistent with GAAP standards.<sup>4</sup> Pacific shall file the schedules, along with supporting documentation, as a compliance Advice Letter filing due no later than 90 days after the effective date of this decision.

## **II. Background on Phase 2A**

### **A. Audit Scope**

When the Commission instituted NRF, it prescribed periodic audits of Pacific. The audits would serve to verify, among other things, that Pacific's financial reporting was accurate, that it was not subsidizing its non-regulated businesses with funds from the regulated local telephone company, and that to the extent ratepayers were to share in Pacific's earnings, Pacific was reporting those earnings correctly. The Order Instituting Rulemaking (OIR) commencing this proceeding identified the follow issues for the Pacific Bell audit:

The scope of the audit is as follows: (1) analyze Pacific's NRF monitoring reports; (2) analyze Pacific's cost allocations and accounting practices and procedures that were established to protect against cross subsidization and anti-competitive behavior; (3) determine whether Pacific and its affiliates are following the Commission's rules for affiliate transactions; (4) determine whether Pacific is properly tracking and allocating costs related to non-regulated activities; and (5) determine whether non-structural safeguards adequately protect ratepayer and competitor interests with respect to non-regulated activities. (D.96-05-036, 66 CPUC 2d 274, 278,

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<sup>4</sup> The schedules in Appendices A, G, H, I, and J are provided for illustrative purposes only and do not reflect the use of GAAP timing that is generally ordered throughout this decision.

and OPs 3 and 4; and Executive Director letter dated September 18, 1998).<sup>5</sup>

Furthermore, the scope of this audit was a source of controversy for some time. In D.00-02-047, the Commission acted to clarify the scope of the audit, stating:

[T]he winning proposal . . . provides the firmest quantitative evidence that the scope of the audit has expanded beyond that of the compliance audit envisioned in D.96-05-036. . . [The] Commission rejected an ALJ proposed decision that would have made this audit subject to P.U. Code § 797 (affiliate transactions) as well. Pacific points out that the winning RFP nevertheless allots 58% of total consulting time to the analysis of affiliate relations, a figure inconsistent with the Commission's order. . . This scope of audit makes little sense for a company subject to price cap regulation and for which 'profit sharing' no longer is in effect.<sup>6</sup>

Thus, the Commission reiterated its concern that the audit ensure compliance with past Commission policies, and that the scope of the audit would be tempered by the fact that "price cap" regulation diminishes the policy significance and frequently eliminates any rate effect of many specific accounting calls.

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<sup>5</sup> Rulemaking (R.) 01-09-001/Investigaton (I.) 01-09-002, Appendix A.

<sup>6</sup> D.00-10-004 with attached corrected redline of D.00-02-047, *mimeo*, p. 7.

**B. Involvement of Commission's Telecommunications  
Division (TD) and Office of Ratepayer Advocates (ORA)**

ALJ Timothy Kenney,<sup>7</sup> who handled Phases 1 and 2A of this proceeding, explained TD's role in a discovery ruling:

TD is not a party to this proceeding, but a division of the Commission that advises decision makers. TD's task in this proceeding has been to manage an audit that was ordered by the Commission. The auditors are not expert witnesses hired by a party to this proceeding, but consultants retained by the Commission to perform work that -- given more time and resources -- TD could have performed itself.<sup>8</sup>

During the audit, ORA also sought and was granted permission to conduct its own discovery examining Pacific's actions on issues covered by the audit. Ultimately, Overland presented its audit at hearing, TD managed Overland's contract and facilitated interaction between auditors and Pacific, and ORA actively pursued various issues raised in the audit.

**C. Findings of Overland Audit**

Overland prepared an audit report that was admitted into evidence during Phase 2A of this proceeding.<sup>9</sup> In the report, Overland stated that it:

identified 67 corrections [increased by the Supplemental Audit Report<sup>10</sup> to 72<sup>11</sup>] to Pacific Bell's regulated operating

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<sup>7</sup> ALJ Sarah R. Thomas conducted the Phase 2B hearings in this proceeding.

<sup>8</sup> *Administrative Law Judge's Ruling Regarding Pacific Bell's Motion to Confirm its Right to Conduct Depositions*, dated May 14, 2002, at 5-6.

<sup>9</sup> Exhibit (Exh.) 2A:404.

<sup>10</sup> Exh. 2B:415 (Supplemental Audit Report).

<sup>11</sup> See Exh. 2B:409 at 5:9-13 (Welchlin Opening Testimony).

revenues, expenses and rate base. Audit corrections to bring financial results into compliance with CPUC requirements increased the regulated intrastate net operating income that Pacific Bell reported during the audit period by \$1.94 billion. This translates into recommended customer refunds under NRF earnings sharing rules of \$349 million for the years 1997 and 1998. NRF earnings sharing rules were suspended by the CPUC effective in 1999. Customer refunds would have totaled \$457 million if the sharing rules had been effective.<sup>12</sup>

#### **D. Phase 2A vs. Phase 2B**

We addressed approximately two-thirds of the audit dollar results – attributable to four issues – in the Phase 2A decision, D.04-02-063. As a consequence, no possible actions taken in this decision could lead to an outcome that requires Pacific to share earnings with ratepayers. Nevertheless, we believe that it is important to resolve those accounting issues that fall into this part of the audit proceeding.

### **III. General Issues**

#### **A. Pacific's Books and Generally Accepted Accounting Principles**

Pacific contends that even if we agree with the audit on an adjustment – or Pacific concedes that the auditors' findings are correct – it does not automatically follow that Pacific's California books<sup>13</sup> should be restated in the year in which the error occurred. Rather, Pacific claims that, in certain cases, Generally Accepted

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<sup>12</sup> We explained earnings sharing, and the NRF structure, in our OIR, and incorporate that explanation here.

<sup>13</sup> Pacific's California earnings report is entitled the Intrastate Earnings Monitoring Report (IEMR).

Accounting Principles (GAAP) allow adjustment only in the year in which the error was discovered. Because the audit did not take place until 2001, following Pacific's reasoning, the adjustments would occur after the audit period (and after the Commission suspended earnings sharing) and not result in ratepayer sharing.

We disagree that this is the only proper means of reflecting the audit changes. In particular, although we look to GAAP for guidance on any specific accounting issue, the entire premise behind the "sharing" of earnings is that we have an accurate picture of Pacific's revenues and costs in the year under review.

Pacific explains that its so-called "FR" books (its witness could not explain the origin of this acronym) are the starting point to create the Intrastate Earnings Monitoring Reports (IEMRs). The IEMRs are the reports directly at issue in this proceeding, as they contain Pacific's California results in the format ordered by the Commission. Historically, the FR books were Pacific's externally reported results, used for Securities and Exchange Commission (SEC) purposes, and thus were governed by GAAP. Even though Pacific started using another set of books – the "ER" books (again, the witness could not explain the acronym) – for external reporting purposes in 1995, it continued thereafter to maintain the FR books in order to produce the IEMR. At that time, Pacific simply "froze . . . the accounting requirements for the FR books, and . . . continue[d] to maintain the FR books on exactly the same basis that they were prior to that set of new

external [books] being developed.”<sup>14</sup> Any GAAP changes instituted after 1995 are not reflected in the FR books. The only purpose of the FR books after 1995 was to create the IEMR.<sup>15</sup>

Pacific concedes that “[t]he Commission has the power to order Pacific to keep its regulatory books in any manner, limited only by the law.” Nonetheless, it claims that anything that results in an adjustment to the FR must follow GAAP: “Because the FR books are kept pursuant to GAAP, where errors have occurred, the corrections to those errors must conform to GAAP.”

Still, Pacific concedes that even under its reasoning, “material” errors might be recorded in the year they occurred: “the adjustments Pacific does not challenge would appropriately be included in the FR books, and should be reported in calendar year 2002 *because they have no material effect* on the previously reported FR financial results for years 1997, 1998, and 1999.”<sup>16</sup> And Pacific also admits that “where an error occurred outside of the FR books, but in the IEMR calculation process, [Accounting Practices Board Opinion] 20<sup>17</sup> [setting forth the requirement under GAAP that a change in an estimate should not be accounted

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<sup>14</sup> 15 RT 1637:10-14 (Wells). We refer to the hearing transcript in Phase 2B by its volume, page and line numbers. Thus, 15 RT 1637:10-14 refers to Volume 15 of the transcript, at page 1637, lines 10-14.

<sup>15</sup> *Id.* at 1638:26-28.

<sup>16</sup> Pacific Opening/Audit at 25 (emphasis added). We refer to briefs the parties filed in this proceeding by the abbreviated name of the filing party, the round of briefing, and the issue briefed. Thus, for example, Pacific Opening/Audit at 20-21 refers to Pacific Bell’s opening brief on audit issues at pages 20-21, and TURN Reply/Audit at 1-2 refers to TURN’s reply brief on audit issues at pages 1-2.

<sup>17</sup> Exh. 2B:375.

for by restating amounts reported in financial statements of prior periods] does not apply.”<sup>18</sup> Finally, Pacific concedes that the FR books do not even accommodate GAAP changes made after 1995, so it is unclear why changes to the books for 1997-99 would “violate GAAP.”

GAAP provides useful guidance and consistency with it is appropriate in almost all circumstances. In particular, the Commission has adopted GAAP, with limited exceptions, as the system of accounting rules that Pacific must follow.<sup>19</sup> Pursuant to GAAP, Pacific should make accounting corrections in the period in which errors are discovered, unless the corrections would have a material impact on the accounting in the period in which the error occurred.<sup>20</sup> If the correction of the error in a period would have a material impact on the accounting period, then Pacific should make the correction in the period and restates its books. The error corrections ordered herein should all be made consistent with this policy.

In an era in which accounting frauds have plagued major corporations, GAAP provides a reliable, rational, non-controversial framework for accountants and regulators to keep books and records. This system recognizes that “corrections” occur routinely in the normal course of business. GAAP requires that the books accurately reflect the financial condition of the company based on

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<sup>18</sup> Pacific Opening/Audit at 26.

<sup>19</sup> D.87-12-063, 26 CPUC 2d 349, 372 Ordering Paragraph 1. None of the exceptions to GAAP specifically enumerated in this decision are relevant here.

<sup>20</sup> Accounting Principles Board Opinion 20, Exh. Pacific: Phase 2B: 375.

the best information available at the time, and it does not “re-open” prior period financial reports to update estimates unless the corrections are significant and material as determined in GAAP.

Although there can be an issue concerning what constitutes a “material” impact for regulation, as opposed to material for the purposes of GAAP, the record makes it clear that this issue is largely moot in this proceeding. With the adoption of D.04-02-063, we know that even if we adopted every modification recommended by Overland for the issues we consider herein, the corrections would not rise to the level of sharing.

Thus, we see no reason to modify the current definition of materiality adopted in D.87-12-063. Nevertheless, nothing forbids us to order adjustments in the IEMR regulated books, and we will order adjustments to these books to resolve issues concerning Local Number Portability (LNP) accounting and the booking of Cash Working Capital (CWC), as discussed below.

## **B. Overland’s Qualifications and Conduct in the Audit**

### **1. Certified Public Accountant (CPA) Requirement**

Pacific contended during Phase 2A and 2B of this proceeding that Overland was not qualified to perform the audit because the firm is not registered by the state board of accountancy in California or in any other state and thus is not a certified public accounting firm. We address these contentions of Pacific raised in both phases here.

We find no merit in Pacific's allegation that Overland did not meet the criteria established by D.96-05-036. In D.00-02-047, the Commission had before it Overland's proposal to perform the audit,<sup>21</sup> which included full disclosure of Overland's qualifications to conduct the audit.<sup>22</sup> Indeed, the Commission explicitly recognized in D.00-02-047 that Overland is not a CPA firm, but a consulting firm that employs and subcontracts with CPAs.<sup>23</sup> With this knowledge in mind, the Commission explicitly authorized TD to hire Overland.<sup>24</sup> Thus, the Commission itself determined that Overland met the criteria established by D.96-05-036.

Mr. Harpster, one of the lead auditors, is a CPA with 22 years of regulatory and consulting experience. He has participated in more than 35 proceedings before the Federal Energy Regulatory Commission, courts in Arizona and Louisiana, and numerous state commissions, including four separate proceedings before this Commission involving SoCalGas and PG&E.<sup>25</sup>

With respect to California utilities, Overland has also performed several significant regulatory audits on behalf of the Commission during the past eight years. In 1994, Overland conducted an audit of the operating expenses

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<sup>21</sup> D.00-02-047, *mimeo.*, at 7-8 and finding of fact 6; 2000 Cal. PUC LEXIS 184.

<sup>22</sup> Exh. 2A:407, Sections V and VI (Overland Consulting's Proposal to Perform a Regulatory Audit).

<sup>23</sup> D.00-02-047, *mimeo.*, at 3 and 7.

<sup>24</sup> *Id.*, *mimeo.*, at 10 and conclusion of law 8.

<sup>25</sup> Exh. 2A:402 at 1-2 & Attachment GCH-1, at 1 (Phase 2A, Harpster Opening Testimony).

associated with Pacific Gas and Electric's (PG&E's) pipeline expansion project. In 1996, Overland performed a regulatory audit of Southern California Gas (SoCalGas) in connection with the company's performance-based ratemaking case. In 1997 and 1998, Overland performed a regulatory audit of PG&E's holding company and affiliate relationships, and in 1998 and 1999 they audited administrative and general expenses in connection with PG&E's general rate case. In 1999, Overland performed an audit of Roseville Telephone Company's affiliate transactions and non-regulated activities, and in 2000 submitted testimony concerning Roseville's IEMR earnings calculations. Since 2000, Overland has performed the regulatory audit of Pacific Bell.<sup>26</sup>

## **2. Generally Accepted Auditing Standards**

We also find no merit in Pacific's allegation that Overland failed to conduct the audit in accordance with Generally Accepted Auditing Standards (GAAS) because (1) Overland's auditors lacked adequate technical training and proficiency as auditors, (2) Overland failed to exercise due professional care, and (3) Overland conducted its audit in a biased manner.

GAAS are promulgated by the American Institute of Certified Public Accountants (AICPA). GAAS include 10 broadly phrased sets of standards and general principles that guide the audit function. They are classified as general standards, standards for fieldwork and standards for reporting. For example, General Standard No. 1 provides: "The examination is to be performed by a person or persons having adequate technical training as . . . auditor[s]."

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<sup>26</sup> Exh. 2A:400 at 3 (Phase 2A, Welchlin Opening Testimony).

Overland and its personnel were qualified to conduct the audit for the previously stated reasons.

### **3. NARUC Requirements**

Pacific also claims that Overland represented to the Commission that it would perform its audit in conformity with certain unspecified standards of NARUC, the National Association of Regulatory Utility Commissioners. The one NARUC standard Pacific claims Overland violated states that “[t]he consulting firm should present draft reports, consistent with the client’s requirements, in order to afford the client and the auditee the opportunity to make pertinent comments and factual corrections wherever necessary, and to allow for the discussion of conclusions and recommendations before a final report is prepared.”

In the management of the audit, the Commission’s Telecommunications Division (TD) ordered Overland not to follow the NARUC audit procedures. [We caution staff in future audits of this nature to provide an opportunity for the audited party to address audit errors. We believe such opportunity will benefit parties and reduce the number of contentious issues to resolve in our formal process.](#)

### **4. Policy Discussions**

Pacific also complains that the auditors engaged in detailed policy discussions, allegedly in violation of the audit standards. It is indeed true that D.96-05-036 states that the “work product [of the audit] should not include

lengthy policy discussions . . . .”<sup>27</sup> However, the Commission said in the same decision that, “The [audit report] should include an analysis of all issues uncovered, including any relevant documentation . . . . Recommendations as to specific accounting measures would also be welcome.” We also asked for “a thorough, aggressive audit.”<sup>28</sup> We therefore interpret our instructions to include more than simply pointing out errors. Rather, we expected the auditors to suggest means of resolving problems.

Many of the items Pacific identifies as “lengthy policy discussions” relate directly to accounting treatment and therefore are entirely within the letter of the Commission’s order. One Overland recommendation relates to the Commission’s “authority to set accounting . . . standards,” another relates to “remov[ing] parent billings . . . from regulated expenses,” a third relates to whether affiliates should collect sales referral fees when they provide referral services to Pacific’s customers, a fourth relates to “treatment of costs associated with . . . services marketed to customers outside . . . Pacific’s local exchange territory,” and a fifth relates to “treatment of costs incurred to enter the long distance market.”<sup>29</sup> The points Overland makes are entirely consistent with the requirement of “an analysis of all issues uncovered,” and “[r]ecommendations as to specific accounting measures.”

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<sup>27</sup> D.96-05-036, 66 CPUC 2d 274, 279 (1996).

<sup>28</sup> *Id.*

<sup>29</sup> Pacific Opening/Audit at 20-21.

However, we note that it is the Commission that has the final word on interpreting its past decisions and on determining whether a practice complies with Commission policies.

#### **5. Pacific's Allegation Concerning Errors by Overland**

Finally, Pacific criticizes errors in Overland's audit. In an audit as complex as this, errors are sure to occur. In this context, when the Commission ordered Overland not to provide an advance copy of the audit to Pacific, the Commission virtually assured that the audit would have many more errors than would arise under different circumstances. Once again, we believe it is unfair to direct this criticism at Overland. It is the Commission that bears responsibility for this action.

Despite the failure to provide an advance copy to Pacific, we note that our hearing procedures provide checks that permit the correction of specific errors.

#### **IV. Undisputed Audit Adjustments**

As ORA points out, "Pacific has conceded at least 20 out of the 72 audit adjustments, at least to the extent of agreeing that [the] accounting treatment it used for . . . purposes of its IEMR [Pacific's California regulatory earnings report] was incorrect."<sup>30</sup> The undisputed issues relate to expenses Pacific incurred in shutting down its Advanced Communications Network; its sale of Bellcore; and parent SBC's political and legislative influence expenditures, its charitable contributions, memberships and foundation expense, among others.

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<sup>30</sup> ORA Opening/Audit at 10.

A chart listing the undisputed items appears as Appendix D to this decision. Pacific shall make all the changes in Appendix D consistent with GAAP timing requirements. Pacific shall include these changes in its compliance Advice Letter filing, due within 90 days of the effective date of this decision.

## **V. Disputed Audit Adjustments**

We discuss the disputed audit adjustments in the same order as Overland discussed them in the audit report, as follows:

- Issues affecting Pacific's Revenues and Other Operating Income
- Issues affecting Operating Expense
- Employee Benefits
- Depreciation Accounting
- Income Taxes
- Net Plant
- Other Rate Base Items
- Affiliate Transactions
- Regulated and Nonregulated Allocation

While the parties did not all agree that this was the appropriate order in which to discuss the issues, or even that any particular issue "belonged" under a particular category, they all agreed on a joint outline arranged in this order. Thus, for ease of understanding, we use the outline as well.

After discussing the foregoing specific audit adjustments, we discuss the following four issues:

- NRF Monitoring (items for consideration in Phase 3 of the proceeding)
- Whether Pacific Impeded the Audit

- Phase 2 Remedies
- Recovery of Audit Costs

**A. Revenue and Other Operating Income****1. Contingent Liabilities**

Overland's recommended adjustment for contingent liability accruals reduces operating expenses by almost \$103 million, on an intrastate pre-tax basis, during the audit period.<sup>31</sup> The accruals result from Pacific's estimates of future anticipated expenses related to lawsuits and regulatory proceedings. Overland claims that the documentation provided by Pacific does not enable it to substantiate these accruals.

Among other supporting documentation, Overland requested the specific basis for Pacific concluding a liability existed and the basis for determining the amount of the liability. Pacific did provide Overland over 4,900 documents to support the contingent liability accruals. The documents included case identifications, pleadings from the underlying proceedings, narrative discussions of issues and a description of the process utilized for determining contingent liability accruals.

Pacific claims that these non-privileged documents are sufficient for an analysis of its contingent liability accruals. Overland disagrees. Overland disallows all such accruals as unauditible, replacing the accrued amounts with actual payouts where available and with nothing where no such payouts occurred.

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<sup>31</sup> This discussion refers to issues referenced as index 1, 10, 68 and 69 in Appendices A, B, C and D.

Pacific objects to furnishing further documentation supporting its decisions on how and why to post accruals for these liabilities, citing the attorney-client privilege. Pacific argues that these documents reveal communications from its attorneys on how and why accruals are posted for the liabilities. Pacific argues that Overland sought the amounts allocated to each jurisdiction by case and proceeding. Pacific notes that had Pacific provided that information, Pacific would have had to disclose privileged information regarding the full amounts of the specific individual contingent liabilities (because by adding the intrastate and interstate portions together, one has the entire claim). Absent a direct order by the Commission requiring Pacific to furnish this information, the information would have been provided voluntarily. Pacific argues that had Pacific provided that information voluntarily, it would constitute a waiver of the privilege. For this reason, Pacific concluded that it should not provide the information.

TURN and ORA alternatively argue that the documents are not privileged, that Pacific impliedly waived the privilege and that even if the information was privileged, release of it would not waive the privilege as to the claimants in the relevant legal and regulatory proceedings.

The California Supreme Court has determined that the Commission cannot compel the disclosure of attorney-client privileged information<sup>32</sup> and, in a situation in which the privilege is found to exist, its application may well create obstacles for Overland, or any other party seeking disclosure. The broad powers

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<sup>32</sup> *Southern Cal. Gas Co. v. Public Utilities Com.* (1990) 50 Cal.3d 31, 37.

granted to the Commission under the Constitution do not exempt it from complying with the attorney-client privilege.<sup>33</sup> It is vital when considering the issue of attorney-client privilege to understand that it is the decision-maker, initially the law and motion ALJ or assigned ALJ, who must determine whether a claim of privilege can be found to exist.

Over time, procedures have been developed by the courts and adopted by this Commission to determine whether a claim of attorney-client privilege can be sustained. Factors to be considered involve whether the communication involved an attorney, whether disclosure of the information to third parties may have broken the chain of privilege or whether treatment of the information constituted a waiver of the privilege. Thus, Pacific's claim that information is covered by the attorney-client privilege does not, by itself, resolve the matter.

Disputes over the attorney-client privilege have dogged the Commission's audit process over the years. For example, the 1992 decision in the *Matter of the Application of Pacific Bell* notes that the audit was suspended to resolve a discovery dispute over the attorney-client privilege.<sup>34</sup> Pacific objected that many of the documents the audit team wished to review were protected by the attorney-client privileged. After conducting an in camera review of the disputed

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<sup>33</sup> *Id.* at 39.

<sup>34</sup> D.92-07-076, Finding of Fact no. 4.

documents,<sup>35</sup> the administrative law judge sustained in part Pacific's objection based on attorney-client privilege.

We disagree with TURN and ORA's argument that the contested information is not privileged. Moreover, GAAP requires the accrual of contingent liabilities. The difficulty presented by the contingent liability accruals is that due to the nature of the accruals, the auditing of the accrual amount necessarily involves privileged communications concerning specific cases.

We also disagree with TURN and ORA's argument that a waiver of the attorney-client privilege occurred here. Pacific has done nothing in the present proceeding to place at issue its privileged communications. Merely revealing that one has consulted an attorney is not enough to waive the privilege.<sup>36</sup> The fact that the Pacific's accruals are at issue does not place in issue its attorneys' state of mind or their advice. Nowhere in this proceeding does Pacific state that it intends to rely on its attorneys' advice or state of mind to support the contingent liability accruals. Moreover, under California law, TURN and ORA face the burden of proving that Pacific has waived its attorney-client privilege.<sup>37</sup>

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<sup>35</sup> Generally, the courts cannot compel disclosure *in camera* to rule on the privilege. *Moeller v. Sup. Ct.* (1997) 16 C.4th 1124, 1135. However, the rule is not absolute. A litigant may still have to reveal some information *in camera* to permit the court to evaluate the basis for the claim *Id.*

<sup>36</sup> *Mitchell v. Superior Court* (1984) 37 Cal. 3d 591, 609.

<sup>37</sup> *Titmas v. Superior Court* (App. 4 Dist. 2001) 87 Cal.App.4th 738, 745; *State Farm Fire and Casualty Co. v. Superior Court* (App. 2 Dist. 1997) 4 Cal.App.4th 625, 639.

Rather, Pacific maintains that its accruals are supported by the non-privileged documentation. Pacific has made its showing absent disclosing its actual legal advice. If we conclude, after considering the documentation that Pacific has not supported its accruals, we can disallow the expenses. Pacific does not, however, impliedly waive its privilege if it simply fails to make an adequate showing.

In sum, the Commission cannot compel the disclosure of privileged information. Pacific has not waived the privilege.

We are then left with Overland's inability to verify the correctness of the contingent liability accruals. Overland states that it would violate GAAS for it simply to accept Pacific's claimed accruals without further documentation. More importantly, with the non-privileged documentation provided by Pacific, Overland found that the some of accruals appeared to be unjustified.

On this major substantive point, we agree with Overland. Because of Pacific's refusal to disclose the relevant information to Overland, the Commission lacks a sufficient record to justify the booking of these expenses on an accrual basis. Therefore, we agree with Overland's recommendation that Pacific's contingent liability accruals should be reduced in accordance with the audit recommendation. As shown in Appendix A, we find that the intrastate regulatory after-tax has an error of \$52.8 million in 1997, of \$1.1 million in 1998, and of \$7.0 million in 1999 for contingent liabilities – Operating Expense. We also find an audit error of \$8.7 million for PIU Accrual, \$13.7 million for USOAR Rewrite, and \$24.0 million for contingent liabilities – Revenues for 1997 on an intrastate regulatory after-tax basis as shown in Appendix A. Pacific should correct these errors with the timing of the correction set by GAAP.

## **2. Uncollectible Revenues and Settlements**

In 1996, Pacific implemented a new automated bill collection system called the Revenue Collection Risk Management System (RCRMS). Overland states that as a result of problems that Pacific agrees occurred with RCRMS, Pacific's uncollectible revenues and its uncollectible settlements with contract billing customers were overstated during the audit period.<sup>38</sup> Pacific incurred additional uncollectibles in 1996 principally because RCRMS had an error that prevented nonpaying customers from having their telephone service disconnected. Thus, Pacific incurred significant bad debt and related write-offs because nonpaying customers continued to have service. Had the accounting for uncollectible revenues and expenses related to RCRMS been correctly posted in 1996, rather than when Pacific recognized and corrected the problem in subsequent years, Pacific would have had higher earnings in 1997, 1998 and 1999. Overland states that intrastate uncollectible revenues were overstated by \$53.5 million in 1997.<sup>39</sup> In addition, because Pacific failed to accrue additional uncollectibles for AT&T, MCI, Sprint and other contract billing customers in the year it recognized the RCMRS problems, intrastate uncollectible settlement expenses were overstated by \$42.1 million during the audit period<sup>40</sup>

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<sup>38</sup> This discussion appears in the revenue section of this decision because Overland included it in the revenue portion of the audit report. This discussion refers to issues referenced as index 3 and 13 in Appendices A, B, C and D.

<sup>39</sup> Exh. 2A:404 at 5-17 (Audit Report)

<sup>40</sup> Exh. 2A:404 at 6-37 (Audit Report)

The dispute is over when Pacific should have accrued the additional uncollectible revenue and settlement expenses: in 1996, when the RCRMS problem was discovered and corrected, or in subsequent years. ORA contends Pacific was well aware of the problems in 1996 and should have accrued the expense in that year. Pacific agrees that it was aware of problems with RCRMS in 1996,<sup>41</sup> but contends it did not realize the magnitude of the problem from an expense perspective until 1997, and therefore appropriately booked the expenses in 1997. In addition, because Pacific failed to accrue additional uncollectibles for AT&T, MCI, Sprint and other contract billing customers in the year it recognized the RCMRS problems, intrastate uncollectible settlement expenses were overstated by \$42.1 million during the audit period.

While Pacific's bad debt write-offs shot up in November and December 1996 – a fact ORA's witness Michael Brosch found to be evidence that Pacific should have accrued an amount for estimated bad debts that year – Pacific claims there were also significant decreases in the July-September 1996 period. The numbers effectively offset each other, masking the problem, Pacific contends.

Evidence in the record contradicts Pacific's claim and shows that other than in the period in 1996 at issue, Pacific's bad debt did not fluctuate drastically as it did during that period. The fluctuation should have put Pacific on notice of a serious problem in 1996, and Pacific should have taken action to accrue an amount for estimated bad debts in that year.

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<sup>41</sup> Pacific Opening/Audit at 47.

Pacific's collections history shows a fairly even ebb and flow of net bad debt from January 1995 through August 1996, when the percentage of accounts showing net bad debt ranged from a high of approximately three percent to a low of approximately one percent. The trend never lasted more than two months in any one direction – up or down – during that period.<sup>42</sup>

In contrast, the rate of bad debt soared steadily from August 1996 to the end of the year. The graphic depiction of this debt showed a line headed steadily upward from a low of one percent in August 1996 to a high of five percent in December 1996. Never again through December 1997 was the volatility nearly as great. Moreover, Pacific's own internal document dated July 23, 1996 showed Pacific was well aware of a number of financial problems stemming from the RCRMS system as of that date.<sup>43</sup>

The evidence was plain that Pacific had a significant problem in 1996, and it should have recorded the expense that year. Had it done so, rather than carrying the 1996 expense forward to 1997, it would have reported lower expense and higher potentially shareable earnings in 1997. We therefore agree with the audit that Pacific should have recorded RCRMS-related expenses in 1996 rather than 1997.

As we have noted previously, ordering Pacific to make such an adjustment and to restate its books would have no impact on shareable earnings. For this

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<sup>42</sup> See Exh. 2B:369.

<sup>43</sup> Exh. 2B:120 at 14:3-19 (Brosch Opening Testimony, citing Pacific's discovery responses).

reason, we see no purpose in ordering this specific departure from GAAP accounting practices.

### **3. Directory Publishing**

The remaining issue with revenue impact relates to how Pacific Bell Directory accounted for its revenues (and expenses) during the audit period. Prior to the fourth quarter of 1996, Pacific accounted for revenues and expenses over the life of the directory. In 1996, it changed its policy to “conform to the policies of SBC,”<sup>44</sup> and began recognizing revenue and expense when the directory is issued.

Overland stated it could not determine whether the change had an impact on 1997 revenues and expenses, and we do not find that there is any need to pursue the item further. Pacific correctly recognized a one-time pre-tax gain of \$143 million in 1996. The extensive audit could not establish that there were any effects in 1997 for which Pacific failed to properly account.

## **B. Operating Expenses**

### **1. Local Number Portability Costs**

#### **a) Introduction**

Overland found that Pacific did not properly account for its local number portability (LNP) costs,<sup>45</sup> citing two separate reasons. First, it claimed Pacific should have deferred these costs – required by the Telecommunications Act of 1996 (1996 Act) and the FCC – as a regulatory asset (to be amortized over a

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<sup>44</sup> Pacific Opening/Audit at 50.

<sup>45</sup> This discussion refers to issues referenced as index 5 and 70 in Appendices A, B, C and D.

longer period supported by rates), rather than booking such costs as an immediate expense.<sup>46</sup> Deferral would have reduced operating expenses – and increased earnings potentially shareable with ratepayers – by \$171 million on an intrastate pre-tax basis during the audit period.<sup>47</sup>

Costs that are deferred as a regulatory asset do not appear on the IEMR as an expense. Because lower expenses increase earnings – and, potentially, sharing – while regulatory assets have little impact on earnings, the difference between an expense and a regulatory asset has great significance to Pacific’s IEMR.

TURN adds that “as of early 1996, the Commission made it clear that at least some portion of costs incurred to implement local number portability was probable of recovery as an allowable cost for ratemaking purposes.”<sup>48</sup> Pacific contends that Overland and TURN are incorrect that the criteria for deferring the costs as a regulatory asset were met at any time before a July 16, 1999 FCC order<sup>49</sup> concluding its investigation of the long-term number portability tariff

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<sup>46</sup> The LNP requirement, implemented in several FCC decisions, stemmed from the 1996 Act, and obligated Bell Operating Companies such as Pacific to advance the ability of users of telecommunications services to retain, at the same location, existing telecommunications numbers without impairment of quality, reliability, or convenience when switching from one telecommunications carrier to another. *See* 47 U.S.C. § 251(b)(2).

<sup>47</sup> Exh. 2B:415 at S6-2 (Supplemental Audit Report).

<sup>48</sup> TURN Opening/Audit at 15.

<sup>49</sup> Pacific Opening/Audit at 53, citing Exh. 2B:334 at 14 (Wells Direct Testimony). The Wells testimony cites *In the Matter of Long-Term Number Portability Tariff Filings*,

*Footnote continued on next page*

transmittals. Pacific argues that to defer LNP costs would have violated the requirements of Statement of Financial Accounting Standards (SFAS) No. 71,<sup>50</sup> which governs deferral of costs as a regulatory asset.

Second, Overland stated that LNP expenses were not even relevant to Pacific's California expense reporting. Overland noted that "[t]he FCC has affirmatively and directly asserted jurisdiction over the LNP costs recovered through the FCC tariff," and concluded that "the costs . . . should be assigned directly to the interstate jurisdiction."<sup>51</sup> Overland cited a May, 1998 FCC order in support of its conclusion.<sup>52</sup> Using a jurisdictional separations approach, Overland found that Pacific never should have reported LNP costs as intrastate expenses on its IEMR.

Pacific contends that the only issue is the state-federal jurisdictional separations, not the deferral of costs as a regulatory asset: "the dispute regarding the assignment of LNP costs boils down to a dispute regarding the timing of the [jurisdictional] separation of the costs [between the federal, or interstate, and California, or intrastate, jurisdictions]."<sup>53</sup> Once the FCC decided that LNP costs should be characterized as 100% interstate, Pacific states, the costs should have

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CC Docket No. 95-35, *Memorandum Opinion and Order*, FCC 99-158, ¶ 1 (rel. July 16, 1999).

<sup>50</sup> FAS 71 prescribes the appropriate accounting for the effects of certain types of regulation. A complete copy of FAS 71 appears in the record as Exh. 2B:191.

<sup>51</sup> *Id.* at S6-1.

<sup>52</sup> *In the Matter of Telephone Number Portability*, CC Docket No. 95-116, *Third Report and Order*, FCC 98-82 (rel. May 1998).

<sup>53</sup> Pacific Opening/Audit at 53.

moved off the IEMR books and onto the federal books. Pacific agrees that the FCC's May 1998 order should have triggered this change.<sup>54</sup>

We order Pacific to remove all LNP costs from the intrastate regulated books (the IEMRs covered by this audit). We do not agree with Overland that it was appropriate for Pacific to record an intrastate regulatory asset for LNP costs during the audit period. For the reasons discussed below, LNP costs did not meet the requirements of SFAS No. 71.<sup>55</sup>

**b) Criteria for Deferral as a Regulatory Asset – FAS  
71**

Paragraph 9 of the FAS 71 requirements provides that a regulated enterprise shall capitalize (defer as a regulatory asset) **all or part** of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

- a. It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
- b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.

If the “part” of the cost deferred is tied to a specific cost and recovery is probable, Pacific believes it is appropriate to record a regulatory asset. Pacific

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<sup>54</sup> *Id.*

<sup>55</sup> FAS 71 prescribes the appropriate accounting for the effects of certain types of regulation. A complete copy of FAS 71 appears in the record as Exh. 2B:191.

reasons that SFAS 71 requires not only that the costs being deferred be “probable” of recovery, but also that the costs are identifiable:

If the amount of the incurred cost to be capitalized is unspecified, or if specified, not probable of future recovery, then none of the costs can be deferred as a regulatory asset. Additionally, at the time the regulatory asset is created, the future revenue authorized by the regulatory authority must relate specifically to the previously incurred costs.<sup>56</sup>

Pacific argues that the failure of either of these elements is fatal to the creation of a regulatory asset. Pacific explains that its inability to record a regulatory asset for LNP costs resulted from the fact that there was no specific cost which was probable of recovery. TURN contends that FAS 71 does not require that a utility know the amount of probable recovery when it makes the decision to defer a regulatory asset.

After FAS 71’s issuance, FAS 90 refined the definition of “probable” by making it consistent with FAS 5. FAS 5 defines something as “probable” if it meets the first of two conditions:

- a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. [footnote omitted]. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b. The amount of loss can be reasonably estimated.

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<sup>56</sup> Uffelman Reply Testimony, Exh. Pacific: Phase 2B:337, at 5-6.

TURN reasons that since the term “probable” only appears in paragraph (a) of SFAS 5, only paragraph (a) should be read into SFAS 71. According to TURN, “if *any* amount is probable of recovery, [SFAS] 71 mandates creation of a regulatory asset.”<sup>57</sup> TURN’s interpretation appears to be that the only time it is appropriate not to record a regulatory asset is when the amount of cost probable of recovery is zero.

We agree with Pacific’s analysis of SFAS 71. Guidance is provided by the SEC’s Division of Corporate Finance:

Under SFAS 71, a utility may defer certain costs of providing services if the rates established by the regulators are designed to recover the utility’s **specific costs** and the economic environment gives reasonable assurance that those rates can be charged and collected through the periods necessary to recover the costs.<sup>58</sup>

Chapter 12 on Rate Regulation and GAAP of Accounting for Public Utilities also states:

Evidence that a regulatory asset is probable of recovery is a matter of professional judgment based on the facts and circumstances of each case. The SEC has increasingly scrutinized documentation of the basis of recording regulatory assets.<sup>59</sup>

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<sup>57</sup> TURN Opening/Audit at 9.

<sup>58</sup> Securities Exchange Commission’s Division of Corporate Finance, *Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*, March 31, 2001;.

<sup>59</sup> Rate Regulation and GAAP of Accounting for Public Utilities, Section 12.07[1], at 12-29.

We find that the prerequisites for Pacific to defer the LNP costs as a regulatory asset were not met. There was significant uncertainty surrounding potential recovery for LNP costs. The FCC did not issue its Cost Classification Order until December 14, 1998, and the FCC did not conclude its investigation of the long-term number portability tariff transmittals until July 16, 1999. In the proceeding leading up to the decision, the Commission requested that local commissions be allowed to determine the system by which LNP costs were to be recovered. That the Commission deemed some cost recoverable does not obligate Pacific to guess what the amount may be and record a regulatory asset in that amount. The only relevant inquiry then for the treatment of LNP costs is whether the costs should have been jurisdictionally separated.

Finally, we note that as a policy, this Commission must adopt a strict and clear definition of what constitutes a regulatory asset. Failure to distinguish those situations in which the Commission clearly intends to create a regulatory asset from those in which the Commission simply leaves open the possibility of cost recovery is a prescription for regulatory trouble. In particular, a regulatory policy that finds that a regulatory asset exists even when the Commission only offers a chance of cost recovery would undermine the financial community's confidence in those regulatory assets that the Commission intends to create.

### **c) Jurisdictional Separations**

Again, we find that as of May 1998, when the FCC issued its Third Report and Order, Pacific should have recovered all of the expense related to LNP exclusively in the federal jurisdiction. Pacific agrees that the May 1998 FCC

order triggered an allocation of 100% of the costs to the interstate jurisdiction: “By May 1998, it was determinable that the FCC intended LNP costs to be fully allocated to the interstate jurisdiction. . . .”<sup>60</sup> Thus, Pacific should not have reported any LNP costs on its IEMR after the May 1998 FCC order. In addition, once these costs were determined to be federal jurisdiction, Pacific should have amended its IEMRs to remove these expenses for 1998 and 1997. We order Pacific to do so now.

**d) Conclusion**

In summary, Pacific should have charged all LNP expense to the federal jurisdiction once the FCC’s May 1998 order on LNP cost recovery made it clear that these were federal expenses.

This error correction, however, either alone or in combination with all the other error corrections and adjustments proposed by Overland in this phase of the proceeding, will have no impact on the regulatory outcome. Pacific should therefore modify its IEMR to remove all LNP costs, including plant and depreciation, from reported intrastate results of operations during the period covered by this audit. Pacific should modify its IEMR to remove all LNP costs, including plant and depreciation, from its 1997, 1998 and 1999 reported intrastate results of operations. The intrastate regulatory after-tax adjustment for the LNP costs is \$51.3 million in 1997, \$27.9 million in 1998, and \$22.3 million in 1999 as shown in Appendix A. The plant adjustment is \$14.3 million in 1997, \$32.3 million in 1998 and \$42.8 million in 1999. The adjustment for LNP

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<sup>60</sup> Pacific Opening/Audit at 53.

Depreciation on the expense side is \$687,000 in 1997, \$1.6 million in 1998 and \$2.5 million in 1999.

## **2. Local Competition Implementation Costs**

The auditors also found that Pacific improperly included \$49 million on an intrastate pre-tax basis in local competition implementation costs in its operating expenses for 1997 and 1998, and that Pacific should have deferred such costs as a regulatory asset for future recovery.<sup>61</sup> Removing such cost from expense would have raised the amount of earnings subject to sharing in those years. As with the LNP issue, a SFAS 71 analysis is appropriate for evaluating the treatment of local competition costs.

Pacific claims it never had the certainty it needed – probability of recovery of each specific cost it incurred – and therefore never was required to defer an asset. Once again, TURN claims that SFAS 71 provides only that recovery of a category of cost must be probable, not that management be able to estimate the full amount of recoverable costs.

TURN claims the SFAS 71 regulatory asset deferral requirement was met even earlier than does Overland. Overland cites a 1998 Commission decision, D.98-11-066,<sup>62</sup> as the basis for creating a regulatory asset. TURN, on the other hand, claims that earlier Commission decisions are at least as relevant as the

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<sup>61</sup> This discussion refers to issues referenced as index 6 in Appendices A, B, C and D.

<sup>62</sup> 1998 Cal. PUC LEXIS 978.

1998 decision. TURN states that “[a]s of the issuance of D.96-03-020<sup>63</sup> [in 1996], it was probable that Pacific Bell would recover some amount greater than zero. And under SFAS 71, a regulatory asset should have been established.”<sup>64</sup> In D.96-03-020, TURN’s cited case, the Commission stated,

[W]e conclude that reasonably incurred costs to implement competitive local exchange service are appropriate, and it is not unreasonable that end-users pay for such costs. . . . We shall consider establishing an end-user surcharge for certain reasonably incurred implementation costs at a later date . . . . We will, however, authorize Pacific . . . to establish a memorandum account to record actual implementation costs incurred on and after January 1, 1996. . . .<sup>65</sup>

Finally, in D.98-11-066, the case Overland cites, the Commission adopted an interim surcharge to allow for immediate recovery of specific types of implementation costs, subject to refund after a reasonableness review.<sup>66</sup> Pacific claims that D.96-03-020,<sup>67</sup> D.97-04-083<sup>68</sup> and D.98-11-066<sup>69</sup> provided it no assurance of cost recovery. It also claims that a later decision – D.00-09-037<sup>70</sup> – approving a settlement regarding the actual costs Pacific would recover, likewise

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<sup>63</sup> 1996 Cal. PUC LEXIS 257.

<sup>64</sup> TURN Reply/Audit at 17-18.

<sup>65</sup> D.96-03-020, 1996 Cal. PUC LEXIS 257, 65 CPUC 2d 156, 167 (1996).

<sup>66</sup> D.98-11-066, 1998 Cal. PUC LEXIS 978, 83 CPUC 2d 183, 193-94 (1998).

<sup>67</sup> 1996 Cal. PUC LEXIS 257.

<sup>68</sup> 1997 Cal. PUC LEXIS 495.

<sup>69</sup> 1998 Cal. PUC LEXIS 978.

<sup>70</sup> 2000 Cal. PUC LEXIS 697.

provided no basis to record a regulatory asset. Pacific asserts that each of these decisions contains limitations on Pacific's right to recovery, rendering it impossible to determine as a result of any of the decisions that it was appropriate to defer a regulatory asset.

Overland's reliance on the interim cost recovery authorization in D.98-11-066 is misplaced. As noted by Pacific, the Commission, in D.00-09-037, stayed the authorization to recover these costs pending the resolution of rehearing applications that challenged the authorization of interim cost recovery. It was not until September 2000, in D.00-09-037, that an amount for local competition cost recovery was authorized.

We are likewise not persuaded by TURN's analysis. D.96-03-020 authorized Pacific to establish memorandum accounts for "possible" recovery, but it concluded that "[n]o cost recovery for implementation costs should be approved at this time."<sup>71</sup> The Commission in D.00-09-037 later confirmed that its 1996 decision had determined "it was premature at that point to authorize any implementation cost recovery."<sup>72</sup> D.98-11-066 similarly determined that it was "premature to authorize any specific cost recovery allowance for implementation costs at this time . . . ."<sup>73</sup>

Under the FAS 71 standard we discussed in connection with LNP costs previously, Pacific properly expensed the audit amount of \$49 million.

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<sup>71</sup> D.96-03-020, 65 CPUC2d 256, 214.

<sup>72</sup> D.00-09-037, mimeo, p.2.

<sup>73</sup> D.98-11-065, mimeo, p. 33.

### **3. Merger Savings**

The audit and ORA differ on how to account for a ratepayer refund that came about as a result of Pacific Telesis' 1996 merger with SBC.<sup>74</sup> The audit recommends a \$35 million reduction in intrastate operating expenses to reflect the CPUC-ordered allocation of merger savings between ratepayers and shareholders. Pacific made IEMR ratemaking adjustments to reflect the merger savings allocation in 1998 and 1999. The audit modifies Pacific's adjustments to correct claimed errors and, in the auditors' view, more accurately reflect the timing of the ordered merger savings.

With the exception of agreed-upon small corrections needed to reduce IEMR expenses by \$4.2 million on a Pacific total company basis both in 1998 and 1999,<sup>75</sup> ORA and Pacific oppose this audit adjustment in favor of Pacific's accounting approach. In 1997, Pacific recorded in its books a large expense accrual on the actual amount of the refund (in present value terms, \$213 million in payments to ratepayers over nine years and \$34 million in contributions to a Community Partnership). Then, Pacific reversed this accrual as an offset in subsequent years, so that the business recognized approximately \$50 million per year pursuant to the Commission's merger order. We find that Pacific's accrual was proper.

We agree with ORA that we should not adopt Overland's contrary approach to the accruals. Overland assumed that Pacific would have realized

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<sup>74</sup> This discussion refers to issues referenced as index 7 in Appendices A, B, C and D.

<sup>75</sup> See Pacific Opening/Audit at 67; ORA Opening/Audit at 31.

savings as a result of the merger, and imputed those savings to the business, lowering its reported expenses. Because shareholders funded half of the merger refund, Overland assumed that shareholders should receive 50% of the imputed savings. However, ORA claims Overland's approach is based on "phantom" savings figures and that there is no proof that these savings actually materialized.<sup>76</sup>

We agree with ORA and Pacific that there is no evidence in the record that the savings Overland assumed ever came about. Thus, there should have been no assumption that ratepayers would lose the 50% of imputed savings Overland decided should inure to the benefit of Pacific's shareholders. We reject the change recommended by the audit, but do adopt the \$2.5 million and \$2.5 million conceded errors for both 1998 and 1999 respectively on an intrastate after-tax basis as shown in Appendix A. Pacific should correct these accounting errors, with the timing of such an adjustment set by GAAP.

#### **4. Software Buy-Out Agreement**

In December 1999, Pacific accrued \$55.7 million in operating expenses for the buy-out of its existing obligation to make future payments into 2003 to Lucent for software right-to-use fees. The buy-out was effected through an amendment of Pacific's existing contract with Lucent, replacing Pacific's obligation to make quarterly payments for the contract period (October 1, 1999

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<sup>76</sup> For a detailed discussion of these issues, *see* Exh. 2B:120 at 16-25 (Brosch Opening Testimony).

through June 30, 2003) with a one-time payment of \$55.7 million. All other terms and conditions of the existing contract remained in effect.<sup>77</sup>

It is Overland's opinion that the transaction was only a financial restructuring of the existing contract, and should have been recorded as a "prepayment" rather than an expense pursuant to FCC Part 32 rules.<sup>78</sup> Overland recommends reducing Pacific's 1999 expenses by \$44 million.

Pacific contends that it canceled the existing contract and entered into another contract for perpetual use of the software. It claims that the new contract was properly expensed rather than charged as a prepayment in accordance with Pacific's 1998 10-K filing with the SEC in which it stated that "[t]he costs of computer software purchased or developed for internal use are expensed as incurred."

Overland also cites as the basis for its opinion Section 32.1330 of FCC Part 32,<sup>79</sup> which requires that prepayments be amortized to the appropriate expense account over the term of the prepayment. Pacific disagrees with Overland, and claims that its accounting treatment was consistent with FCC Part 32 Rules that were in effect at the time of the purchase.<sup>80</sup>

We disagree with Overland's view on this matter. The substance of the transaction was not an advance payment of an operating expense in exchange for

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<sup>77</sup> Exh 2A:404 at 6-31 (Audit Report).

<sup>78</sup> This discussion refers to issues referenced as index 9 in Appendices A, B, C and D.

<sup>79</sup> 47 C.F.R. § 32.1330.

<sup>80</sup> Exh. 2B: 336 at 14 (Uffelman Opening Testimony).

a price reduction. Under the terms of the contract, Pacific purchased a perpetual software license from Lucent with payment terms that were contingent upon the number of access lines utilizing the relevant switch software. The amendment replaced the contingent payment terms with a fixed fee. Pacific initiated the purchase in 1999 and completed the transaction with the outright purchase of a perpetual right to use the software. We therefore reject Overland's recommended \$44 million adjustment for the year 1999.

### **5. Incentive Pay Accruals**

Overland states that for the years 1997-99, "[i]ntrastate operating expenses are overstated by \$29 million as a result of the over-accrual of incentive pay costs."<sup>81</sup> Actual incentive pay was lower than the accrued amount, and it is the difference between the accrual and the actual payout that Overland seeks to remove from expense. Pacific trueed up the difference in the year following the accrual, and contends Overland's proposal – to adjust the accruals in the year they were made to reflect actual payouts – would violate GAAP.

Pacific does not deny there was a difference between the accrued amount and the actual payout; it only disagrees on the timing of the true-up. Although GAAP does not preclude retroactive changes to the IEMR books, we agree with Pacific that it acted prudently in following GAAP, which recommends true-up when the issue is resolved and prohibits the restatement of past periods. Moreover, Pacific's estimate, while in error, was reasonable.

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<sup>81</sup> This discussion refers to issues referenced as index 11 in Appendices A, B, C and D.

**6. Other Expense Related Issues – “Royalty Payment”**

Overland notes that in 1998 Pacific allocated a \$30 million parent company “management fee” among regulated expense accounts. According to Overland, the transaction “reflects the elimination of royalties Pacific paid to SBC in 1998.”<sup>82</sup> Pacific contends that Overland mischaracterizes the item as a “royalty payment” when in fact it was an “‘on-top’ adjustment that reclassified certain portions of the parent joint cost allocation related to management fees.”<sup>83</sup>

It appears that the difference of opinion on this matter revolves around how Pacific adjusted the fee out of its intrastate regulated operations, as opposed to whether Pacific made the adjustment. Therefore, there is no dollar adjustment to address here, and we adopt no change based on the audit report.

**C. Employee Benefits****1. Other Post Retirement Costs (FAS 112)**

In 1997, Pacific recorded a \$9.6 million (on an intrastate pre-tax basis) entry related to pre-1976 disabilities that Pacific’s actuaries had not previously valued. Overland found that Pacific should not have made the entry in 1997, and that it artificially increased expenses by \$9.6 million in that year to the possible detriment of ratepayers.<sup>84</sup> ORA contends that the catch-up accrual should be removed from the 1997 IEMR results because “SBC Pacific has failed to explain adequately why these pre-1976 liabilities were not known or knowable before

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<sup>82</sup> Exh. 2A:404 at 6-13 (Audit Report).

<sup>83</sup> Pacific Opening/Audit at 73.

<sup>84</sup> This discussion refers to issues referenced as index 16 in Appendices A, B, C and D.

1997.”<sup>85</sup> It appears that ORA seeks to deny the accrual altogether, rather than having Pacific record it in its books for the 1970s, based on Pacific’s inability to prove the accrual was appropriate.

We agree with ORA that Pacific has not justified why it could not have located this accrual prior to 1997. There is no basis to depress 1997 earnings to correct a supposed error of accrual from the 1970s. Nevertheless, ordering such a revision will have no impact on shareable earnings, and we therefore decline to order a restatement of financial books for these years.

## **2. Other Employee Benefits Issues**

Overland opines that Pacific should be required to provide stand-alone actuarial reports for the Pacific Bell component of SBC benefit plans. Pacific contends this is a costly and unnecessary task, that Pacific was never required to do so when it was part of the Pacific Telesis Group consolidated benefit plans, and that the Commission should deny the Overland suggestion.

Overland’s motivation is to ensure that the actual Pacific Bell costs – and only those costs – are charged to Pacific Bell expense. We find Overland’s suggestion reasonable. Our decision in Phase 2A also orders that Pacific produce stand-alone actuarial reports, and we refer parties to that decision as well.

### **D. Depreciation Accounting for Intrabuilding Network Cable Amortization**

The audit report proposes a \$61.4 million adjustment (\$33.05 million in 1997 and \$28.34 in 1998) to correct errors admitted by Pacific in its accounting for

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<sup>85</sup> ORA Reply/Audit at 24.

amortization of its intrabuilding network cable investment.<sup>86</sup> While all sides agree that Pacific made an error, there is a dispute as to when Pacific should have accounted for the error. If it reflects the error only in 1998, the year in which it discovered the problem, ORA claims 1998 expenses will be overstated, and the greater the expenses in 1998, the less the earnings potentially available for sharing with ratepayers. Because the error took place in each of the years 1994-1997, Overland and ORA agree that Pacific should adjust its books in each of these years.

Pacific, in contrast, took a “catch-up accrual” approach: when it discovered it had underdepreciated the cable in the first period of time, it decided to overdepreciate for the second period. Pacific explained that it mistakenly applied the FCC depreciation schedule to the asset, which allows for lower rates of depreciation each year than does the CPUC. It discovered the error in 1997.

While Pacific’s witness, Peter Hayes, admitted that the way Pacific made the adjustment overstated amortization expense in 1997, he claimed that the Commission’s rules did not allow Pacific to make the adjustment in any other way.<sup>87</sup> He claimed Pacific did not have “depreciation freedom” that would have allowed it to make the depreciation adjustments in prior years.<sup>88</sup> He claimed that Pacific only gained depreciation freedom in connection with D.98-10-026,<sup>89</sup> in

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<sup>86</sup> This discussion refers to issues referenced as index 17 in Appendices A, B, C and D.

<sup>87</sup> 12 RT 1263:2 – 1265:3 (Hayes).

<sup>88</sup> *Id.* at 1271:11 – 1272:3.

<sup>89</sup> 1998 Cal. PUC LEXIS 669.

which the Commission “chose to discontinue reviewing depreciation rates and accruals.”<sup>90</sup>

We agree. In 1997, when the error was discovered, Pacific could not adjust its intrastate financial reporting. Pacific did not have the freedom to set its depreciation rates in this manner until January 1, 1999, as a result of D.98-10-026. Pacific was unable to go back and unilaterally depart from the Net Book Value method previously prescribed by the Commission. We find that Pacific acted reasonably and reject the audit’s approach.

## **E. Income Taxes**

### **1. Accumulated Deferred Income Taxes**

Overland found that Pacific overstated the rate base deduction for accumulated deferred income taxes (ADIT) by an average of \$7 million per year due to the improper use of “normalization” accounting. Overland states that the differences between book and taxable income should be accounted for using “flow-through” accounting treatment rather than normalization to the extent allowed by federal tax law.<sup>91</sup> This issue has implications both for how Pacific accounts for ADIT generally, and for how it does so for the Universal Service Fund.

In our Phase 2A decision, we adopted flow-through tax treatment. For the reasons set forth there, we also adopt such treatment here. The annual rate base deductions are \$57.8 million for 1997, \$55.2 million for 1998 and \$43.3 million for

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<sup>90</sup> 12 RT at 1282:18-26 (Hayes).

<sup>91</sup> This discussion refers to issues referenced as index 37 in Appendices A, B, C and D.

1999. As noted previously, because of D.04-02-063, these adjustments, even if made in the years when the error occurred, would have no effect on shareable earnings, either by themselves or in conjunction with other adjustments.

Pacific should correct these errors in its capital accounts, with the timing controlled by GAAP rules.

## **2. Sales and Use Tax Accruals**

Overland states that for 1997-99, “[i]ntrastate regulated sales and use tax expense is understated by \$857,000 as a result of the reversal of prior period accruals for tax audits.” Overland finds the accruals are unsupported and states that it has not been able to audit them.<sup>92</sup>

Pacific responds that its accruals are neither unsupported nor unauditible and have been recorded in compliance with SFAS 5. As support, Pacific cites “management’s professional judgment - nothing more, nothing less.”<sup>93</sup>

We rejected Pacific’s argument in connection with its contingent liability accruals and also do so here. The purpose of an audit is to test management’s judgments, and to ensure that all accounting transactions that raise questions are verified. Nor is Pacific correct that in all cases, “[w]hen subsequent events indicate that a previously recorded liability has been reduced or eliminated, a reversal is appropriate in the current period.”<sup>94</sup> Pacific should amend its books for the period in which the transaction occurred if the transaction was

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<sup>92</sup> This discussion refers to issues referenced as index 25 in Appendices A, B, C and D.

<sup>93</sup> Pacific Opening/Audit at 80.

<sup>94</sup> *Id.* at 81.

“material,” consistent with GAAP rules and procedures. Even Pacific does not disagree with this premise. As we stated in the order commencing the audit, materiality for regulatory purposes is ultimately up to the Commission to decide. However, because of D.04-02-063, the adjustments contemplated by Overland have no financial consequences for ratepayers. Thus, the issue of materiality has no financial consequence for ratepayers, there is no need to adopt a standard of materiality that differs from that the Commission adopted in D.97-12-063. In particular, the Commission adopted GAAP, with limited exceptions, as the system of accounting rules that Pacific must follow to resolve issues of materiality unless directed otherwise. We order no adjustments or error corrections inconsistent with GAAP, except for the booking of LNP and CWC in the IEMR reports as discussed herein.

### **3. Payroll Tax Correction**

Pacific used a computer program to process certain manual paychecks and in so doing failed to generate accruals for the employer’s portion of payroll taxes. Pacific does not dispute that it made an error, but claims that its 1999 catch-up entry to increase other operating taxes by \$9.7 million in that year was all that was necessary to correct the error.<sup>95</sup>

Once again, Pacific corrected an error from a prior period in a subsequent year, which affected the reported earnings in the both years. It is consistent with

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<sup>95</sup> This discussion refers to issues referenced as index 26 in Appendices A, B, C and D.

our decision in other respects to require Pacific to make corrections with the timing controlled by GAAP

#### **4. Booking of Deferred Taxes**

It is Overland's opinion that Pacific overstated its intrastate regulated deferred income tax expenses by \$59 million in 1998 and 1999 on an after-tax basis as a result of an accounting error.<sup>96</sup>

The parties agree there was an error in Pacific's Excess Deferred Tax amortization, so the only disagreement is over how to account for the error.<sup>97</sup> Once again, Overland suggests reflecting the change in the affected year, while Pacific supports making the correction in the year it discovered the error. (Indeed, Pacific made a correcting entry in November 2000.)

As we discuss in several other places in this decision, we let GAAP procedures control the timing of this error correction.

#### **5. Ameritech Severance Accruals**

Overland opines that Pacific improperly accounted for current period income tax expense and operating deferred income tax expense related to severance and employee related benefits that were accrued in December 1999.<sup>98</sup> The severance accrual occurred when SBC terminated Pacific Bell employees as a

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<sup>96</sup> Exh. 2A:404 at 9-22 (Audit Report); Exh. 2B:415 at 9-6 (Supplemental Audit Report).

<sup>97</sup> This discussion refers to issues referenced as index 24 and 38 in Appendices A, B, C and D.

<sup>98</sup> This discussion refers to issues referenced as index 22 in Appendices A, B, C and D.

result of SBC's merger with Ameritech.<sup>99</sup> It is Overland's opinion that Pacific's current period intrastate operating income taxes and intrastate operating deferred income tax expense were each overstated by \$8 million because Pacific should have booked these expenses below-the-line. Overland recommends that Pacific's 1999 IEMR income tax expense be reduced by \$8 million. Overland also recommends that Pacific's 1999 intrastate operating deferred income tax expense be reduced by \$8 million.

Pacific agrees with Overland that it overstated its 1999 current intrastate operating income taxes by \$8 million as a result of the misclassification of the Ameritech severance accrual temporary difference, but maintains that because of normalization accounting there was no effect on the total operating tax expense it reported in the IEMR.

The disagreement centers around the treatment of the income tax effects associated with the severance accrual. Pacific maintains that its normalization income tax policy makes the issue moot because the accounting error misstated current and deferred income taxes by equal and offsetting amounts. Pacific's position is premised on the belief that the Commission will not adopt Overland's income tax policy recommendations from Phase 2A of this proceeding.

There is no disagreement that these costs should have been booked below-the-line. We believe that this issue can be addressed in this order by having Pacific account for the severance accrual and the associated income tax

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<sup>99</sup> Exh. 2A:404 at 9-22 (Audit Report).

effects on a consistent basis, below-the-line. We direct Pacific to correct this error with the timing controlled by GAAP.

## **F. Net Plant Accounting**

### **1. Property Records**

Overland cites three separate documents in support of its conclusion that Pacific does not keep proper track of its plant in service. Overland concludes that based on these documents – either alone or in combination – Pacific has a serious internal control problem in maintaining accurate property records. Because Pacific continues to depreciate plant recorded on its books even if it cannot locate the plant in the field, the problem affects Pacific's financial reporting.

### **2. FCC Continuing Property Records (CPR) Audit**

Overland relies on an FCC audit of Pacific's property records to reach the conclusion that Pacific overstated its recorded plant balances for certain central office equipment. The FCC staff found that Pacific was not able to locate equipment corresponding to 8.4 percent of the sampled items, and found substantive deficiencies in the records for an additional 10.1 percent of the sampled items. Thus, 18.5 percent of the sampled items did not comply with the FCC's rules for property records.

Pacific contends the FCC's audit recommendations were never adopted and therefore that the audit is an inappropriate basis for Overland's conclusion. The FCC undertook the audit in 1997 as part of an audit of all Regional Bell Operating Companies' central office equipment records. While Pacific criticized

the audit after the FCC issued its draft audit report in 1998, its witness conceded that the FCC's decision not to pursue the audit was not due to those criticisms.<sup>100</sup>

The question, then, is whether we can respond to an audit that the FCC never concluded or acted upon. We do not believe the record contains enough information about why the FCC did not pursue the audit for us to act upon it. While Pacific's witness tried to depict the FCC's decision not to pursue the audit as a rejection of the audit results, he conceded at hearing that the FCC decision was based more on a changed regulatory environment.

### **3. Pacific's 1999 Computer Inventory**

Pacific also conducted an inventory of its own computer records in 1999 in anticipation of the transfer of its information technology (IT) department to SBC Services. The inventory resulted in \$98 million in plant retirements for plant that could not be found in the physical inventory. Overland states that, "[t]he failure to record retirements on a timely basis is the most plausible, if unproven, explanation for the missing plant."<sup>101</sup>

The 1999 computer inventory suggests that Pacific lacks adequate controls over its plant and property records.

### **4. SAVR Retirements**

A third document also reflects Overland's concerns with Pacific's plant internal controls.<sup>102</sup> In May 1997, Pacific carried out its own Statewide Asset

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<sup>100</sup> 12 RT 1288:18-1289:14 (Hayes).

<sup>101</sup> Exh. 2A:404 at 10-17 (Audit Report).

<sup>102</sup> This discussion refers to issues referenced as index 18 and 19 in Appendices A, B, C and D.

Verification and Retirement Project (SAVR) to audit its central office property records.<sup>103</sup> The project consisted of a 100 percent physical inventory of 689 Pacific Bell central offices. The SAVR project identified \$414 million of plant that was recorded in Pacific's plant accounts but was not physically present in the central offices. This amount represents 4.5 percent of the investment recorded in Pacific's central office equipment plant accounts.

As with its 1999 computer inventory discussed in the previous section, Pacific found plant records but could not locate the physical plant in the central offices. Pacific therefore retired the unlocated assets from the company's books by crediting plant in service for the original cost of the item and debiting accumulated reserve for depreciation. Pacific also located plant that did not show up in the property records, and made accounting adjustments ("reverse retirements") that were the reverse of what it did for plant it could not locate: debiting plant in service and crediting the reserve for depreciation by an amount equal to the estimated original cost of the discovered plant.

Overland states that this process skewed depreciation expense in 1997 and 1998. For the plant that Pacific could not find, Overland calculates that the overstatement amounted to \$17 million on an intrastate pre-tax basis. The dispute relates to whether Pacific should have recorded the changes to its accounting in the affected years, or in subsequent years when it discovered the error. There was an absence of clear guidance from the Commission, the FCC or GAAP at the time of the SAVR retirement accounting.

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<sup>103</sup> *See id.* at 10-12.

Once again, Pacific claims that such retroactive adjustments violate GAAP and, therefore, foreclose the Commission's ability to make the retroactive adjustments, a claim we reject as a blanket justification to avoid regulatory scoring of company performance during the years subject to sharing.<sup>104</sup> On the other hand, we note that since this issue has no effect on "shareable earnings" and no effect on our regulatory program, we defer to the GAAP procedures for determining the timing of such error corrections.

The "reverse retirements" raise slightly different issues. Here, the concern is that Pacific located equipment for which it had no records. Therefore, Pacific recorded a "reverse retirement" by debiting the plant account and crediting reserve for depreciation in an amount equal to the estimated original cost of the plant. Pacific recorded \$123.9 million in reverse retirements as a result of the SAVR project.<sup>105</sup>

Overland concluded that Pacific's reverse retirement entries unreasonably increased intrastate depreciation expense by \$5.5 million on an intrastate pre-tax basis during the audit period. Overland believed that there was a more plausible explanation for the presence of unrecorded plant than that Pacific simply failed to account for it when acquired. Rather, Overland explained that Pacific either charged the equipment to expense when it was originally acquired or booked it

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<sup>104</sup> Concerning Intrabuilding Network Cable Amortization we followed the GAAP procedures because Commission rules affecting depreciation prevented any other plausible accounting treatment.

<sup>105</sup> *Id.* at 10-13.

with other continuing property record items.<sup>106</sup> Yet Overland produced no evidence to support its explanation. We therefore disagree with Overland's approach and reject its recommendation on reverse retirements.

## **5. Other Net Plant Issues**

### **a) Restructuring Reserve Adjustment**

Overland states that intrastate net plant is overstated by an average of \$29 million as a result of an error in Pacific Bell's Restructuring Reserve - IEMR ratemaking adjustment.<sup>107</sup> Overland tried to obtain an explanation from Pacific before writing up its audit findings, but did not receive one until February 1, 2002. However, Overland did not change its conclusion based on the new information: "[t]he response to [Overland's data request] confirms that the correction to net plant recommended in the audit report is proper."<sup>108</sup>

Pacific asserts that Overland's calculations are wrong because they do not account for more recent activity. However, Overland was not focused on recent activity, but rather on the period 1997-99, and during that period, Overland concluded that net plant was overstated. Since Pacific cites no new reason to change that conclusion, we reject Pacific's claim. Indeed, Pacific concedes an error of \$4.4 million for each year, reflecting the fact that the "depreciation

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<sup>106</sup> *Id.* at 10-15.

<sup>107</sup> This discussion refers to issues referenced as index 35 in Appendices A, B, C and D.

<sup>108</sup> Exh. 2B:415 at S10-3 (Supplemental Audit Report).

amounts were keyed in with the wrong sign,”<sup>109</sup> so even Pacific admits that Overland’s finding is partially correct.

Pacific’s explanation does not refute Overland’s audit findings, and we adopt the audit recommendation of \$29.0 million for each of the three audit years. Pacific should make this error correction in its books, with the timing of the correction dictated by GAAP.

**b) Depreciation Adjustment**

Pacific acknowledges that to the extent we adopt any of Overland’s adjustments to depreciation expense, we should also adjust accumulated reserve for depreciation.<sup>110</sup> Pacific should show how it has or proposes to reflect this adjustment in the compliance Advice Letter filing it is to make within 90 days of the effective date of this decision. The timing of this error correction should be made consistent with GAAP.

**c) Allowance for Funds Used During Construction (AFUDC)**

It is Overland’s opinion that Pacific’s method of calculating its Allowance for Funds Used During Construction (AFUDC) is unreasonable<sup>111</sup> and does not logically implement the method adopted for Pacific in Resolution RF-4, which the Commission adopted on November 18, 1980.<sup>112</sup> As a result, Overland

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<sup>109</sup> Pacific Opening/Audit at 90.

<sup>110</sup> This discussion refers to issues referenced as index 36 in Appendices A, B, C and D.

<sup>111</sup> This discussion refers to issues referenced as index 71 in Appendices A, B, C and D.

<sup>112</sup> A copy of the Resolution is included in Overland’s Audit Report (Exh. 2A:404) as Attachment 10-9.

concludes that Pacific's AFUDC rate is overstated, its intrastate net plant balances are overstated by an average of \$7.9 million, and its intrastate regulated pre-tax depreciation expense is overstated by \$1.7 million for the audit period.

The AFDUC rate reflects the company's average cost of debt, unless a specific new borrowing is associated with the construction of the project. Overland interprets Resolution RF-4 to calculate the cost rate for other externally generated funds as the weighted average cost of new long-term debt and equity securities issues during the past 12 months. During the audit period, Overland found that Pacific ignored new equity issues and based the cost rate solely on the cost of new debt issuances. Overland believes that Pacific's method effectively establishes an AFUDC rate that exceeds a capital structure of 100 percent while RF-4 requires that the capital ratios used to calculate the overall AFUDC rate add up to 100 percent.

Overland found that when Pacific's combined depreciation expense, short-term borrowings, and investment tax credit for a period exceeds its annual construction expenditures, Pacific considers this negative amount as a negative source of externally generated funds. The result is that this negative amount is treated as a use of capital. Overland maintains that it is illogical to have any amount for externally generated funds when Pacific did not issue any "other externally generated funds" during the construction period.

Citing changes adopted in D.98-10-026, which allowed the use of economic depreciation, Pacific believes it would be appropriate to prospectively allow the same AFDUC rates for intrastate purposes that is used for interstate and external reporting. Pacific agrees that perhaps the intrastate AFUDC rates are overstated but notes that it has consistently applied the Commission's methodology for the past 20 years. There is no Commission ruling or order disallowing the

methodology Pacific employs to implement the Resolution RF-4 AFUDC calculations.

We find that Pacific acted appropriately in calculating AFDUC rates using the same methodology for the past 20 years. Pacific shall use the Resolution RF-4 AFUDC methodology, as clarified in this decision. We adopt Pacific's recommendation to use the FCC's AFUDC rate beginning with the year 2004.<sup>113</sup>

**d) PBOP Pre-Funding Plant Adjustment**

Overland states that Pacific's intrastate net plant is overstated by \$13.3 million for each of the three audit years as a result of an alleged failure by Pacific to account properly for "pre-funding" of post-retirement benefits other than pensions (PBOP) contributions made prior to the adoption of FAS 106.<sup>114</sup>

Overland states Pacific should have expensed the contributions as it did for FCC purposes. Pacific claims it could not have done so because prior to the adoption of FAS 106 this Commission did not grant rate recovery of the pre-paid PBOPs; it could only record PBOP expense when it paid for actual PBOP benefits.

There is no evidence in the Phase 2B record on this issue other than the audit itself. Related pre-funding issues are addressed in the Phase 2A decision, where we found that Pacific need not have expensed PBOP pre funding contributions in accordance with Overland's audit recommendation. The same treatment should occur here. Therefore, we reject Overland's recommendation of a rate base adjustment of 13.3 million for each of the three audit years.

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<sup>113</sup> See 47 C.F.R. § 32.2000(c) (FCC Part 32 AFUDC methodology, using average cost of debt unless new borrowing is associated with the construction project).

<sup>114</sup> This discussion refers to issues referenced as index 72 in Appendices A, B, C and D.

**G. Other Rate Base Items****1. Cash Working Capital**

The audit report and ORA reached different conclusions about cash working capital.<sup>115</sup> Cash working capital is the amount of funds or investment associated with the timing difference between when a utility incurs the costs of providing service and when it receives revenues for those services. If Pacific pays its suppliers before the customer pays for the associated services, cash working capital is the amount required to finance those expenditures until it receives payment from the customer. (Conversely, if Pacific receives payment for service prior to when it pays its suppliers, cash working capital associated with such a transaction is theoretically a negative amount.)

The Commission's Standard Practice U-16 controls for purposes of calculating cash working capital. Cash working capital requirements typically are calculated through a "lead-lag" study, which compares revenue and expense "lags" to calculate the average annual amount of cash working capital associated with a particular expense category.<sup>116</sup> Adjustments to cash working capital in this context really are no more than modifications of the assumptions about the lag time between Pacific's payments to and from suppliers.

Overland concluded that because Pacific's lead-lag studies are out-of-date (not updated since 1988), Pacific could not support its lead-lag assumptions. The audit report attempted to determine actual lags by focusing its attention on

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<sup>115</sup> This discussion refers to issues referenced as index 27 in Appendices A, B, C and D.

<sup>116</sup> TURN Opening/Audit at 30-31; Exh. 2A:404 at 11-5 (Audit Report).

various items of expense (*e.g.*, deferred income tax expense, amortization expense, as well as one time expenses such as a refund required as a condition of the Pacific Telesis-SBC merger) and on actual revenue lags.

Overland initially concluded that Pacific's corrected working capital requirement averaged \$149 million during the audit period, \$325 million lower than the average amount claimed by Pacific.<sup>117</sup> In its supplemental audit report, Overland changed its recommendations based on new information Pacific produced in discovery to find that Pacific's revised intrastate cash working capital averaged only \$3 million per year during the audit period.<sup>118</sup>

ORA and TURN advocate setting the cash working capital figure at zero for the audit period. TURN clarifies that doing so "reflects an assumption that an expense is recovered in revenues concurrent with the incurrence of the expense itself. In other words, a cash working capital figure of zero does not necessarily mean that the expense is being ignored for cash working capital purposes or removed from rate base, but rather that the correct determination of the 'lag' for that expense is zero."<sup>119</sup>

While Pacific "is open to the possibility of re-examining the Cash Working Capital methodology on a going forward basis and would welcome a simpler calculation," it claims that Standard Practice U-16 precludes the changes the

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<sup>117</sup> Exh. 2A:404 at 11-35 (Audit Report); for a detailed description of the multiple steps Overland used to reach this conclusion, *see id.* at 11-3 – 11-35.

<sup>118</sup> Exh. 2B:415 at S11-5 (Supplemental Audit Report).

<sup>119</sup> TURN Opening/Audit at 31.

audit, ORA and TURN advocate for the audit period. No party takes issue with Pacific's strict compliance with Standard Practice U-16.

We described Standard Practice U-16 in D.95-12-055: "The Commission's 'Standard Practices' are accounting guidelines which we have used for purposes of ratemaking. They are not rules that the utilities must follow. They are, however, rules that we will follow in developing rates unless the utility can demonstrate 'special circumstances' which warrant a deviation."

We find that no such special circumstances exist here. While Pacific's expense lags have not been updated since 1988, they still reflect the lags experienced during the audit period. It does not follow that because the quantity of transactions increased that actual lag days have changed. The record does not support such a conclusion.

The Commission's Standard Practice U-16 requires the inclusion of non-cash items in working capital. ORA objects to including non-cash items such as depreciation in cash working capital, since these expenses do not actually require Pacific to make a cash outlay. ORA reasons, "[d]epreciation expenses and other non-cash items are merely accounting entries that have no relationship to a company's required minimum bank deposit. . . . By including these non-cash items in the working cash allowance, SBC Pacific has inflated the rate base."<sup>120</sup>

Excluding non-cash items from cash working capital requirements actually brings that requirement to a negative (below zero) figure. ORA therefore claims that its proposal to set the requirement at zero is actually quite conservative,

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<sup>120</sup> ORA Reply/Audit at 29, 32, citing Exh. 2B:122, Q&A 20 (Carver Direct Testimony).

since it reduces the working capital requirements by less than the amount required to make the working capital figure a negative number.

We agree with ORA that cash working capital should not include depreciation since this expense does not require Pacific to make a cash outlay. However, Standard Practice U-16 is contradictory about whether depreciation should be included. It appears Pacific was in compliance with Standard Practice U-16 when it followed the numerical example described in the detailed methodology. Therefore, we clarify that for the current and future financial periods Pacific shall no longer include depreciation in its cash working capital calculations, regardless of whether the simplified or detailed method is employed.

Pacific proposed a smaller adjustment for cash working capital, and we adopt it here. As shown in Appendix A, the rate base deductions would have been \$142.2 million in 1997, \$91.3 million in 1998, and \$91.1 million in 1999. Pacific should reflect the rate base reductions in its accounts, and revise its IEMRs, starting in 1997.

## **2. Other Rate Base Calculation Issues**

Overland found that Pacific made several errors with regard to its rate base calculation. There are six affected items: 1) prepaid directory expenses, 2) prepaid pension, 3) accrued FAS 112 liability, 4) accrued vacation pay liability, 5) accrued FAS 106 liability and 6) accrued contingent liabilities. Overland recommends that four of the items – accrued FAS 112 liability, accrued vacation pay liability, accrued FAS 106 liability, and accrued contingent liabilities – be deducted from rate base, and that the remaining two items – prepaid directory expenses and prepaid pension – be added to rate base.

Pacific opposes Overland's recommended rate base treatment of each item. Pacific does not address the individual items but simply argues that they should not have been included in the calculation of rate base on the IEMR for 1997-99 because they are not included in D.91-07-056.<sup>121</sup> In D.91-07-056, the Commission ordered that the method and components used to determine the rate base in the calculation of shareable earnings should be the same as those used to determine the rate base used in the start-up revenue requirement in D.89-12-048.<sup>122</sup>

However, D.89-12-048 never specifies what elements comprise rate base. Pacific asserts that D.89-10-031 states: "For Pacific, the startup revenue requirement shall be based upon the Monthly Results of California Intrastate Operations report filed with CACD in compliance with the Commission's November 5, 1979 letter." Pacific asserts that the only components that the Commission requires to be included in the rate base calculation are Telecommunications Plant in Service, plus Plant Held for Future Use, plus Materials and Supplies, less Depreciation Reserve, less Tax Reserve, plus Cash Working Capital. We agree with Pacific.

With these concepts in mind, we turn to the individual items Overland addresses.

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<sup>121</sup> 1991 Cal. PUC LEXIS 439.

<sup>122</sup> 1989 Cal. PUC LEXIS 633.

**a) Prepaid Directory Expense**

Overland seeks to add prepaid directory expense to rate base.<sup>123</sup>

Currently, Pacific charges its prepaid directory publishing costs when the directory is published. Overland recommends that the prepaid publishing costs be included in rate base and amortized over the 12-month life of the published directory.<sup>124</sup>

We disagree with Overland's finding. As noted elsewhere in this decision (*see* Section entitled "Other Revenue/Operating Income Issues – Directory Publishing," above), Pacific recognizes directory revenues and expenses at the time the directory is published. Overland stated it could not determine whether the change had an impact on revenues and expenses.<sup>125</sup> As noted above, our regulatory approach does not recognize this item as a component of ratebase, and therefore no adjustment, either positive or negative, is consistent with our rules.

**b) Prepaid Pension Assets**

Overland opines that Pacific should include prepaid pension assets in rate base. Because the Phase 2A decision deals fully with this issue, we defer to that decision for resolution of the matter.

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<sup>123</sup> This discussion refers to issues referenced as index 28 in Appendices A, B, C and D.

<sup>124</sup> Exh. 2A:404 at 11-28 (Audit Report).

<sup>125</sup> Exh. 2A:404 at 5-10 (Audit Report).

**c) Accrued FAS 112 Liability**

Overland seeks to remove this liability from the balance sheet.<sup>126</sup> This change would reduce rate base by the amount of the liability so removed.

Pacific recorded its FAS 112 liability in Account 4310.<sup>127</sup> The FCC requires amounts in that account to be removed from interstate rate base.<sup>128</sup> Although FCC accounting methodology is not controlling for our purposes, the Commission often looks to the FCC for guidance.

As noted above, our regulatory approach does not recognize this item as a component of ratebase, and therefore no adjustment, either positive or negative, is consistent with our rules.

**d) Accrued Vacation Pay Liability**

Overland recommends that carry-over vacation pay – vacation pay accrued by employees in prior years – be deducted from rate base.<sup>129</sup>

In accordance with the discussion in the previous section, this is not a component of ratebase, and therefore no adjustment, either positive or negative, is consistent with our rules.

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<sup>126</sup> This discussion refers to issues referenced as index 29 in Appendices A, B, C and D.

<sup>127</sup> Exh. 2A:404 at 7-34, table 7-12 (Audit Report).

<sup>128</sup> *In the Matters of Responsible Accounting Officer Letter 20, Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32, et al.*, AAD 92-65, CC Docket No. 96-22, FCC 97-56 (rel. Feb. 20, 1997) (FCC Order 97-56), ¶ 19.

<sup>129</sup> Exh. 2A:404 at 11-31 (Audit Report). This discussion refers to issues referenced as index 30 in Appendices A, B, C and D.

**e) Accrued FAS 106 Liability**

Overland seeks to remove Pacific's FAS 106 liability accruals from the balance sheet, which would reduce rate base by the amount on the balance sheet.<sup>130</sup>

As noted above, our regulatory approach does not recognize this item as a component of ratebase, and therefore no adjustment, either positive or negative, is consistent with our rules.

**f) Accrued Contingent Liabilities**

Finally, Overland recommends that contingent liabilities be deducted from rate base.<sup>131</sup>

As noted above, our regulatory approach does not recognize this item as a component of ratebase, and therefore no adjustment, either positive or negative, is consistent with our rules.

**H. Affiliate Transactions**

**1. Introduction**

The audit did not conclude that internal control weaknesses affecting affiliate service transactions had a material impact on Pacific's CPUC financial results during the years 1997 through 1999. The audit found problems with the internal controls necessary to ensure that when Pacific transacts business with

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<sup>130</sup> This discussion refers to issues referenced as index 31 in Appendices A, B, C and D.

<sup>131</sup> Exh. 2A:404 at 11-34 (Audit Report). This discussion refers to issues referenced as index 32 in Appendices A, B, C and D.

SBC affiliates, regulated operations are adequately compensated and do not subsidize unregulated aspects of the business.

The audit recommends adjustments during the audit period that increase Pacific's net income by \$97 million during the audit period.<sup>132</sup> In addition, ORA recommends continued audits of Pacific's affiliate transactions on the ground that Pacific hindered the auditors' initial efforts.

After addressing the undisputed affiliate transactions issues, we discuss the alleged deficiencies in Pacific's affiliate transactions practices.

For reasons discussed below, we find that a continued audit of affiliate transactions is not warranted for this audit period.

## **2. Undisputed Affiliate Transactions Adjustments**

Pacific conceded 13 of Overland's affiliate transaction-related adjustments, and we thereby adopt them.<sup>133</sup> Moreover, in light of the audit findings, Pacific acknowledges that it should improve some existing internal controls, related to classification of costs among its FCC Part 32<sup>134</sup> accounts; retention of certain data to support allocations to Pacific; and revision to certain portions of the SBC Operations cost apportionment methodology.<sup>135</sup>

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<sup>132</sup> *Id.*

<sup>133</sup> *See* Exhs. 2B:362A (revised chart, "Affiliate Transactions-Overland," listing disputed and "nondisputed" issues) and 2B:344 at 6-7 (Henrichs Direct Testimony).

<sup>134</sup> 47 C.F.R. § 32 *et seq.* (FCC's Part 32 Uniform System of Accounts, as adopted in relevant part by this Commission in D.87-12-063, 1987 Cal. PUC LEXIS 412).

<sup>135</sup> Exh. 2B:344 at 9 (Henrichs Direct Testimony).

Pacific states that it has already made several “enhancements” in response to the audit report. It has expanded its internal Advisory Oversight Group (AOG) staff; notified its responsible controller organizations regarding proper expense classification of shared services costs billed to Pacific; had AOG review its external affairs and lobbying costs; and refined its determination of cost causative factors for certain cost pools in SBC Operations.<sup>136</sup>

We next turn to a discussion of disputed issues.

### **3. Disputed Affiliate Transactions Adjustments**

The auditors reached conclusions and made recommendations on a large number of issues concerning affiliate transactions. These include: internal accounting controls; Pacific’s management control over actions of its parent and affiliate organizations; compliance with affiliate transaction requirements; transfer or use of customer information, trademarks and other intangible assets; and treatment of the costs of developing Advanced Services, Inc. (ASI), Pacific’s digital subscriber line (DSL) affiliate. We discuss each of these in turn.

#### **a) Internal Accounting Controls**

Overland’s review of internal accounting controls resulted in the following conclusion:

We did *not* conclude that internal control weaknesses affecting affiliate service transactions had a *material* impact on Pacific’s CPUC-basis financial results during the years 1997 through 1999.<sup>137</sup>

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<sup>136</sup> *Id.*

<sup>137</sup> Audit Report, p. 12-3 (emphasis added); 10 TR 1004:16-19.

The audit found weaknesses in Pacific's internal controls in the area of affiliate transactions. The audit report contains the following findings (marked by bullets):

- Certain affiliates have allocation processes Overland could not effectively audit.
- Pacific's customer data system and possibly other operational support systems continue to be used by affiliates without compensation to Pacific Bell, even though SBC charges Pacific \$400 million annually for the use of its name.

Pacific claimed in response that Overland is speculating, and that "neither ORA nor Overland presented one shred of evidence that Pacific is not compensated for use of the customer database in violation of any affiliate transaction rules or regulations."<sup>138</sup> However, as we discuss in the Section entitled "Transfer or Use of Customer Information, Trademarks and Other Intangible Assets," below, the witness Pacific offered on this subject could not state whether or not SBC Operations made use of Pacific's customer data once it completed work on a Pacific-specific project.

- Pacific Bell's transfer price calculations appear to be seriously flawed and lack cost support.

In response, Pacific claimed it gave Overland adequate information and that "Overland's alleged difficulty in auditing this area speaks, once again, to its lack of qualifications as an auditor. . . ."<sup>139</sup> However, one of the items Pacific

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<sup>138</sup> Pacific Reply/Audit at 59.

<sup>139</sup> *Id.* at 60.

gave to Overland – “fair market value studies supporting Pacific’s transfer prices” –was inadequate to show the prices were fair, as we discuss in the Section entitled “Compliance with Affiliate Transaction Requirements,” below. We cannot determine whether the other information Pacific furnished – “fully distributed cost studies” and “general ledger detail” – was inadequate for Overland to determine how Pacific made its transfer price calculations.<sup>140</sup>

- Neither Pacific Bell nor SBC could supply information accurately depicting the affiliate organization as it was constructed for inter-company accounting and billing purposes.

In response, Pacific claimed that, “the type of organizational chart Overland desires serves no business function and is burdensome to maintain.”<sup>141</sup> This response is so dismissive of Overland as to raise a concern that Pacific was being willfully unhelpful to Overland’s efforts. All it appears Overland was trying to do was to trace how Pacific’s organizational structure functioned. Pacific provided Overland a list of “Responsibility Codes in its CENET database” and urged Overland to figure out who did what from a large personnel database of “a company like SBC that employs nearly 200,000 individuals.”<sup>142</sup>

- There is a lack of documentary support for corporate legal department charges to Pacific Bell.
- Subject matter experts designated to answer questions on behalf of SBC Services were unable adequately to define

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<sup>140</sup> *Id.*

<sup>141</sup> *Id.* at 61.

<sup>142</sup> *Id.*

the organization's boundaries or assure the auditors that anyone at SBC had a complete understanding of what SBC Services billed to affiliates in 1998 or 1999. In many respects, SBC Services was a tangle of accounting methods and affiliate billings that could not be effectively defined or audited.<sup>143</sup>

We are concerned with certain aspects of the organization of SBC's centralized functions. Pacific concedes this point, at least in part: "During the audit period, shared functions migrated from subsidiaries, including Pacific, to SBC Services. *Based on this migration, at least initially, the operations of SBC Services may have been difficult to analyze.*"<sup>144</sup> Pacific then makes the oft-repeated assertion that "information was provided to Overland that was sufficient to analyze the migration to a proprietary chart of accounts."<sup>145</sup>

Affiliate transactions are one of the more difficult areas of regulatory accounting to understand. It may well be that when Pacific's staff that works with affiliate transactions day in and day out attempt to explain Pacific's methods to outsiders - regardless of their accounting expertise - the explanations are not clear. Since Overland did not conclude that that the existing internal controls had led to a material impact on Pacific's CPUC-based financial results during the years 1997-1999, we find no basis for further investigation into this matter.

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<sup>143</sup> See ORA Opening/Audit at 43-44.

<sup>144</sup> Pacific Opening/Audit at 136 (emphasis added).

<sup>145</sup> *Id.*

We now turn to Overland's specific recommendations on Pacific's affiliate transactions.

**b) Compliance with Time Reporting Document  
Retention Requirements**

Pursuant to a 1997 Consent Decree, the FCC required employees of certain SBC parent organizations to keep time records for affiliate transactions purposes.<sup>146</sup> Overland found Pacific to be out of compliance with this requirement and concluded that there were significant weaknesses in Pacific's internal controls related to affiliate transactions during the audit period.

At the threshold, there is a disagreement over which entities were required to keep the records. Overland opines that the Consent Decree applied to the SBC holding company as well as SBC Operations and SBC Services; Pacific claims the Consent Decree by its terms only binds SBC Communications Inc., the holding company, and is silent as to the other two entities.

The evidence supports Pacific's interpretation. The plain language of the Consent Decree clearly states which affiliates are included and obligated by its requirements. Neither SBC Services nor SBC Operations is included in the Consent Decree. SBC Services and SBC Operations voluntarily adopted the time reporting requirements and have maintained those records only for consistency with the Parent. Accordingly, we need not address whether these entities actually complied.

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<sup>146</sup> Exh. 2B:363 (FCC Consent Decree 97-9, AAD No. 95-32, Feb. 7, 1997).

**(1) 1998 Affiliate Oversight Group (AOG) Compliance  
Review of SBC Operations**

Overland claims that Pacific's own 1998 internal review of its affiliate transaction compliance made findings such as "SBC-OPS is not in compliance at this time," "A 70% rate of response and only 85% of employees . . . must be remedied," and "payroll data is unreliable."<sup>147</sup> Pacific contends these findings were in the draft report and that the final report stated that "SBC-Ops at year end true up will be in compliance. . . ."

As previously discussed, we find that SBC Operations is not obligated by the Consent Decree to maintain time reporting document. We also find the final report more credible.

**(2) SBC Operations "Image Maker" Program**

Overland believes that Pacific's "Image Maker" program also provides evidence of inadequate internal controls at Pacific. At hearing, Pacific was able to refute Overland's concerns in this area.

Overland found evidence that it believed showed that the Image Maker program, an advertising campaign intended to create a standardized advertising image of SBC's affiliates in various phone directories, allowed SBC to preview directory ads before they ran and ensure better ad placement and size than third-party companies. The evidence was an email message in which an SBC employee described Image Maker as "the strategy the Corp . . . has initiated to get all the SBC subsidiaries equal or better advertising with their competitors in every directory in the eight state territory."

Pacific submitted four declarations<sup>148</sup> conclusively refuting the contents of the email message, and establishing that the Image Maker program made recommendations only after directories were published. Thus, for example, if in a published directory Pacific's advertisements were not as prominent as those of a competitor, the Image Maker program highlighted this point and suggested modification of the ad in future directories.

Because the program was based on analysis of already-published directories, we find no wrongdoing in the program or lack of internal control in its existence. We therefore reject Overland's recommendation in this regard.

### **(3) Centralized Tracking for Legal Matters**

Overland expresses concern about SBC's current process for tracking legal matters, stating the process is unauditible and suggesting that Pacific create a centralized database to track costs and assist in budgeting and control. Pacific claims it already has such tracking within the legal department, and that adding other requirements to this process would only increase legal department expenses which are allocated in part to Pacific. Pacific also claims that SBC has a procedure in place to allocate legal costs in accordance with the requirements of FCC Part 64.<sup>149</sup>

There are substantial differences between Overland's opinion and Pacific's statements. The record does not establish that deficiencies exist in Pacific's tracking of legal matters, and we do not order change.

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<sup>147</sup> Exh. 2A:404 at 15-3 (Audit Report).

<sup>148</sup> Exh. 2B:630.

<sup>149</sup> 47 C.F.R. § 64 *et seq.* Pacific Opening/Audit at 126.

**c) Affiliate Issues: Management Fees and Research  
Assessment****(1) Alleged Excessive Management Fees**

ORA and the audit both raised concerns that Pacific's parent entity and shared services affiliates load excessive "management fees" onto Pacific's regulated operations. Overland concluded that Pacific had no decision-making role in the quantity, type or price of these services. It noted that there was no documented dispute between Pacific and the entities charging Pacific such fees, which led to the conclusion that Pacific simply was not disputing those charges.

ORA concurred that the management fees raise concerns. It pointed out that, at the very least, the 30-fold increase in charges SBC Services passed on to Pacific over time – from \$30 million in 1999 to \$1.1 billion in 2000 – casts doubt on Pacific's assertion that its affiliates adhere to cost controls to ensure that all SBC companies receive the lowest cost service.<sup>150</sup>

Pacific noted that it has no control over the pricing of these services, nor does the Parent or the other affiliates. The FCC and the Commission rules for affiliate transactions govern these costs. Pacific does, however, have the ability to dispute the level or nature of the bills it receives for these costs. Pacific claims that the regulated entity does have a say in how much it pays SBC for services, even if it does not keep detailed written records. Pacific's witness testified as to "informal process" for resolving disputes done by telephone along with journal entries for corrections.<sup>151</sup>

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<sup>150</sup> ORA Reply/Audit at 37.

<sup>151</sup> 12 TR 1907:22-28; 1908:1-4, 18-28; 1909:1; 1911:12-1191:23; 1911:26-1912:22.

We find that Pacific's management had appropriate recourse concerning SBC decisions on the type and amount of management fees to assess on the regulated utility. We discuss the specific findings in more detail below.

## **(2) Corporate Charges for Research**

Technology Resources Inc. (TRI) is responsible for research and development (R&D) for SBC and its affiliates. Overland expressed concern that it could not determine whether TRI's billings to Pacific were appropriate.<sup>152</sup> Pacific's only attempted justification was that Pacific was not qualified to question TRI's billings: "as the technology expert it is in the best interest of the affiliate to give TRI the ultimate decision with regard to project pursuit."<sup>153</sup> Regarding the billings, however, Overland found "the amounts allocated to Pacific Bell were not very significant," and "SBC's acquisition of additional plant laden telcos (Southern New England Telephone and the Ameritech Bells) are likely to draw some of TRI's costs away from Pacific Bell in the future. We agree with Overland and find no change in TRI billings as reasonable.<sup>154</sup>

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<sup>152</sup> This discussion refers to issues referenced as line 21 of Appendix A.

<sup>153</sup> Pacific Opening/Audit at 130.

<sup>154</sup> Exh. 2A: 404 at 16-1 (Audit Report).

**d) Compliance with Affiliate  
Transaction Requirements**

**(1) Overview of Issues**

Again, Pacific notes that Overland “did not conclude that internal control weaknesses affecting affiliate service transactions had a material impact on Pacific’s CPUC-based financial results during the years 1997 through 1999.”<sup>155</sup>

Pacific explained SBC’s process of passing its costs on to affiliates, which relies on FCC Part 64 guidelines to establish a hierarchy of cost allocation. The first principle of such assignment is that “costs shall be directly assigned to either regulated or nonregulated activities whenever possible.”<sup>156</sup> Overland found that most of SBC’s allocations were based not on this first principle requiring direct assignment, but rather were based on a general allocator based on the size of the affiliate’s investment. Since the regulated telephone companies have the greatest amount of investment, they bear a large portion of costs.

Part 64 only allows reliance on a general allocator after all other, more specific, methods of allocation have been tried:

(b) In assigning or allocating costs to regulated and unregulated activities, carriers shall follow the principles described herein:

...

(2) Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.

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<sup>155</sup> Pacific Opening/Audit at 130, citing Exh. 2A:404 at 12-3 (Audit Report).

<sup>156</sup> 47 C.F.R. § 64.901(b)(2).

(3) Costs which cannot be directly assigned . . . will be described as common costs . . . . Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy:

(i) Whenever possible, common cost categories are to be allocated based on direct analysis of the origin of costs themselves.

(ii) When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another cost category (or group of categories) for which a direct assignment or allocation is available.

(iii) *When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.*<sup>157</sup>

Pacific claims that it follows the Part 64 methodology.

We next review Overland's findings and the evidence in the record to resolve each issue identified by Overland.

## **(2) Booking of Parent Costs**

Pacific acknowledges that it "inadvertently classified certain expenses to the incorrect Part 32 accounts" and "has implemented a number of enhancements to ensure appropriate Part 32 classification of costs."

IEMR earnings were not impacted because the misallocations were appropriately designated as above- or below-the-line.<sup>158</sup> In addition, Pacific has

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<sup>157</sup> *Id.* § 64.901 (emphasis added).

<sup>158</sup> Pacific Opening/Audit at 132.

implemented a number of enhancements to ensure appropriate Part 32 classifications of costs in the future. Thus, we need order no further action on this matter.

### **(3) Booking of Costs for Shared Services Affiliates**

Overland states that SBC Operations did not retain certain documents supporting the SBC Operations allocation factors. Pacific concedes that “in certain areas documentation was inadvertently lost.” It states that AOG, its internal auditing group, has expanded its role to include oversight of SBC’s shared service organizations’ cost allocation systems, allocation methodologies and document retention, and that AOG centralized the document retention function.

Overland acknowledges that costs allocated from SBC Operations to Pacific did not have a material impact on Pacific’s financial results. Moreover, the AOG has expanded its role to include oversight of SBC’s shared service organizations’ cost allocation systems, allocation methodologies and document retention. A comprehensive review was performed and document retention enhanced. There is no need for further Commission action.

### **(4) Services Provided by Pacific Bell to Affiliates**

It was Overland’s opinion that SBC was not able to provide an audit trail demonstrating that its system of billing affiliates for services Pacific provided to SBC unregulated affiliates was functioning properly.<sup>159</sup> Overland then went on to make the following observation:

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<sup>159</sup> Exh. 2A:404 at 17-1 (Audit Report).

We believe controls functioned as intended from the point at which affiliate units were input into the affiliate billing system. . . These generally functioned to provide the intercompany balance control as intended.<sup>160</sup>

We find that this observation supports the general conclusion that proper internal controls are functioning as intended for Pacific's billing system and collection of affiliate costs. Overland also found that there were discrepancies between costs Pacific tracked for marketing services performed on behalf of affiliates and the amount Pacific billed the affiliates for these services.<sup>161</sup>

Overland then expressed concern that Pacific was not charging its affiliates a 10% mark-up as required in D.86-01-026. Pacific claims such markup is not required for its transactions with *regulated* affiliates due to an FCC order that "Transactions between two regulated affiliates do not present the same potential for cost shifting and need not adhere to these [affiliate] rules."<sup>162</sup> Pacific claims it does impose the 10% mark-up on its nonregulated affiliates. Pacific explains that application of the 10% mark-up for billings to regulated affiliates creates the potential for cross-subsidization, which is at odds with the fundamental basis for affiliate rules.

Overland is also concerned that Pacific has not justified the rates it charges affiliates under the requirement that it charge the higher of fair market value

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<sup>160</sup> Audit Report, p. 17-8.

<sup>161</sup> Exh. 2A:404 at 20-37 – 20-38 (Audit Report).

<sup>162</sup> FCC *Order on Reconsideration*, FCC 87-305, ¶ 122.

(FMV) or fully distributed cost (FDC). Pacific claims it uses a market research firm to survey and provide the FMV of third party services. Pacific states this method of determining FMV is consistent with the FCC's Accounting Standards Order, in which the FCC "set a baseline for a good faith determination of fair market value by requiring carriers to use methods that are routinely used by the general business community."<sup>163</sup>

Pacific's practice of using a market research firm to survey and provide FMV of third party services meets the FCC requirement stated above. We agree with Pacific that market studies prepared by a third party consultant provide a reasonable proxy for market value. Overland's assertion that market comparisons should be made on a whole function basis is unnecessary and exceeds regulatory requirements.

**e) Other Compliance Issues Concerning Affiliate  
Transaction Rules - AMDOCS**

Overland found that Pacific Bell Directory did not follow Commission rules requiring purchases from AMDOCS – an SBC software subsidiary – to be recorded at the lower of FDC or FMV. Pacific does not disagree, claiming it "inadvertently did not apply the appropriate affiliate rules." Overland also found that the negotiated prices did not have a material impact on Pacific Bell Directory's contribution to regulated operating income.<sup>164</sup>

Since this issue had no material impact, we reach no finding on this matter.

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<sup>163</sup> FCC *Accounting Standards Order*, CC 96-150, ¶ 154.

<sup>164</sup> Henrich's Corrected Direct Testimony, Exh. Pacific:Phase 2B:344, p. 77.

**f) Transfer or Use of Customer Information,  
Trademarks and Other Intangible Assets**

Overland found that “electronic access to Pacific Bell’s customer database was effectively transferred to SBC Operations during the audit period” and that “Pacific Bell has not been compensated for the transfer.” TURN concurs.

Pacific did not dispute that it allows SBC Operations to use its customer database for the purpose of marketing Pacific Bell’s services. However, Pacific claimed that it simply gave Shared Services “access” to the database, and denied that there was a “transfer” of customer records. TURN asserts that the record actually supports the conclusion that there was a “transfer” of data.

Pacific categorically denies that its affiliates make any use of Pacific’s customer information except to conduct marketing for Pacific’s own benefit. Pacific adds that it is compensated when required in accordance with existing FCC and Commission affiliate transaction rules. Overland states that constraints of time and scope prevented it from assessing the potential for cross-subsidies relating to the transfer of intellectual property and proprietary information.

Customer database usage is a viable component of SBC Operations marketing services fully distributed labor cost. We find that the policies and procedures, where SBC Operations markets on behalf of affiliates, are consistent with D.87-12-067, which provides a 13% sales fee for the revenues associated with customer data usage. The “access” that Overland refers to is proper, as it is access provided to SBC Operations on Pacific’s behalf. Where joint marketing occurs, the access is still on Pacific’s initiative with appropriate fees paid when required. We do not find that SBC Operations has provided use of Pacific’s customer database to any other affiliate. Overland has provided no evidence to the contrary.

**g) Transfer of Pacific Bell Directory to Pacific Telesis Group**

Overland reports that Pacific Bell did not obtain the Commission's permission to transfer Pacific Bell Directory to its then-parent, Pacific Telesis Group. Overland, however, did not attempt to draw a conclusion, legal or otherwise, about whether the transfer was permitted. Overland notes that Pacific did inform Commission staff (in writing) of the determination that Commission approval was not required in order to effectuate the transfer.

On the specific question of whether § 851 *et seq.* approval was required in these circumstances, we note that a specific resolution addressed the transfer, and in it the Commission stated: "It is appropriate for the Commission to evaluate the transfer of [Pacific Bell Directory] to Pacific Telesis. Therefore, the Commission will consider ORA's recommendation to review this transaction, and if an investigation is deemed appropriate, the Commission will open a proceeding to review this transaction."<sup>165</sup>

The Commission, however, neither deemed an investigation appropriate nor opened a proceeding to review this transaction. There is no new information in this record that provides cause to order such a filing.

**h) Advanced Services, Inc.**

Overland opines that Pacific's intrastate ratepayers should be compensated for the development of the digital subscriber line service (DSL), service and the transfer of tangible and intangible assets to Pacific's affiliate,

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<sup>165</sup> Resolution T-16545, *Order Adopting Modifications to the Reporting Requirements Under NRF Monitoring Program*, dated August 23, 2001, at 15.

Advanced Services, Inc. (ASI). ASI is important because it is the entity in which most of Pacific's DSL services are housed. There is currently a very active and growing market for DSL in Pacific's territory.

Overland recommends that the Commission review the transactions and investments related to ASI and advanced services in general to determine whether Pacific Bell's affiliate transactions and asset transfer accounting with ASI are consistent with Commission rules. Pacific's witness agreed that this was an appropriate audit issue.<sup>166</sup>

Overland found that during the audit period, Pacific expensed \$225 million in developing DSL and capitalized an additional \$261 million in DSL investment, but recorded just \$25 million in regulated revenues for DSL service. Overland concludes that Pacific's regulated customers provided over \$190 million in net funding for the development of DSL assets to ASI.

**(1) Appropriateness of Considering ASI in this Proceeding**

At the threshold, there was controversy over whether we should consider Pacific's behavior vis-à-vis ASI at all in this proceeding. Pacific noted that we have another open proceeding in which Pacific seeks approval pursuant to Pub. Util. Code § 851 to transfer assets from Pacific to ASI,<sup>167</sup> and urged us to consider all ASI issues there. We find that the current record lacks information that is necessary for us to rule on the issue of ratepayer compensation for DSL

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<sup>166</sup> 12 RT 1285:3-8 (Hayes).

<sup>167</sup> Application 02-07-039.

development costs. Therefore, we agree that it is appropriate to defer certain issues to the § 851 proceeding.

## **(2) Ratepayer Funding of DSL Development Costs**

ORA and TURN claim the Commission should compensate ratepayers for bearing the risk of investment in DSL. In contrast, Pacific claims that ratepayers have not borne these expenses and therefore need not receive compensation. Pacific claims that it never increased basic rates or any other non-DSL price in order to recover the development costs. “[O]ther than customers that specifically purchased advanced services, no costs were otherwise charged to customers and thus there is nothing to reimburse.<sup>168</sup> Pacific also claims it charged DSL development costs to below-the-line accounts, consistent with Commission requirements for new product development as described in D.94-06-011. In 1998, it claims it received Commission Advice Letter approval in Resolution T-16191 to place the service above-the-line.

Overland states that prior to 1998, Pacific accounted for the services below-the-line, but that as development costs mounted, Pacific moved DSL expenses above-the-line to regulated services accounts, where they reduced regulated operating income in 1998 and 1999.<sup>169</sup> Overland found that during the audit period, Pacific incurred \$261 million in costs to develop DSL, but recorded revenues of just \$25 million: “[DSL] was transferred to ASI just as service deployment was being ramped up, but regulated customers were not reimbursed

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<sup>168</sup> Pacific Opening/Audit at 156-57.

<sup>169</sup> Exh. 2A:404 at 19-3 (Audit Report).

for the development they funded. As such, regulated customers subsidized more than \$190 million in DSL development benefiting unregulated affiliate ASI.”<sup>170</sup>

If California ratepayers did bear a risk and the costs associated with DSL development, then they should be compensated. The question is whether ratepayers did in fact bear risks and costs associated with DSL development, how much risk and cost they bore, and how California ratepayers should be compensated for the risk they bore associated with the cost of DSL’s development.

We lack a sufficient record here upon which to resolve the TURN and ORA claim for ratepayer compensation. We lack information about the “separation” of costs and revenues between the interstate and intrastate jurisdictions, which may be a relevant consideration in deciding the ratepayer compensation issue.<sup>171</sup> We also lack data about affiliate payments and other

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<sup>170</sup> *Id.* While no longer obligated to do so, Pacific continues to maintain its advanced services business in a separate affiliate. When the FCC approved Pacific’s merger with Ameritech, it allowed SBC to choose whether to keep advanced services operations in ASI or to reintegrate them into the regulated utility subject to certain conditions. Pacific benefited from keeping the assets separate from the regulated telephone company because in so doing it could avoid the obligation to resell its DSL service to potential competitors pursuant to 47 U.S.C. § 251(c). However, in *Association of Communication Enterprises v. FCC*, 235 F.3d 662, 665 (D.C. Cir. 2001), the court decided that transferring advanced services assets into an unregulated affiliate did not get incumbent local exchange carriers out from under the resale obligation. Therefore, transferring ASI no longer accomplished that goal for Pacific. Nonetheless, for its own reasons, it continues to house ASI in an unregulated affiliate.

<sup>171</sup> For instance, if DSL-related costs are treated as intrastate costs and revenues from the sale of DSL services are treated as interstate revenues, there would be a mismatch

*Footnote continued on next page*

revenues that Pacific may receive from furnishing DSL-related services to ASI. Furthermore, it would be helpful to have expense, investment, and revenue information for the years 2000 and beyond, information we also lack here. We believe the ASI asset transfer proceeding would be a better docket in which to determine whether ratepayers are entitled to compensation, and therefore defer this issue to that docket.

In addition to DSL service, Pacific should be able to identify each service transferred from Pacific to ASI and to track the revenues, expenses, and investment for each service.

**i) Affiliate Transactions Audit Adjustments**

Overland proposes adjustments of \$11.5 million in 1997, \$38.5 million in 1998 and \$47.4 million in 1999 on an intrastate after-tax basis as a result of its affiliate transactions analysis based on the information provided thus far. We discuss its proposed adjustments in turn.

**(1) Operating Revenue Adjustments – 1999 Employee Transfer Fee**

Overland states that “Pacific Bell transferred 2,935 employees to SBC Services in December 1999, but did not accrue the \$47 million in associated transfer fee revenue” in that year. At hearing, Pacific established that it did book the fee, but did so on January 1, 2000 rather than on December 31, 1999. Overland conceded during the hearing that Pacific’s actions were appropriate, and we take no further actions on this matter.

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between costs and revenues, which could be relevant to our determination with respect to ratepayer compensation.

**(2) Operating Expense Adjustments for Executive Compensation<sup>172</sup>**

Overland states that compensation for SBC executives exceeded the regulated limit established by the Commission in D.86-01-026. Pacific claims that D.86-01-026, adopted under rate-of-return regulation, does not apply to utilities operating under NRF.

However, ORA points out that “[t]he Commission’s longstanding policies regarding excessive executive compensation, unreasonable legal expenditures, image building public relations costs, corporate mergers and acquisitions and the parent company’s strategic planning must not be ignored in the conduct (sic) of this first ever SBC Pacific NRF regulatory audit.”<sup>173</sup> Moreover, ORA points out, the Commission has made “ratemaking adjustments” even in the context of NRF.

We do not need to reach the issue ORA raises. With regard to executive compensation, Pacific agreed voluntarily to limit its regulated operations’ exposure for Pacific Bell executive compensation to \$200,000 per year per executive. Its witness so testified:

- Q. Did Pacific Bell make a ratemaking adjustment on the IEMR for executive compensation during the audit period?
- A. Yes. Pacific voluntarily reduced intrastate regulated operating expense by \$20 million, \$8 million, and \$7 million in 1997, 1998 and 1999 respectively.<sup>174</sup>

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<sup>172</sup> This discussion refers to issues referenced as index 46 and 56 in Appendices A, B, C and D.

<sup>173</sup> ORA Reply/Audit at 46.

<sup>174</sup> Exh. 2B:338 at 61:7-11 (Ellis Direct Testimony).

Nor should Pacific's regulated operations bear the expense of executive compensation over \$200,000 per year if the executives work for affiliates of Pacific Bell, rather than for Pacific Bell itself. At least as to the audit period, we find that SBC entities' executive compensation recorded for regulatory purposes should be capped at \$200,000 per year per executive in keeping with Pacific's voluntary "ratemaking adjustment," regardless of where those executives are employed.

Finally, for its excess executive compensation costs, the Commission's affiliate transaction rules require that there be some benefit associated with an allocated cost. Pacific showed no such benefit. Therefore, we adopt the intrastate regulatory after-tax amounts of \$1.5 million in 1997, \$6.8 million in 1998, and \$7.1 million in 1999 for the excess executive compensation from the parent company. We also adopt the intrastate regulatory after-tax amounts of \$2.0 million in 1999 for the excess executive compensation from MSI – USA as shown in Appendix A. Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

### **(3) Operating Expense Adjustment for Executive Award Payments Allocated to Pacific**

SBC made award payments to certain of its key executives in connection with SBC's 1998 investment in AMDOCS, a telecommunications software company, and SBC's merger with Ameritech.<sup>175</sup> In turn, SBC allocated a portion of these payments to Pacific using a general allocator under Part 64. It is

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<sup>175</sup> See Exh. 2A:404 at 14-3 (Audit Report).

Overland's opinion that the payments were not attributable to Pacific Bell under cost causative principles.<sup>176</sup> We agree. We also find that Pacific's regulated operations should not have borne any of these executive award payments because they exceeded the \$200,000 threshold for executive pay we set forth in the previous section. The executive award payments for AMDOCS and Ameritech are embedded in the excess executive compensation from parent company. Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

**(4) Executive Compensation Allocated From  
Parent to Pacific Bell Directory**

Similarly, Overland states that certain executive compensation awards payments should not have been allocated by the SBC parent organization to Pacific Bell Directory and were excessive.<sup>177</sup> We agree because compensation in the amount of \$200,000 exceeded the cap on ratepayer contribution to executive compensation to which Pacific voluntarily agreed, as explained above, and because Pacific failed to establish a causal connection between the compensation and Pacific's operations. The excess compensation allocated from parent to Pacific Bell Directory is embedded in "Parent Impact of Adjustments on Billings to PBD" (Joint Exhibit #55). Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

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<sup>176</sup> This discussion refers to additional issues embedded in the figures referenced as index 46 in Appendices A, B, C and D.

<sup>177</sup> Exh. 2A:404 at 14-3, 14-8 and 18-8 (Audit Report). This discussion refers to issues embedded in the figures referenced as index 55 in Appendices A, B, C and D.

**(5) Special Executive Compensation Allocated From Parent to Pacific Bell Directory<sup>178</sup>**

Pacific Bell Directory bore yet another executive compensation expense - called “special executive compensation” – based on a general allocator. Pacific contends that, “because the scope of responsibility of these key executives is to oversee the operations of SBC, the costs are appropriately allocated to the SBC family of companies, including Pacific Bell Directory.”<sup>179</sup> Pacific fails to prove the linkage, and once again this compensation exceeds the executive compensation cap. Thus, we accept Overland’s recommendation. The special executive compensation allocated from parent to Pacific Bell Directory is embedded in “Parent Impact of Adjustments on Billings to PBD” (Joint Exhibit #55). Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

**(6) Executive Compensation Allocated from SBC Operations**

Pacific also bore the expense of the AMDOCS acquisition/Ameritech merger executive compensation allocated to it by SBC Operations (and not just the parent, as we discuss above).<sup>180</sup> Once again, we disallow any executive compensation in this area in excess of \$200,000, for the reasons set forth above.

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<sup>178</sup> This discussion refers to additional issues embedded in the figures referenced as index 55 in Appendices A, B, C and D.

<sup>179</sup> Pacific Opening/Audit at 162.

<sup>180</sup> This discussion refers to issues referenced as index 40 and 41 in Appendices A, B, C and D.

In addition, Pacific failed to show that it appropriately bore this expense from a cost causation perspective. We therefore adopt Overland's recommendation to disallow the expense. The intrastate regulatory after-tax amount for AMDOC Awards from SBC Operations is \$253,000 in 1999. The intrastate regulatory after-tax amounts for excess executive compensation from SBC operations are \$481,000 in 1998 and \$625,000 in 1999 as shown in Appendix A. Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

**(7) Executive Compensation Allocated  
from SBC Services<sup>181</sup>**

Once again, Pacific bore executive compensation related to the AMDOCs acquisition/Ameritech merger – this time allocated to it by SBC Services. We again adopt the audit recommendation to disallow this expense, based both on the \$200,000 cap and on Pacific's failure to show that it appropriately bore the expense from a cost causation perspective. The intrastate regulatory after-tax executive compensation allocated from SBC services is \$163,000 in 1998 and \$135,000 in 1999 as shown in Appendix A. Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

**j) Legal Expenses**

**(1) Legal Expenses Allocated from Parent to Pacific**

Overland opines that SBC improperly allocated to Pacific legal fees associated with SBC's work on 1) Constitutional issues regarding the

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<sup>181</sup> This discussion refers to issues referenced as index 44 in Appendices A, B, C and D.

Telecommunications Act of 1996 (1996 Act), 2) Section 271 long distance service applications pursuant to the 1996 Act, and 3) Pacific's participation in the AT&T/Media One merger proceeding.<sup>182</sup>

Pacific claims that each of the three matters "relate to SBC legal activities benefiting both regulated and non-regulated subsidiaries," but as TURN points out, Pacific nowhere explains that benefit or demonstrates that the expense directly applied to the utility's regulated activities. While Pacific lists several obligations that the 1996 Act imposes on the regulated utility, it never claims that its litigation of the constitutional issues and the Section 271 long distance application raised those issues. Thus, we agree with TURN that, "Pacific Bell has failed to demonstrate that these costs meet the utility's own standard."<sup>183</sup>

TURN further notes that "Pacific Bell did not even bother with the pretense of citing aspects of [the AT&T/Media One merger] that might have implications for its regulated operations." Because Pacific concedes that "[r]elevance and direct application to Pacific's regulated operations guides whether or not these legal costs are attributable to Pacific," and Pacific makes no such showing, we disallow the expenses and adopt Overland's recommendation. The intrastate regulatory after-tax amounts are \$439,000 in 1998 and \$212,000 in 1999 as shown in Appendix A. Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

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<sup>182</sup> This discussion refers to issues referenced as index 48 in Appendices A, B, C and D.

<sup>183</sup> TURN Reply/Audit at 35.

**(2) Legal Expenses Allocated From Parent to Pacific Bell Directory**

Overland proposes an adjustment lowering Pacific's operation costs for legal expenses it claims the parent misallocated to Pacific Bell Directory.<sup>184</sup> Once again, Pacific simply asserts that the expenses meet the requirement that such costs be relevant and directly applicable to Pacific Bell Directory's operations with no further evidence.

We adopt Overland's audit recommendation on this issue, as Pacific has failed to demonstrate – as it is required to do – how the legal expenses the parent operation billed benefited Directory. The legal expenses allocated from parent to Pacific Bell Directory are embedded in “Parent Impact of Adjustments on Billings to PBD” (Joint Exhibit #55). Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

**k) Public Relations and Corporate Sponsorship Allocated from Parent to Pacific and Pacific Bell Directory**

Pacific disputes Overland's audit adjustments related to parent expenses for public relations and corporate sponsorship allocated to Pacific Bell and Pacific Bell Directory, because Pacific maintains that NRF does not allow “ratemaking adjustments.”<sup>185</sup> However, the issue is not whether a ratemaking adjustment is proper, but whether Pacific Bell and Pacific Bell Directory are improperly cross-subsidizing the parent's activities. Such cross-subsidies are

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<sup>184</sup> This discussion refers to additional issues embedded in the figures referenced as index 55 in Appendices A, B, C and D.

<sup>185</sup> This discussion refers to issues referenced as index 49 in Appendices A, B, C and D.

anticompetitive, because they allow the parent to operate on more favorable terms than comparable businesses outside SBC, which do not have a regulated utility to rely on to subsidize their unregulated operations.

Pacific did not dispute the auditor's non-affiliate-transaction adjustments in connection with similar items.<sup>186</sup> If Pacific's regulated operations should not bear the cost of image advertising, as Pacific concedes, then it follows that Pacific should not bear the cost of such advertising carried out by an unregulated parent or affiliate of Pacific, as occurred here.

The public relations and corporate sponsorship expense from parent company amounts is \$1.7 million in 1997, \$8.6 million in 1998, and \$8.8 million in 1999 on an intrastate regulatory after-tax basis as shown in Appendix A. The piece from Pacific Bell Directory is embedded in "Parent Impact of Adjustments on Billings to PBD" (Joint Exhibit #55). Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

**I) Corporate Development Costs<sup>187</sup>**

Pacific was charged in 1998 and 1999 when an unregulated affiliate, MSI, conducted market research and investigated potential acquisitions throughout the world. Once again, Pacific claims without evidence that the costs were

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<sup>186</sup> See table of "Undisputed Audit Adjustments" in Appendix D to this decision, showing Pacific's agreement to similar adjustments related to parent political and legislative influence expense, and parent contributions, memberships and foundation expense. See also D.94-06-011, 153 PUR 4<sup>th</sup> 65 (1994), 1994 Cal. PUC LEXIS 456, at \*116 (noting that Pacific records and should continue to record dues, donations and political advocacy expenses below-the-line).

<sup>187</sup> This discussion refers to issues referenced as index 50 in Appendices A, B, C and D.

appropriately allocated from the parent to Pacific and Pacific Bell Directory, and once again we reject Pacific's claim and adopt Overland's audit recommendation.

These expenses relate to international lines of business,<sup>188</sup> and we see no relationship between such investments and the regulated utility. Pacific's argument that these corporate acquisitions somehow benefit Pacific "by lowering Parent allocations to Pacific as the portfolio of SBC companies grow" is entirely circular.<sup>189</sup> If the allocation does not otherwise benefit Pacific, such benefit does not occur simply because in the future Pacific's share of the allocation will lessen as SBC grows bigger. Thus, we adopt Overland's recommendation of \$3.1 million in 1998 and \$3.5 million in 1999 on an intrastate after-tax basis from parent company as shown in Appendix A. The piece from Pacific Bell Directory is embedded in "Parent Impact of Adjustments on Billings to TBD" (Joint Exhibit #55). Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

**m) Strategic Planning Costs<sup>190</sup>**

Pacific's only argument against Overland's questioning of the SBC parent's allocation of "strategic planning" expenses to Pacific and Pacific Bell Directory is that NRF countenances no ratemaking adjustments. The issue here is whether Pacific and Pacific Bell Directory are cross-subsidizing the parent's strategic

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<sup>188</sup> See Exh. 2A:414 at 14-34 (Audit Report) (listing corporate development projects around the world).

<sup>189</sup> Pacific Opening/Audit at 167, citing Exh. 2B:344 at 27 (Henrichs testimony).

<sup>190</sup> This discussion refers to issues referenced as index 51 in Appendices A, B, C and D.

planning activities, which benefits the parent at the expense of competing telecommunications companies.

Pacific nowhere explains how the strategic planning activities benefit the regulated utility, and without such justification, it is improper for the utility to subsidize them. We therefore adopt Overland's recommendation of \$1.7 million in 1997, \$532,000 in 1998, and \$410,000 in 1999 for the strategic planning expenses from the parent company on an intrastate after-tax basis as shown in Appendix A. The piece from Pacific Bell Directory is embedded in "Parent Impact of Adjustments on Billings to PBD" (Joint Exhibit #55). Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

**n) Parent Out of Period Expense<sup>191</sup>**

The parent company billed Pacific \$7.4 million in 1998 for services rendered in 1997. Overland states they should have been billed in 1997, but Pacific claims the true amount of the services was not known or billed until 1998. Because Pacific's only basis for argument is that GAAP does not allow us to "reopen a closed accounting period," and we have already rejected that argument elsewhere, we adopt Overland's recommendation of -\$3.4 million in 1997 and \$3.4 million in 1998 on an intrastate after-tax basis. Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

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<sup>191</sup> This discussion refers to issues referenced as index 53 in Appendices A, B, C and D.

**o) Regulated and Nonregulated Cost Allocations**

Overland proposes a number of adjustments that are discussed below. However, Overland's ultimate conclusion is that "Pacific's procedures for regulated and nonregulated activities were well controlled and consistent with Commission requirements and FCC Part 64 attributable cost principles."<sup>192</sup>

**(1) Marketing Service – Affiliate Billings<sup>193</sup>**

A significant issue arose at the hearings as to whether Pacific's affiliates fully compensate the regulated business when Pacific performs marketing functions for them. In finding a mismatch between revenues and expenses (with revenues to Pacific much lower than its expenses), Pacific maintained that ORA was comparing apples to oranges.

We find that Pacific did properly record the inter-company revenue associated with marketing services provided to affiliates. We agree with Pacific that ORA and Overland's findings are based on incorrect comparison of the results of two separate and distinct processes: 1) the CASS process which determines expenses associated with market services; and 2) the affiliate billing process which determines the revenue associated with marketing services. Because the adjustment is based on an improper comparison, we reject the recommended adjustment.

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<sup>192</sup> Audit Report, p. 20-1.

<sup>193</sup> This discussion refers to issues referenced as index 63 in Appendices A, B, C and D.

**(2) Allocation of National-Local Strategy  
Implementation Costs<sup>194</sup>**

Overland states that Information Technology (IT) costs associated with Pacific's effort to expand service into 30 metropolitan areas outside of Pacific's service area should be charged to SBC National-Local, its competitive local exchange affiliate, and not to the regulated telephone company. According to Overland, Pacific Bell caused regulated California operating expense to be overstated by \$7.9 million in 1999 on a regulated basis.

Pacific maintains that Overland misunderstood its data. It claims the data provided contained all IT costs related to the project no matter who performed the work. It states that Pacific employees recorded only 3.5% of the total IT hours worked, and that Pacific has already billed SBC National-Local for the work performed. Therefore, Pacific claims, its regulated operations did not subsidize work Pacific performed on behalf of Pacific's National-Local affiliate.

Pacific's claim is inconsistent with the evidence in the record. Contrary to Pacific's statement in its brief that Overland misunderstood its data, Pacific in discovery claimed the allocation was proper because Pacific's effort to expand into metropolitan areas outside Pacific's service territory "was thought to benefit the company as a whole rather than a specific regulated or nonregulated area. Therefore, residual allocation was chosen as the method to allocate these costs."<sup>195</sup>

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<sup>194</sup> This discussion refers to issues referenced as index 65 in Appendices A, B, C and D.

<sup>195</sup> Exh. 2A:404 at 20-49 n.54 (Audit Report), citing Pacific Bell Data Response OC-1040 part 3.

Pacific would not have had to make this claim if, as it asserts, it was not billing Pacific for the work. We fail to see how these expenses benefited the regulated utility and adopt Overland's audit recommendation. Any cross-subsidy flowing from Pacific's regulated operations to its National-Local competitive local exchange affiliate would be anticompetitive, as unaffiliated competitive local exchange carriers receive no such subsidy.

Thus, we agree that Pacific's regulated operations should not have borne any expense related to Pacific's National-Local affiliate. Pacific shall remove \$3.7 million on an intrastate regulatory after-tax basis. Pacific should correct this error in its financial books, with the timing and extent of restatement (if any) determined by GAAP.

**(3) 1997 Corporate Sponsorship Costs – Pacific Bell  
Park<sup>196</sup>**

Overland states that in 1997 Pacific improperly recorded a portion of the payment it made for the naming rights to Pacific Bell Park above-the-line. Overland opines that Pacific may not record this type of "corporate image advertising" above-the-line pursuant to D.86-01-026, and that \$1,014,546 should be removed from operating expense for that year. In D.01-06-077, we stated that "[t]he Commission does not allow recovery from ratepayers of institutional or goodwill advertising."<sup>197</sup>

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<sup>196</sup> This discussion refers to issues referenced as index 66 in Appendices A, B, C and D.

<sup>197</sup> 2001 Cal. PUC LEXIS 604, at \*44-45, citing D.83162 (1974), 77 CPUC 117, 154-55 & D.96-12-074, *mimeo.*, at 135-36.

Pacific's only rebuttal is that D.91-07-056 "eliminated ratemaking adjustments." However, in D.01-06-077, we have already assessed this argument vis-à-vis institutional or goodwill advertising in the context of NRF and decided that such a ratemaking adjustment is proper. Therefore, we agree with Overland that Pacific should not have recorded the expenses in the amount of \$1.0 million (on an intrastate after-tax basis) above-the-line. Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

#### **(4) Depreciation Expense Allocation<sup>198</sup>**

Overland next states that monthly depreciation recorded in 1999 was improperly distributed between regulated and non-regulated activities. Pacific then made correcting entries in December 1999 to correct errors in the prior 11 months, using the allocation ratio applicable in December 1999. Overland states that when Pacific corrected the error, it should have used allocation ratios applicable for each month in 1999 in which the errors occurred, rather than using only the December 1999 ratio. Because the ratio changed over those months, the result was an understatement of non-regulated depreciation expense.

Pacific alleges that it often makes correcting entries and that there is no precedent for allocating correcting entries differently than the regular monthly allocation process. It claims that to do what Overland suggests would violate the Cost Allocation Manual (CAM) that Pacific has filed:

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<sup>198</sup> This discussion refers to issues referenced as index 60 in Appendices A, B, C and D.

There is no precedent for allocating correcting entries differently than the regular month allocation process. The Cost Allocation Manual (Section 6) describes the allocation process and does not allow the allocation process to be changed if significant correcting entry is performed in any one month.<sup>199</sup>

We agree with Pacific's analysis. Pacific followed the existing Commission policy during the audit period when it allocated the December correcting entries using the December 1999 cost allocation ratios for depreciation expense. We therefore reject the audit recommendation.

**(5) Product Advertising Expense<sup>200</sup>**

Overland finds that Pacific's Product Advertising Expense was not allocated between regulated and non-regulated activities in accordance with cost causation principles. Overland analyzed the expenses in detail, and devised an allocator based on such principles. This analysis resulted in a reduction to operating expense of \$3.7 million in 1998 and 1999 on an intrastate after-tax basis.

As with the depreciation expense we discuss in the previous section, Pacific's defense is that it "allocated product advertising expense according to the Cost Allocation Manual as discussed in Section VI."<sup>201</sup> We accept Pacific's position and reject the audit recommendation on the same basis as we set forth in the previous section.

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<sup>199</sup> Ellis Revised Direct Testimony, Exh. Pacific: Phase 2B:338, p 37-38.

<sup>200</sup> This discussion refers to issues referenced as index 61 in Appendices A, B, C and D.

<sup>201</sup> *Id.*

**(6) External Relations Costs Assigned to Regulated Operations**

Overland states that the majority of the external-relations-costs in Pacific's account number 6722 were improperly assigned directly to regulated operations.<sup>202</sup> These costs were incurred by Pacific's parent, and involved the following activities: federal and state government relations, including California state political and legislative influence activities; executive oversight of external affairs, corporate policy and carrier relations; and FCC regulatory relations.<sup>203</sup> None of these activities appear to have been appropriately recorded to Pacific's California regulated operations.

Pacific's brief addresses a different issue and is of no assistance to us here.<sup>204</sup> Nor does it appear Pacific's witness addressed the issue. However, Pacific concedes elsewhere that audit adjustments for political and legislative influence and regulatory affairs are appropriate when the regulated utility carries out the activities.<sup>205</sup> If we were to allow Pacific to charge such activities to the regulated utility when an affiliate carries them out, we would encourage Pacific to transfer functions to affiliates for inappropriate reasons. Pacific's regulated operations should not be charged differently depending upon which

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<sup>202</sup> This discussion refers to issues referenced as index 47 in Appendices A, B, C and D.

<sup>203</sup> Exh. 2A:404 at 20-26 (Audit Report).

<sup>204</sup> In the section of its brief headed "Account 6722 External Relations," Pacific actually discusses the next issue on our list, allocation of Customer Service expense in Account 6623.

<sup>205</sup> See Appendix C to this decision, reflecting undisputed issues including "Parent Political and Legislative Influence Expense."

entity engages in the legislative and regulatory activities. Moreover, we have ruled that regulated operations should not show such expense.<sup>206</sup>

We agree with Overland's recommendation that California regulated operations not bear the expense of political and legislative influence activities and other external relations expenses. It may indeed be the case that Pacific does not dispute the audit findings, which we hereby adopt. The intrastate after-tax amounts are \$8.6 million in 1997, \$10.0 million in 1998, and \$4.2 million in 1999 on an intrastate after-tax basis as shown in Appendix A. Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

#### **(7) Allocation of Customer Service Expenses<sup>207</sup>**

Overland states that Pacific misallocates Customer Service expense between regulated and nonregulated cost categories. The account containing this expense contains a significant amount of Pacific's salary and wage costs, so the dollar amounts are significant – in the hundreds of millions of dollars. However, Overland concludes that, “because the flaws produced offsetting allocation errors, the overall regulated and non-regulated allocation results were reasonable.”<sup>208</sup>

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<sup>206</sup> D.94-06-011, 153 PUR 4<sup>th</sup> 65 (1994), 1994 Cal. PUC LEXIS 456, at \*116 (noting that Pacific records and should continue to record dues, donations and political advocacy expenses below-the-line).

<sup>207</sup> This discussion refers to issues referenced as index 62 in Appendices A, B, C and D.

<sup>208</sup> Exh. 2A:404 at 20-27 (Audit Report).

Overland recommended that we increase regulatory after-tax expenses to reflect a greater allocation of customer service expenses to regulation operations. We adopt this change as reasonable. The intrastate regulatory after-tax amounts are \$1.0 million in 1997, \$3.4 million in 1998, and \$4.8 million in 1999. Pacific should correct this error in its financial books, with the timing and extent of restatement determined by GAAP.

### **(8) InterLATA Service Application Costs**

Overland recommends that the Commission “consider whether costs associated with applying for interLATA service should be charged to regulated operating income or be charged to SBC’s interLATA long distance subsidiary.”

Pacific responds that, “because providing interLATA service is regulated by the Commission (and the FCC), ‘Pacific’s application to change the nature of that regulation was considered a regulated activity.’”<sup>209</sup> It also accuses Overland of improperly trying to change policy.

It appears the costs were properly charged to regulated operating income. The portion of the audit devoted to this issue is one paragraph. Therefore, we lack an adequate record to adopt Overland’s recommendation.

### **(9) Fluctuation Analysis**

This issue deals with whether Pacific maintains documentation of a “fluctuation analysis” of its CPUC Cost Allocation System (C-CASS) or CPUC Product Cost Allocation System (P-CASS), and other concerns about Pacific’s fluctuation analysis process. Pacific performs fluctuation analyses to show

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<sup>209</sup> Pacific Opening/Audit at 174, quoting Exh. 2B:338 at 45 (Ellis Direct Testimony).

changes from month to month in the assignment of costs to regulated and nonregulated categories. Overland found Pacific's documentation lacking in several respects and recommended that the Commission order Pacific to document its results to provide an adequate audit trail.

Pacific's response deals only with Overland's recommendations regarding the C-CASS and P-CASS systems, and not its criticisms of Pacific's other fluctuation analyses. On that issue, Pacific appears to claim that the C-CASS and P-CASS analyses are not necessary because Pacific performs a higher level analysis for the CASS.<sup>210</sup> However, this argument ignores Overland's statement that even at the CASS level, "the fluctuation explanations that were obtained simply stated the cause of the fluctuation in generic terms . . . . The fluctuations did not focus on specific explanations from operations that would explain what products or marketing initiatives were causing the resulting monthly fluctuations."<sup>211</sup>

We order Pacific to make a compliance filing within 90 days of this decision's effective date explaining in detail its fluctuation analysis process and addressing more specifically the auditors' concerns regarding the lack of specificity or a proper audit trail. In Phase 3B of this proceeding, we will then determine whether Pacific's method requires change.

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<sup>210</sup> See Exh. 2B:338 at 46-47 (Ellis Direct Testimony).

<sup>211</sup> Exh. 2A:404 at 20-16 (Audit Report).

**(10) C-CAM Updates**

Overland states that Pacific's Commission Cost Allocation Manual (C-CAM) is not sufficiently up-to-date and that certain descriptive information is missing. Overland states that responsible Pacific staff acknowledged the need to update the C-CAM. Pacific's staff also identified certain listings in the CAM that required updating, although Overland found the listings the staff identified to be inadequate. Further, Overland claims Pacific's staff told its auditors that certain aspects of the C-CAM had not been updated since 1996.

Pacific testified, to the contrary, that all aspects of the C-CAM were updated in December 2000, and that this update is adequate. We cannot reconcile Pacific's testimony with Overland's representation that Pacific staff informed it that the updates occurred in 1996 and identified areas needing updating. We find Pacific's testimony more credible and therefore reject Overland's recommendation.

**(11) Subsidiary Account Translation Data**

Overland suggests that Pacific maintain an audit trail translating the trial balances of its individual subsidiaries to Pacific's FR book (the books it uses to derive the IEMR report). Overland explains that Pacific reports the overall financial results of its Pacific Bell Information Systems (PBIS)<sup>212</sup> and Pacific Bell Network Integration (PBNI) subsidiaries in the FR books, but that it does not maintain detail about how it translates the subsidiaries' trial balances to the FR

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<sup>212</sup> It is unclear whether this subsidiary is the same as Pacific Bell Information *Services*, which is the provider of Pacific's voice mail services. We assume it is for purposes of this discussion.

books. It claims this is a significant internal control weakness within Pacific's financial reporting structure."<sup>213</sup>

Pacific points out that Overland found no errors in Pacific's translation data, and therefore argues that the additional detail is unnecessary. Most importantly, Pacific states that "[t]he underlying detail is irrelevant as the entire costs and revenues for both of these subsidiaries were removed from regulated intrastate operations on the IEMR."<sup>214</sup>

It appears that PBIS (Pacific's voice mail provider) and PBNI (Pacific's provider of networking solutions primarily to business customers) have a significant financial impact on Pacific's business. Therefore, we believe the financial data regarding these subsidiaries' impact on the IEMR should appear in detail so that we have the opportunity to determine how Pacific calculates its IEMR results. Accordingly, we adopt the audit recommendation and require Pacific to make a compliance filing within 90 days of the effective date of this decision detailing how it will make more transparent and auditable the process it uses for translating PBIS' and PBNI's financial trial balances to its FR books and IEMR reports.

### **(12) Enhanced Sales Time Reporting Systems (ESTRS)**

Overland suggests that Pacific include the PBNI results in its Enhanced Sales Time Reporting System (ESTRS) process. After 1998, Pacific ceased doing so. Pacific uses ESTRS as a statistically valid sampling process to determine the

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<sup>213</sup> Exh. 2A:404 at 20-15 – 20-16 (Audit Report).

<sup>214</sup> Exh. 2B:338 at 48:15-17 (Ellis Direct Testimony).

allocation of marketing hours between regulated and nonregulated work activities. Overland concluded that, “it is unlikely that the omission had a large impact on the overall distribution of activities between regulated and non-regulated categories.”<sup>215</sup>

Pacific responds that PBNI’s status changed when it became a part of Pacific in September 1998. At that time, all PBNI personnel automatically reported all of their time to a nonregulated tracking code, so study of how to divide their time between regulated and nonregulated activities was no longer necessary.

We agree with Pacific that if all of the PBNI personnel’s hours are reported to a nonregulated tracking code, there is no need to include them in the ESTRS process. We therefore decline to take any action on the audit comments in this regard.

## **VI. Disputes over Information Requests**

The record is replete with allegations that Pacific impeded the audit, although Overland states it did not actually use this term,<sup>216</sup> choosing to state that Pacific “made parts of the audit very difficult.” When we examine the record, we find that Overland did experience the obstacles detailed in the audit report.

Overland identifies the following “impediments” to its completing the audit within the originally scheduled timeframe of one year:

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<sup>215</sup> Exh. 2A:404 at 20-45 – 20-46 (Audit Report).

<sup>216</sup> 10 RT 1005:7-26.

[R]estrictions that Pacific Bell imposed on the data it considered to be relevant and within the audit scope, data request response times that averaged more than two months and sometimes extended for many months, and, notwithstanding objections to requests based on scope or relevance, Pacific Bell's inability or unwillingness to provide certain information and data.

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The restrictions imposed on the audit prevented us from obtaining sufficient data to develop conclusions in some areas.<sup>217</sup>

Mr. Welchlin testified that “[o]n average it took more than 70 days to obtain [Pacific’s] complete response to [discovery] requests.” Pacific objects in its comments that the calculation should have omitted weekends and holidays, making the delays appear shorter. This suggestion runs contrary to how the Commission - and the Civil Discovery Act - calculate discovery response times. Such calculation always is based on calendar days, not business days as Pacific advocates. However, the 70-day average is calculated based on the last response to a series of questions pertaining to a specific data request, and must be viewed with caution, as it does not reflect the average response time to all individual audit questions. Never the less, while Pacific may have provided timely responses to most questions, the interest of the Commission’s proceeding is served when a utility promptly responds to the entire request.

How fast a utility can gather information in response to requests is necessarily governed to a large extent by the rule of reason. If a utility has to

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<sup>217</sup> Exh. 2A:404 at 1-4 (Audit Report).

deal with only a few, narrow data requests, the response time should be measured in days, not weeks. However, this audit was large. About 1,000 data requests pertained to this (2B) phase, and most of these requests contained subparts. Pacific asserts its response ran to thousands of pages of hard copy and millions of pages in electronic media.

A photograph of the entire universe of documents Pacific produced to Overland related to the audit shows that, despite Pacific's claim that it produced a huge number of documents,<sup>218</sup> the document production was contained in approximately 48 boxes, 53 binders and a handful of small computer disk boxes that fit on one set of bookshelves.<sup>219</sup> According to Overland, "it took the company more than 18 months to provide this data."<sup>220</sup>

For an audit covering the operations of a company the size of Pacific Bell – which included focus on many of Pacific's affiliates – this is not an inordinate number of documents. Pacific's witness' claim that the documents it produced would stack as high as more than seven Transamerica Pyramids<sup>221</sup> - or more than a mile high – was misleading when compared to the actual photograph Overland

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<sup>218</sup> See generally 2B:346 § IV, at 5:15-14:13, and especially 14:7-10 (Hogue Opening Testimony) ("Pacific produced nearly 172,000 pages of paper documents and the equivalent of approximately 19 million pages of documents provided on electronic media (hundreds of CD ROMs and floppy disks) to Overland, in order to accurately respond to all of these data requests.").

<sup>219</sup> Exh. 2B:410, Attachment RW-4 (Welchlin Reply Testimony).

<sup>220</sup> *Id.* at 20:26-29.

<sup>221</sup> See <http://www.tapyramid.com>.

produced, which showed that all of the documents fit on one set of bookshelves in Overland's offices.<sup>222</sup>

#### **A. 314 and Attorney Client Privilege**

Pacific acknowledges that it objected to a "limited number" of data requests, including "requests for irrelevant information outside the scope of the audit," and "requests that were overly burdensome or oppressive." It appears that real dispute lies in these objections. Pacific states that if it felt the auditors sought information that was not relevant, or that was burdensome, it did not respond.

This was not Pacific's call to make. Pub. Util. Code § 314 provides broad discretion to

[t]he commission, each commissioner, and each officer and person employed by the commission [to], at any time, inspect the accounts, books, papers, and documents of any public utility. [This provision] also applies to inspections of the accounts, books, papers and documents of any business which is a subsidiary or affiliate of. . . a . . . telephone corporation with respect to any transaction between the . . . telephone corporation and the subsidiary, affiliate, or holding corporation on any matter than might adversely affect the interests of the ratepayers of the . . . telephone corporation.

We emphasize that Overland, as an agent, is entitled to the same access under § 314 as that accorded by the statute to Commission staff. In addition, the

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<sup>222</sup> Compare Exh. 2B:346, Attachment 6 (graphic depiction of seven Transamerica Pyramids) with Exh. 2B:410, Attachment RW-4 (photograph of documents, which "fit on one set of bookshelves in [Overland's] offices"; Exh. 2B:410 at 20:27-28 (Welchlin Reply Testimony)).

right of access does not depend on relation to a particular contemporaneous formal proceeding at the Commission. The need to have access to utility information is on-going; e.g., Commission staff monitors compliance with Commission rules, studies the effect of implementation of certain programs pursuant to statute or Commission order, and determines whether to recommend that the Commission institute formal rulemakings or investigations. Without continuous information-gathering, the Commission could not readily set priorities or take timely steps to address problems of enforcement or implementation.

A necessary consequence of this statutory framework is that our own information-gathering activities are not correctly analogized to discovery in civil litigation, where the right to require production of information is tied to the commencement and subject matter of a particular law suit. As we have seen, in contrast to such “discovery,” our right of access to utility information is continuous and not predicated on the pendency of a particular formal proceeding before the Commission. Since the right of access exists apart from any related proceeding, the right of access is also not subject to the limitation on discovery in civil proceedings requiring that data requests seek admissible evidence or information that would assist in finding admissible evidence. Our own information-gathering is closer in nature to the investigative activity of law enforcement officials.

A utility that responds promptly and completely to information requests by our staff or agents is merely performing its statutory duty, and does not

thereby waive any rights it may have to request confidential treatment of the information. Under § 583, the utility may identify information that should not be open to public inspection,<sup>223</sup> and we will thereafter disclose the information to the public only after we make a determination that the public interest in disclosure outweighs the interest of the utility in keeping the information confidential. In making this determination, we refer to various provisions of the Public Utilities Code and also to the Public Records Act (codified in the Government Code).

Similarly, responding promptly and completely to information requests by our staff or agents does not waive any objection the utility may have if and when staff moves to admit the information into evidence in a formal proceeding. (Indeed, many kinds of objection, such as relevance, are premature at the time of the information request and can only be fairly considered in the context of an evidentiary hearing, at which time the party seeking admission of evidence will be required to show how the proffered information tends to establish a material fact in dispute.)

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<sup>223</sup> Section 583 reads as follows:

“No information furnished to the commission by a public utility, or any business which is a subsidiary or affiliate of a public utility, or a corporation which holds a controlling interest in a public utility, except those matters specifically required to be open to public inspection by this part, shall be open to public inspection or made public except on order of the commission, or by the commission or a commissioner in the course of a hearing or proceeding. Any present or former officer or employee of the commission who divulges any such information is guilty of a misdemeanor.”

There is, however, one type of document that a utility may decline to produce in response to an information request. A document may be protected under the utility's attorney/client privilege, in which case the privilege is waived unless the utility asserts the privilege when responding to an information request seeking the document. An appropriate showing that the document was prepared, and access to the document was controlled, in a manner consistent with the asserted privilege must support the utility's assertion of the attorney/client privilege. To this end, the utility should maintain a privilege "log" that, at a minimum, identifies the document and states the date the document was prepared, the person(s) preparing the document, the person(s) receiving the document, the general subject matter (without disclosing the specific contents), and the methods used to store, retrieve, and limit access to the document.

In short, a utility has little to gain from objecting to information requests. The objection, except for assertions of attorney/privilege, will generally be premature and unnecessary to resist the later introduction of the information into evidence. Moreover, making an objection does not excuse the utility from providing the information. The authority of the Commission, its divisions, its staff and its contract auditors is plenary under § 314. The Commission is not limited by the rules governing civil discovery, the requirements of ALJ Resolution 164 (governing Law and Motion matters at the Commission), or other standard discovery rules, in exercising its right of audit under § 314.

#### **B. Pacific's Conduct**

In discussing the reassignment of audit responsibility from ORA to TD in this case, the Commission noted that, "the transfer of the audit responsibility does not relieve Pacific Bell of its obligation to fully answer any and all data

requests received from all Commission staff, and to provide answers on a timely basis.”<sup>224</sup> Had Pacific simply responded to all the requests as § 314 and the Commission’s own decision required – or at least sought a protective order shielding it from some of the data requests – perhaps its conduct might be deemed legitimate. Pacific, instead, improperly took it upon itself to decide what was and was not relevant to the audit. Its conduct not only contributed significantly to delays in the audit, but also ultimately made it impossible for Overland to finish the portion of the audit related to affiliate transactions.

Pacific effectively conceded that § 314 is broader than regular discovery provisions when in 2001 it attempted to limit ORA’s participation in this proceeding. It contended that the Commission’s recognition that “ORA shall have discovery rights as do other parties in this proceeding”<sup>225</sup> did not give ORA rights as broad as the auditors had: “What is at issue in this matter is not ORA’s general responsibilities, but the degree and extent to which it can or should participate in the audit.”<sup>226</sup> If Pacific itself knew that the auditors’ powers were broader than the “discovery rights [of] other parties in this proceeding,” it is not at all clear why it persisted in making discovery-type objections to the auditors’ data requests.

With regard to Pacific’s specific objections, it claims it was burdensome for “Overland [to ask] for *all* accounting documents rather than a representative

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<sup>224</sup> D.01-08-062, 2001 Cal PUC LEXIS 513, at \*3, citing D.01-02-047, *mimeo.*, at 5-6.

<sup>225</sup> D.01-08-062, 2001 Cal PUC LEXIS 513, at \*6.

<sup>226</sup> *Id.*

sample.”<sup>227</sup> However, when it came to Overland’s conclusion that Pacific had not retained adequate time reporting documentation, Pacific criticized Overland for taking only a representative sample of the documents, rather than all accounting documents. *See* Section entitled “Compliance With Time Reporting Document Retention Requirements,” above. While Pacific claims there were an “unusually large number of data requests,” Overland notes that “Pacific Bell took six weeks just to complete 30 of the 59 data requests submitted at the beginning of the audit. It took Pacific Bell more than 3 months to provide responses to the entire 59 data requests in the first set.”<sup>228</sup>

Pacific claims that it raised reasonable objections to Overland’s requests, including objections based on privilege. As we note above, however, Pacific took an unduly narrow view of Overland’s right to have access to Pacific documents, treating the auditors as simply parties to litigation rather than an extension of the Commission with far broader powers to inspect. Pacific also claims Overland misconstrued Pacific’s agreement to provide data request responses within 10 days, claiming that it only said that for “readily available information,” Pacific would “endeavor to provide it within 10 days.”<sup>229</sup>

Given that it took Pacific, on average, 70 days to respond completely to individual discovery requests, the instances in which Pacific responded within 10 days had to have been extremely limited. Indeed, the fact that the average was

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<sup>227</sup> Exh. 2B:346 at 8:20-21 (Hogue Direct Testimony).

<sup>228</sup> Exh. 2B:410 at 18:29-19:1 (Welchlin Reply Testimony).

<sup>229</sup> Pacific Opening/Audit at 196.

70 days means that in many instances, Pacific took longer than 70 days to respond completely. Moreover, had Pacific only needed slightly more time than 10 days to respond, the average would have been far lower than 70 days.

On balance, we find Overland's interpretation of Pacific's behavior in discovery more credible. First of all, there is nothing in the record to show that Overland had any motivation to exaggerate or to claim erroneously that it did not have data to complete its report. Pacific, on the other hand, may have had a motivation to slow down the audit process, since it was clear Overland was focusing on potential errors in Pacific's accounting methods.

Second, a letter from Pacific's witness to the TD states that "Pacific has answered dozens of questions with responses that covered the 'year prior to the audit period and the year subsequent to the audit period' and several responses provided information back to the early 1990's as the data was relevant to the Commission ordered audit."<sup>230</sup> This claim directly contradicts the point Pacific's witness made in testimony that "Pacific objected to . . . requests for information outside the audit time period . . ."<sup>231</sup> Either Pacific provided information "back to the early 1990s," or it "objected to requests for information outside the audit time period," but both claims cannot be true. Whatever the truth, this direct contradiction troubles us, and leads us to conclude that Pacific was not as forthcoming as it claims.

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<sup>230</sup> Exh. 2B:421 at 2 (Letter from Pacific's Hogue to Commission's Leutza).

<sup>231</sup> Exh. 2B:346 at 7:19 & 21 (Hogue Direct Testimony).

Third, even if Pacific's claim regarding the extraordinary amount of data it produced were true, sheer volume does not necessarily mean quality. Pacific's witness focuses extensively on the volume of the requests and the responses – "Pacific, in fact, provided responses to *all* 1,297 of Overland's data requests (more than 10,000 questions when subparts are counted),"<sup>232</sup> "Pacific's objections totaled less than 5%, or only 65 of the more than 1,300 data requests issued prior to the Report"<sup>233</sup>; "Pacific produced nearly 172,000 pages of paper documents and the equivalent of approximately 19 million pages of documents provided on electronic media . . . ."<sup>234</sup>

While Pacific's witness discusses the substance of three categories of requests in response to the question "Please provide some examples of Overland's data requests that contributed to the delays in the response time," it is clear from the responses that she cited the most egregious cases.<sup>235</sup> Indeed, one of the examples she cites involved Pacific's production of "all public documents (depositions, transcripts, motions, judgments, settlements, etc.) involving litigation cases reported as contingent liabilities." In fact, review of the data request at issue shows that Overland sought only pleadings and motions, not "depositions" or "transcripts," which can be voluminous. Nor is it clear why it

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<sup>232</sup> *Id.* at 7:9-11 (emphasis in original).

<sup>233</sup> *Id.* at 8:1-2.

<sup>234</sup> *Id.* at 14:7-9.

<sup>235</sup> *See id.* at 10:1-11:9 (Q&A 18).

took Pacific 384 days – more than a full year – to respond to the relevant data request, which sought only “public versions of . . . initial complaints filed by the plaintiffs, answers filed by the defendants, motions for summary judgment and court judgments or settlements” for 7 cases.

Overland’s testimony made clear that this was a case in which sheer volume did not indicate quality:

Pacific Bell provided pleadings for 20 cases included in its general civil litigation accruals. The pleadings were voluminous and in many cases highly repetitive. The number of pages provided is not indicative of the exposure to damages. Some of the smaller cases generated the largest number of pages. As one would expect, the documents revealed that the plaintiffs and defendants disagreed about the facts of the case and the validity of the plaintiff’s claims.

However, they did not provide enough information for an auditor to estimate the contingent liability that should be recorded for the cases.<sup>236</sup>

Nor was Pacific’s resistance to discovery limited to responding to Overland’s data requests. When ORA attempted to elicit information from Pacific, it took a decision of the full Commission for Pacific to acknowledge ORA’s broad right to seek data from regulated utilities pursuant to Pub. Util. Code §§ 309.5 and 314. The Commission found “unreasonable” Pacific’s inference from an earlier Commission decision that the Commission had intended to limit ORA’s participation relative to the audit. It stated that, “[t]he fact that ORA may seek information comparable (or even identical) to that

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<sup>236</sup> Exh. 2B:412 at 7:33-8:4 (Harpster Reply Testimony).

sought by the Telecommunications Division in carrying out the audit we have directed, is not inappropriate; indeed it is consistent with ORA's statutory independence to pursue discovery as ORA deems fit."<sup>237</sup>

We find that the preponderance of the evidence supports the claim that Pacific "made parts of the audit very difficult." While we cannot state definitively the magnitude of the problem because Overland's role as a non-party did not afford it room to come before the assigned ALJ or invoke the Commission's Law and Motion process, it is clear Pacific's conduct delayed the audit.<sup>238</sup>

### **C. Comments on Draft Decision**

Contrary to Pacific's assertion in comments that the "correct" version of D.00-02-047 contained additional audit scope limitations over the "incorrect" version, a reading of the relevant ordering paragraphs in the two decisions shows no such additional scope limitation. Thus, Pacific's change in responsiveness to Overland's discovery requests based on the issuance of the "correct" version was not appropriate.

Both decisions state in ordering paragraph 2 that, "The audit scope shall be modified to reflect the changes in scope recommended by the Executive

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<sup>237</sup> D.01-08-062, 2001 Cal PUC LEXIS 513, at \*8.

<sup>238</sup> As Pacific points out, ORA filed one motion that the ALJ summarily rejected. However, it concerned the means by which Pacific hand-delivered materials to ORA (a process question), rather than whether Pacific's substantive discovery responses were inadequate. *See Pacific Reply/Audit* at 99-100. Thus, the motion does not affect the outcome of this discussion.

Director's letter of August 6, 1999." The Executive Director's letter focused only on three in areas in which the audit plan did not comply with Commission directives: 1) the sale of Bellcore, 2) the Pacific-Ameritech merger, and 3) interviews of Pacific Bell's competitors. Thus, the "correct" version of D.00-92-047 did not direct a shift in audit scope on the order of magnitude that Pacific suggests.

## **VII. Phase 2B Remedies (Audit – Pacific Bell)**

### **A. ORA's Proposed Remedies - Summary**

ORA proposes the following remedies, which we discuss in more detail below.

- Pacific should correct the IEMR reports for 1997, 1998 and 1999 to reflect all of the audit adjustments adopted by the Commission.

We order this remedy for only the LNP and CWC issues, as noted above.

- Pacific should correct its IEMR reports for 2000 and 2001 consistent with the adjustments we require for the 1997-99 reports.

We order this remedy.

- Pacific should share earnings for 1997 and 1998 if its earnings exceed the sharing threshold.

This is the current policy, but this issue is moot because there are no shareable earnings.

- Pacific should pay 18 percent interest on top of the amount it shares in earnings for 1997 and 1998, in the form of a surcredit.

We do not order this remedy. This issue is moot because there are no shareable earnings.

- For 1999, Pacific should refund the earnings that would have been shareable had the Commission not suspended sharing in 1999. One means of effecting refunds would be to apply a limited exogenous factor adjustment.

We do not order this remedy.

- Pacific should refund 18 percent of all underreported earnings for the audit years, regardless of whether earnings met the sharing threshold for 1997-98, and regardless of the Commission's suspension of sharing in 1999.

We do not order this remedy, but invite input in Phase 3B on the how the Commission can deter such under-reporting and create incentives for accurate reporting in the future.

- The Commission should lift the suspension of sharing and establish a memorandum account to track excess earnings subject to refund.

We do not order this remedy.

- The Commission should order the 1997-99 audit completed with respect to affiliate transactions, and order Pacific to cooperate fully with the auditors' requests for information.

We do not order this remedy.

- The Commission should order a further audit of Pacific's 2000, 2001 and 2002 reporting, including its affiliate transactions.

We do not order this remedy.

- The Commission should impose a \$20 million annual payment on Pacific as an incentive for Pacific to cooperate with the completion of the 1997-99 affiliate transaction audit and the carrying out of the 2000-02 audit, until it deems Pacific to be cooperating fully with both audits.

We do not order this remedy.

- The Commission should institute a penalty phase to determine whether Pacific violated the affiliate transaction

rules and Public Utilities Code § 2891 regarding disclosure of residential customers' information, and, if so, whether to order penalties or other relief.

We do not order this remedy.

- The Commission should revise its NRF monitoring report program to ensure we are receiving the information we need for effective monitoring and to eliminate reports we no longer need.

Consistent with the scoping memo, we defer this task to Phase 3B.

Preliminarily, Pacific criticizes ORA for proposing remedies that are inconsistent and subject to change on a whim. Pacific cites the many changes in the proposed remedies to demonstrate that ORA's proposals lack a reasonable basis. This decision is not concerned with what ORA proposed in Phase 2A, so we focus only on remedies proposed in Phase 2B. While there are small differences among the various ORA proposals, we find that for the most part, ORA recommends that Pacific correct the errors in its IEMR reports and pay an additional 18 percent as either interest or an "incentive" to ensure proper performance in the future.

Nor do we believe ORA's proposed remedies lack a reasonable basis simply because they have evolved over time. While we reject several of ORA's proposals, we do so based on the merits of each. We now turn to the individual suggested remedies.

#### **B. Correction of IEMR Reports for 1997-99**

ORA first contends that Pacific should correct the IEMR reports for 1997, 1998 and 1999 to reflect all of the audit adjustments adopted by the Commission. Some of these adjustments affecting the reporting for those years, and some have ongoing effect. Pacific should correct this error in its financial books, with the timing and extent of restatement (if any) determined by GAAP. Therefore, we

order Pacific to make a compliance filing no later than 90 days following the effective date of this decision that shows how, consistent with GAAP, the errors uncovered should be reflected in past and ongoing reports.

**1. Correction of IEMR Reports for 2000-2001**

Next, ORA states that Pacific should correct its IEMR reports for 2000 and 2001 consistent with the adjustments we require for the 1997-99 reports, pursuant to Resolution T-16571, in which we accepted Pacific's rate of return for 2000 subject to corrections or adjustments that may result from this proceeding.

We agree with ORA that many of the changes we order to the 1997-99 IEMR reports also apply to subsequent years. If we were to limit the required changes to the IEMRs issued during the audit period, regulatory accounting that we have already found to be in error would continue into the future. Just the opposite should occur: Pacific should correct errors in its financial books to reflect how the adjustments reflect subsequent years, with the timing and extent of restatement (if any) determined by GAAP. Therefore, we order Pacific to make a compliance filing no later than 90 days following the effective date of this decision that shows how, consistent with GAAP (with the exception of the LNP and CWC changes specifically ordered to the IEMR reports above). The corrections made should be reflected in past and ongoing reports.

Moreover, several of the changes we make here do not relate to one-time events that will not recur. Rather, we order many changes in the way Pacific keeps its books and reports its revenues and expenses on an ongoing basis. To the extent that changes affect Pacific's ongoing reporting for 2001 forward, it would hurt ratepayers and the regulatory process for us to allow Pacific to continue disallowed practices. Pacific should therefore make corrections in its financial and regulatory books (and reflect how the adjustments affect

subsequent years), with the timing and extent of restatement (if any) determined by GAAP.

Therefore, we order Pacific to make a compliance filing no later than 90 days following the effective date of this decision that shows how, consistent with GAAP, the errors uncovered should be reflected in past and ongoing reports. Pacific shall make a compliance filing within 90 days of the effective date of this decision listing each finding from this decision that has ongoing effects for its record-keeping, reporting or other activities, declaring that it is no longer engaged in disallowed practices, and demonstrating that its practices comply with this decision. The showing should also make corrections to the IEMR ordered by this decision to resolve the LNP and CWC accounting issues.

## **2. Sharing in 1997 and 1998**

ORA contends Pacific should share earnings for 1997 and 1998 if its earnings exceed the sharing threshold.

They do not.

### **C. Interest on 1997-98 Shareable Earnings**

On top of any earnings sharing Pacific is required to make after re-calculating its financial results for 1997 and 1998, ORA proposes that Pacific also pay 18 percent interest on the shareable amount. ORA chose the 18 percent figure by examining what Pacific charges its customers for late payments. Since ratepayers will receive any shared earnings belatedly, ORA reasons that it is fair to order Pacific to compensate them in the same way it would be compensated if the shoe were on the other foot.

Pacific contends it should pay interest based on the 90-day commercial paper rate. It cites D.01-06-077, in which the Commission ordered Roseville Telephone Company to share earnings retroactively and pay interest based on

the amount ordered in D.89-10-031, which was the 90-day rate. Pacific claims ORA's reliance on the 18 percent figure is arbitrary and effects a penalty on Pacific rather than simply compensating ratepayers for the time value of money. Pacific also notes that its customers agree to the late payment charge, while arguing that here, ORA seeks to impose a rate retroactively that was never disclosed to or agreed upon by Pacific. It contends ORA agreed on the 90-day rate in Phase 2A of the proceeding.

Since there is no sharing, this issue is moot.

#### **D. Method of Payment**

ORA recommends that ratepayers be credited the shareable earnings plus interest in the form of a one-time payment applied as a surcredit in the billing charges set forth in Pacific's tariff in Schedule Cal. P.U.C. Rule No. 33.<sup>239</sup> ORA recommends that the surcredit be applied uniformly across local exchange services and residential intraLATA toll services, "which includes the original end-user basic monopoly services where Pacific still holds a dominate [sic] market share."<sup>240</sup> Other than opposing the entire concept of our requiring sharing and ORA's recommended rate of interest, Pacific does not oppose ORA's specific suggestion. Our original decision establishing NRF stated that "Any

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<sup>239</sup> Pacific's tariffs, including Rule 33, are available on its website at [http://www.sbc.com/Large-Files/RIMS/California/Network\\_and\\_Exchange\\_Services/ca-ne-02.pdf](http://www.sbc.com/Large-Files/RIMS/California/Network_and_Exchange_Services/ca-ne-02.pdf), at sheet 135 *et seq.*

<sup>240</sup> ORA Opening/Audit at 81.

shared earnings will be returned to ratepayers through a surcredit on bills for basic end user monopoly services.”<sup>241</sup>

Since there is no sharing, this issue is moot.

#### **E. Suspension of Sharing in 1999**

ORA and TURN claim that Pacific misled us into suspending sharing in 1999 by presenting an inaccurate picture of the likelihood of sharing in the future. Had the Commission left sharing in place – as ORA and TURN contend it would have had it known the true facts – ratepayers would also benefit from the 1999 earnings adjustments we make in this decision.

There are two aspects to this claim. First, ORA contends that the expense overages that the audit reveals gave the Commission an inaccurate picture of whether sharing was a necessary mechanism. Pacific’s reported expenses always were high enough – and its earnings correspondingly low enough – that it never was forced to share earnings with ratepayers. Had Pacific reported its expenses correctly, ratepayers may have shared in Pacific’s earnings and the Commission would have had a better sense of the necessity for and benefits of sharing.

Second, ORA and TURN claim Pacific submitted misleading evidence in the proceeding in which the Commission decided to suspend sharing. They claim Pacific projected that its future earnings would not rise to the sharing threshold except under extraordinary circumstances. Therefore, they claim Pacific unfairly convinced the Commission that sharing was not necessary.

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<sup>241</sup> D.89-10-031, 1989 Cal. PUC LEXIS 576, at \*6.

ORA suggests that we order Pacific to refund the earnings that would have been shareable had the Commission not suspended sharing in 1999. It states that one means of effecting refunds would be to apply a limited exogenous (LE) factor adjustment.

Pacific claims that to reinstate sharing in 1999 would constitute illegal retroactive ratemaking and would be inconsistent with the purposes of NRF. It also refutes ORA's factual claims, asserting that it fully informed the Commission of the potential for outcomes well above the sharing threshold before the Commission suspended sharing. Pacific also claims we cannot order refunds to ratepayers without meeting the nine LE criteria discussed in the Section entitled "Recovery of Audit Costs," below, and argues that the proposed refunds do not meet those criteria.

We are not prepared to find that the Commission should not have suspended sharing in 1999. To do so would require a reexamination of the entire record leading up to D.98-10-026, our decision suspending sharing, to determine the full basis for the Commission's decision and the evidence it had before it. Nor can we state with any certainty that the Commission would have done anything differently had it had the benefit of the Overland audit.<sup>242</sup>

This does not mean that we will not identify 1999 errors in accounting that we find supported by the audit evidence. Pacific should correct errors in its financial books to reflect how the errors affect subsequent years, with the timing

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<sup>242</sup> We also declined to change our decision to suspend sharing in analyzing Overland's audit of Verizon in Phase 1 of this proceeding. *See* D.02-10-020, *mimeo.*, at 48.

and extent of restatement (if any) determined by GAAP. Therefore, we order Pacific to make a compliance filing no later than 90 days following the effective date of this decision that shows how, consistent with GAAP, the errors uncovered should be reflected in past and ongoing reports.

There may be other ratepayer impacts that we cannot now anticipate from this result. If Pacific received any rate increases or had any rate floor changed as result of its reported 1999 IEMR results, or based any such request in whole or part on such results, it shall call those to our attention in its compliance filing due 90 days after the effective date of this decision. Any party may comment on that filing with 30 days, and suggest remedies and identify other possible effects of Pacific's incorrect reporting. Pacific shall also include the same information for 1997 and 1998 in its filing.

**F. Proposed 18 Percent Interest on All Underreported Earnings**

In addition to suggesting that we impose 18 percent interest on Pacific's shareable earnings – if any – for 1997-98, ORA also recommends that we order Pacific to pay 18 percent on all underreported earnings for the entire audit period 1997-99. This suggestion differs from ORA's earlier 18 percent remedy because it would apply not only to amounts returned to ratepayers in the form of sharing, but also to amounts that fall below the sharing threshold. For 1999, this 18 percent would be the only remedy beyond requiring Pacific to correct its accounting errors because Pacific was not required to share earnings in that year, and because we decline to impose sharing retroactively for 1999.

We deny ORA's suggested remedy for 1997-98. Assessing 18 percent on the additional earnings under the sharing threshold would overcompensate ratepayers by giving them more than they would have received had Pacific reported its earnings correctly in the first place. Under the sharing mechanism,

ratepayers share only in earnings above a certain threshold. Ratepayers by definition receive no amount of earnings below the threshold.

The only justification for imposing the 18 percent on earnings below the threshold – or on any earnings Pacific had and did not report for 1999 – would be to penalize Pacific, or provide other financial incentives for it to report its financial information accurately.

ORA cites *Wise v. PG&E*<sup>243</sup> for the proposition that we may fashion an appropriate remedy where a utility has obtained a rate by fraud.<sup>244</sup> We do not have an adequate basis in the record currently before us to conclude pursuant to the authority ORA cites that Pacific committed fraud in underreporting its earnings or convincing the Commission to suspend sharing in 1999. Therefore, we do not believe *Wise* forms a basis to impose the 18 percent figure on earnings below the sharing threshold.

ORA also cites Pub. Util. Code § 798, which allows us to impose civil penalties on carriers that willfully make imprudent payments to or receive less than reasonable payments from subsidiaries, affiliates or holding companies. We do not have a record before us to justify imposing such a penalty. Thus, we decline to impose the 18 percent figure on any underreported earnings figures for 1997-99.

Over the years, we have adopted financial penalties as an incentive to ensure compliance with our rules, including those related to financial reporting.

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<sup>243</sup> 77 Cal. App. 4<sup>th</sup> 287 (1999).

<sup>244</sup> ORA Reply/Audit at 55.

For example, in our recent decision on Pacific's application pursuant to § 271 of the federal Telecommunications Act of 1996,<sup>245</sup> we described the self-executing financial performance incentives Pacific faces to ensure that it complies with the § 271 requirement that it give competitive local exchange carriers equal access to the ordering, repair, billing and related systems they need to provide local telephone exchange service to customers.<sup>246</sup>

Our discussion of these accounting issues, however, reveals that they are arcane. This makes it virtually impossible to design an incentive program since we cannot clearly characterize the behavior we wish to encourage. Furthermore, since this decision and the Phase 2A decision result in no shareable earnings, we see little benefit to devoting additional regulatory resources to designing an incentive program on this matter.

#### **G. ORA Proposal to Reinstate Sharing**

We do not have an adequate record to determine whether the Commission should reinstitute ratepayer sharing, as ORA contends we should. ORA's only evidence in support of its claim is the same evidence it relies on – and we reject – in favor of our reinstating sharing for 1999. Because we do not believe that evidence gives us an adequate record to require the reimposition of sharing

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<sup>245</sup> 42 U.S.C. § 271.

<sup>246</sup> D.02-09-048, Sept. 19, 2002, *mimeo.*, at 226 *et seq.* See also D.02-04-055, 2002 Cal. PUC LEXIS 285, at \*7-8 (describing measures that either reward or penalize electric utility for performance in connection with incentive based ratemaking); R.98-06-029, 1998 Cal. PUC LEXIS 428, at \*8 (describing incentives used to penalize poor telephone company service quality).

going forward, we deny ORA's suggested remedy. However, this decision does not mean that we cannot consider the reimposition of sharing in Phase 3B.

#### **H. No Additional Auditing of 1997-99 Transactions Needed**

Overland recommends that it be allowed to supplement its 1997-99 audit of Pacific's affiliate transactions. Pacific notes that ORA's expert did not even recommend the years 1997-1999 be revisited by an audit.<sup>247</sup> We reject this recommendation. The results from the audit to date have demonstrated no material impact from affiliate transactions. In addition, our entire audit has had no effect on shareable earnings, nor did it result in any rate rebates to customers. We see no need to devote further resources to audit transactions from these three years. It makes no sense for this Commission to maintain its focus on narrow issues that are 5-7 years old.

#### **I. Audit of Pacific's 2000-03 Reporting Should Commence**

We note that we have already ordered the commencement of a NRF audit for Verizon covering the years 2000 and beyond. (D.02-10-020). The Commission is required by Pub. Util. Code § 314.5 to audit the books of "every electrical, gas, heat, telegraph, telephone and water corporation serving over 1000 customers" once every three years.

Following this precedent, ORA shall immediately commence a comprehensive audit of SBC covering the years 2000 through 2003. The audit shall include (i) an examination of monitoring reports that SBC submitted to the Commission under the New Regulatory Framework (NRF), (ii) examination of

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<sup>247</sup> 11 TR 1143:25-1144:2; 13 TR 1392:26-1393:25.

infrastructure investments and expenses assigned to regulated and unregulated activities, (iii) an investigation of affiliate transactions, and (iv) the revenues and expenses associated with SBC's Directory Affiliate. ORA shall modify the scope of the audit, as appropriate, in response to developments in Phase 3 of this proceeding.

ORA may hire CPAs and other technical experts to conduct all or part of the audit. Any outside experts hired by ORA should perform their work in an objective and independent manner, and have no financial conflicts of interest with respect to Pacific or any of its affiliates. To this end, the part of the audit performed by the hired CPAs should be conducted in accordance with Generally Accepted Auditing Standards (GAAS),<sup>248</sup> with the exception that the materiality threshold should be reduced to a scope determined by ORA.

Pacific shall reimburse ORA for the cost of the CPAs and technical experts. Pacific may seek to recoup these costs in its annual Advice Letter requesting LE recovery for cost increases or decreases.<sup>249</sup> The audit-related costs included in the Advice Letter should not exceed the amount billed to Pacific by the Commission

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<sup>248</sup> Three principles of GAAS are: (i) the audit must be performed by persons with adequate technical training and proficiency as an auditor; (ii) the auditors must maintain an independent mental attitude on all matters relating to the audit; and (iii) due professional care is to be exercised in the performance of the audit and the preparation of the report.

<sup>249</sup> Ordering Paragraph 1(g) of D.98-10-026 states as follows: "Advice Letters shall be filed every October 1 requesting LE cost recovery for cost increases or decreases resulting from (1) items mandated by the Commission and (2) changes in total intrastate cost recovery resulting from changes between federal and state jurisdictions; alternatively, the Advice Letter shall state that there are no such adjustments."

or ORA since the last LE Advice Letter. We place Pacific on notice that it may not recover audit-related costs that arise from Pacific's failure to cooperate with the audit in a timely and reasonable manner. Further, we place Pacific on notice that any failure to cooperate will be subject to monetary penalties and other sanctions.

**J. \$20 Million "Incentive" Payment**

ORA proposes that we impose a \$20 million annual payment on Pacific as an "incentive" for Pacific to cooperate with the completion of the 1997-99 affiliate transactions audit and the carrying out of a 2000-02 audit, until we deem Pacific to be cooperating fully with both audits.

We do not believe ORA's proposed \$20 million incentive payment requirement is a necessary or reasonable means to ensure Pacific's cooperation with the audit. The Commission has the inherent authority to use fines or other sanctions to ensure the necessary cooperation with its future audits.

**K. Penalty Phase**

ORA also asks us to institute a penalty phase to determine whether Pacific violated the affiliate transaction rules and Pub. Util. Code § 2891 regarding disclosure of residential customers' information, and, if so, whether to order penalties or other relief.

We have uncovered no evidence that any accounting transaction has led to any impact on ratepayers and see little reason to expend more regulatory and financial resources on an audit of affiliate transactions stemming from a period that is fro 5-7 years ago.

On the request for a penalty phase under Section 2891, we lack adequate evidence and briefing on the issue. Section 2891 provides that telephone corporations must obtain a residential subscriber's written consent before sharing the subscriber's personal financial, purchasing, and calling pattern information with another person or corporation.<sup>250</sup> The only evidence in the record is that Pacific shares information about its customers with SBC Operations, a subsidiary of Pacific's parent, SBC, which in turn uses the information to conduct marketing and research on Pacific's behalf.

The burden of demonstrating that a violation was committed lies with complainants, and ORA has failed to meet its burden. We do not find Pacific Bell in violation of § 2891 in this proceeding. There is therefore no basis for a penalty phase.”<sup>251</sup>

Similarly, the record before us here does not provide adequate information for us to decide the § 2891 issue. We therefore decline ORA's request seeking a penalty phase in this proceeding.

#### **L. Revisions to NRF Monitoring Program**

Finally, ORA asks the Commission to revise its NRF monitoring report program to ensure we are receiving the information we need for effective monitoring and to eliminate reports we no longer need. Consistent with the scoping memo, we defer this issue to Phase 3B.

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<sup>250</sup> California Public Utilities Code § 2891(d) contains ten exceptions to this requirement, none of which are applicable here.

<sup>251</sup> D.01-09-058, 2001 Cal. PUC LEXIS 914, at \*109-110.

**VIII. Recovery of Audit Costs**

Pacific is seeking to recover a portion of the costs it incurred as a result of the audit.<sup>252</sup> Pacific is requesting recovery for the direct out-of-pocket costs paid by Pacific to the Commission based on billings submitted by Overland. The amount is expected to be just over \$2 million. Pacific proposes that recovery be provided through inclusion of the total payments made to the Commission as a line item in Pacific's next Annual Price Cap Filing.

There is little doubt that the audit was contentious, and that Pacific was not entirely cooperative within the intent of 314. As such, the lack of cooperation has delayed the completion of this proceeding, has complicated the resolution of this regulatory matter, and has clearly increased costs both to Parties and this Commission. For this reason, we cannot find the audit costs reasonable, and Pacific may not recover them.

**IX. Comments on the Alternate Proposed Decision**

The alternate proposed decision of Commissioner Kennedy was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.6 of the Commission's Rules of Practice and Procedure. AT&T, Pacific, ORA, and TURN filed opening comments on October 14, 2003. ATT, Pacific, and ORA filed reply comments on October 29, 2003.

We have reviewed all the comments and replies and have revised this decision based on our consideration of the comments.

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<sup>252</sup> Hogue Corrected Direct Testimony, Exh. Pacific: Phase 2B:346, p. 14.

### **Findings of Fact**

1. In 1997 and 1998, Pacific was under an obligation to share earnings above a certain threshold with ratepayers. In combination with the audit decision resulting from Phase 2A of this proceeding, the earnings did not rise to a level that requires Pacific to share earnings in 1998.

2. In 1999, Pacific also over-reported expenses, but was under no obligation in that year to share earnings with ratepayers.

3. In its audit report, Overland identified 72 corrections to Pacific's regulated operating revenues, expenses and rate base. This decision resolves all but 4 issues; the Phase 2A decision resolves the remaining 4 issues.

4. Because of the policies adopted in D.04-02-063, the adjustments recommended by Overland in this phase of this proceeding have no impact on shareable earnings.

5. Pacific maintained its FR books during the audit period solely for the purpose of creating the Intrastate Earnings Monitoring Reports (IEMRs). Any GAAP changes instituted after 1995 are not reflected in the FR books. The only purpose of the FR books after 1995 was to create the IEMR, which constitute the regulatory scorecard for determining whether there are shareable earnings.

6. The higher Pacific's costs as reported in the IEMR, the lower its net revenues and earnings. This can affect shareable earnings.

7. During a period when revenue sharing is in effect, a reduction in the amount of net revenues shared with ratepayers economically impacts ratepayers. The higher Pacific's costs as reported in the IEMR, the lower its revenues and ultimately its potentially shareable earnings.

8. Pacific's accounting costs can have an effect on the price floors and ceilings the Commission sets for its services. These floors and ceilings are set based on

studies of Pacific's forward-looking costs, which in turn are often derived, in part, from accounting costs.

9. It is essential to the regulatory process that we have accurate information regarding the earnings of companies we regulate.

10. The proposed adjustments of Overland, either taken singly or all together, have no impact on shareable earnings.

11. There are no general facts that support a wholesale departure by the Commission from the GAAP accounting standards, including the standard for "materiality," adopted for regulatory purposes in D.87-12-063.

12. Overland met the criteria for performance of this audit specified in D.96-05-036.

13. Those conducting the audit for Overland were qualified.

14. The Telecommunications Division ordered Overland to contravene NARUC standards for conducting audits despite Overland's committing to such a practice in its proposal letter to the Commission.

15. The Commission's decision to conduct an audit that did not follow NARUC standards added to the acrimony of this proceeding

16. Pacific had adequate opportunity to respond to the audit report.

17. While Overland did engage in policy discussions in its audit report, it made recommendations consistent with the Commission's desire for "analysis of all issues uncovered," "recommendations as to specific accounting measures" and a "thorough, aggressive audit."

18. Overland has little expertise in interpreting Commission policies.

19. Any errors Overland made in its audit are inconsequential in an audit of this size and result in part from the procedures the Commission ordered Overland to follow.

20. Pacific conceded 20 out of 72 audit adjustments, but contends that adjustments to accounting books, if any, should be made consistent with GAAP.

21. The broad powers granted to the Commission under the Constitution do not exempt it from complying with the attorney-client privilege.

22. Pacific has claimed that information concerning its accruals for litigation liability is subject to the attorney-client privilege.

23. Information concerning Pacific's accruals for litigation liability is subject to attorney-client privilege due to the nature of the accruals.

24. Pacific has done nothing in the present proceeding to place at issue its privileged communications.

25. Pacific has presented insufficient record to justify the accruals.

26. In 1996, Pacific implemented the new RCRMS automated bill collection system.

27. Pacific was aware of problems with RCRMS in 1996.

28. Other than in the period in 1996 at issue, Pacific's bad debt did not fluctuate drastically. The fluctuation in 1996 should have put Pacific on notice of a serious problem, but Pacific could not quantify the monetary impact until 1997.

29. In 1996, Pacific changed how it accounted for revenues and expenses related to published directories. Prior to 1996, it accounted for them over the life of the directory. In 1996, it began recognizing revenue and expense when the directory is issued.

30. In April 1996, the Commission issued D.96-04-052, promising Pacific a true-up for recovery of past costs related to interim number portability.

31. Concerning Directory Publishing, Pacific accurately posted a one-time pre-tax gain of \$143 million in 1996.

32. Overland's extensive audit failed to identify any improper accounting for 1997, but it was unable to determine whether the change in accounting policy for Directory Publishing had an impact on reported revenues and expenses in 1997.

33. Since there was no specific LNP cost subject to recovery from the California regulatory jurisdiction prior to May 1998, FAS 71 and FAS 90 did not permit the creation of a regulatory asset since there were no specific costs for which recovery was reasonably assured.

34. In May of 1998, the FCC declared LNP costs subject to federal jurisdiction.

35. To account for LNP costs properly, Pacific should have made an after-tax adjustment for LNP cost of \$15.6 million in 1998 and \$22.3 million in 1999.

36. Pacific lacked a regulatory promise of recovery of local competition implementation costs. This lack of a regulatory promise precluded the creation of a regulatory asset to cover these expenses.

37. Lacking a regulatory promise of recovery of local competition costs, Pacific properly expensed the audit amount of \$49 million.

38. Overland incorrectly concluded that Pacific would have realized savings as a result of Pacific Bell-SBC merger, imputed those savings to the business, and attributed 50% of the imputed savings to Pacific's shareholders. There is no proof that these savings actually materialized. Thus, there should have been no assumption that ratepayers would lose the 50% of imputed savings Overland decided should inure to the benefit of Pacific's shareholders.

39. In December 1999, Pacific amended its contract with Lucent for software right-to-use fees.

40. The costs associated with it were properly accounted as expenses by Pacific.

41. For the years 1997-99, Pacific's overstated its intrastate operating expenses by \$29 million as a result of the over-accrual of incentive pay costs. Actual incentive pay was lower than the accrued amount.

42. Pacific's error in estimated expenses was reasonable, as were the procedures it followed to adjust accounts were consistent with GAAP, and reasonable.

43. There is no dollar impact related to the expense issue Overland calls a "royalty payment," and that Pacific titles a "management fee," but only a difference of opinion on how – rather than whether – Pacific should adjust the fee out of its intrastate regulated operations.

44. In 1997, Pacific recorded a \$12.6 million entry related to pre-1976 disabilities that Pacific's actuaries had not previously valued. Overland found that Pacific should not have made the entry in 1997, and that it artificially increased expenses by \$9.6 million in that year to the possible detriment of ratepayers. It is not, however, reasonable to depart from GAAP in accounting for this item.

45. The audit report proposes an adjustment to correct errors admitted by Pacific in its accounting for amortization of its intrabuilding network cable investment. All sides agree that Pacific made an error. There is a dispute only as to when Pacific should have accounted for the error. The error took place in each of the years 1994-1997. Pacific recorded a catch-up accrual in 1997.

46. Pacific acted reasonably in recording a catch-up accrual in 1997 for intrabuilding network cable investment to correct previous errors.

47. Overland found that Pacific overstated the rate base deduction for accumulated deferred income taxes (ADIT) by an average of \$7 million per year due to the improper use of "normalization" accounting.

48. Overland could not adequately audit Pacific's intrastate regulated sales and use tax expense because Pacific contended the accruals depended only on "management's professional judgment - nothing more, nothing less."

49. Overland's audit findings concerning sales and use tax accruals. These findings on an after tax basis are \$461,000 in 1997, \$457,000 in 1998, and -\$1.4 million in 1999. To the extent required by GAAP, Pacific should reflect these findings in its regulatory accounts.

50. Pacific does not dispute the audit finding that when it processed certain manual paychecks, it failed to generate accruals for the employer's portion of payroll taxes. Pacific made a catch-up entry in 1999 to correct the error, rather than reflecting a change in 1998 and prior periods.

51. It is reasonable to require that Pacific correct the timing of its payroll tax corrections to the extent required by GAAP, Pacific should reflect these findings in its regulatory accounts.

52. Pacific does not dispute the audit finding that it overstated its intrastate regulated deferred income tax expenses by \$59 million in 1998 and 1999 as a result of an accounting error. Pacific corrected the error in 2000. No adjustment is necessary.

53. It is reasonable to correct the booking of deferred taxes so that taxes are booked in the year owed to the extent that such practice is consistent with GAAP.

54. Pacific overstated by \$8 million in 1999 its current period intrastate operating income taxes and intrastate operating deferred income tax expense related to its severance of Ameritech employees. There is no disagreement that these costs should have been booked below-the-line.

55. It is reasonable to direct Pacific to correct errors in its books, to the extent that this practice is consistent with GAPP, to remove the current period and deferred income tax associated with the Ameritech severance accruals.

56. The FCC continuing property records audit, Pacific's 1999 computer inventory, and Pacific's 1997 SAVR audit of its central office property records, in combination, suggest that Pacific has an internal control problem in maintaining accurate property records during the audit period.

57. The SAVR audit in particular found that 4.5% of Pacific's recorded plant was not present in the central offices. Pacific also found plant in its central offices that did not appear in its plant accounts.

58. During the audit period, Pacific reported financial results for property it did not have, had property in inventory that it did not report, and generally lacked control over its property records and inventory.

59. For plant it could not locate, Pacific retired the assets from the company's books by crediting plant in service for the original cost of the item and debiting accumulated reserve for depreciation. This approach overstated depreciation in 1997 and 1998. Pacific should have recorded the corrections to its accounting in the affected years. Pacific, however, reasonably recorded the corrections to its accounts in the years when it discovered the error – a practice consistent with GAAP.

60. For plant it located in the central offices for which it had no record, Pacific assumed that it had never recorded that plant in its accounts. There is no evidence that Pacific either charged the equipment to expense when it acquired it or lumped it in with other "continuing property" items.

61. Overland produced no evidence supporting its hypothesis that unrecorded equipment was all charged to expense when acquired or lumped in with other “continuing property” items.

62. Pacific’s practice of “reverse retirement” offers a reasonable accounting treatment for addressing the discovery of “unrecorded” plant.

63. Pacific’s intrastate net plant is overstated by an average of \$29 million as a result of an error in Pacific Bell’s Restructuring Reserve IEMR ratemaking adjustment. Pacific should correct this error consistent with GAAP.

64. To the extent we adopt any of Overland’s adjustments to depreciation expense, we should also adjust accumulated reserve for depreciation in a manner consistent with GAAP.

65. Overland found that when Pacific’s combined depreciation expense, short-term borrowings, and investment tax credit for a period exceeds its annual construction expenditures, Pacific considers this negative amount as a negative source of externally generated funds. The result is that this negative amount is treated as a use of capital.

66. There is no Commission ruling or order disallowing the methodology Pacific employs to implement the Resolution RF-4 calculations. It is not reasonable to reverse this long-standing methodology.

67. Cash working capital requirements typically are calculated through a “lead-lag” study, which compares revenue and expense “lags” to calculate the average annual amount of cash working capital associated with a particular expense category.

68. While Pacific has not updated any of its lead-lag studies, used to determine its cash working capital needs, since 1988, there is no evidence that the studies are inaccurate.

69. Pacific appropriately determined its cash working capital requirements pursuant to the Commission's Standard Practice U-16.

70. There are no circumstances that warrant deviation from Standard Practice U-16.

71. Standard Practice U-16 authorizes including "non-cash" items such as depreciation in cash working capital. In D.91-07-056, the Commission ordered that the method and components used to determine rate base in the calculation of shareable earnings should be the same as those used to determine the rate base used in the start-up revenue requirement in D.89-12-048.

72. D.89-12-018 designated that the components that comprised rate base would be those in the start up revenue requirement adopted in D.89-10-031. In D.89-10-031 the Commission stated that the start up revenue requirement should be based upon the Monthly Results of California Intrastate Operations report filed with CACD in compliance with the Commission's November 5, 1979 letter. The Monthly Results of California Intrastate Operations report sets rate base as: Telecommunications Plant in Service, plus Plant Held for Future Use, plus Materials and Supplies, less Depreciation Reserve, less Tax Reserve, plus Cash Working Capital.

73. Pacific proposed to an adjustment to cash working capital based on arguments presented in the proceeding.

74. It is reasonable to deduct \$142.2 million in 1997, \$91.3 million in 1998 and \$91.1 million in 1999 from the working capital amounts included in rate base. Since Cash-Working Capital is a regulatory construct, Pacific should modify its IEMR books to reflect this change.

75. There is no factual basis to change the current accounting practices applying to directory publishing.

76. The Phase 2A decision deals with audit corrections related to prepaid pension assets.

77. Pacific recorded its FAS 112 liability in Account 4310.

78. Overland's proposed adjustments to rate base arising from FAS 112 liability issues are inconsistent with our regulatory practice, because this item is not a recognized component of ratebase.

79. 82. Overland's proposed adjustments to rate base arising from vacation pay liability considerations are inconsistent with our regulatory practice, because this item is not a recognized component of ratebase. Overland's proposal to exclude Pacific's FAS 106 liability from rate base is inconsistent with our regulatory practice, because this item is not a recognized component of ratebase.

80. It is unreasonable to accept Overland's recommended rate base adjustments concerning contingent liability accruals because this item is not a recognized component of ratebase.

81. Overland reported that it did not find that Pacific's internal controls for affiliate transaction had a material impact on Pacific's CPUC-basis financial results during the years 1997 through 1999.

82. The plain language of the 1997 Consent Decree clearly states which SBC affiliates are obliged to provide time reports for affiliate transactions.

83. SBC holding company, SBC Services and SBC Operations are not on the list of affiliates that must provide time reports for transactions regarding SBC affiliates.

84. Overland's opinion that the Consent Decree applies to the SBC holding company as well as SBC Operations and SBC Services rests on faulty analysis.

85. Pacific provided evidence adequate to refute Overland's allegation that Pacific's "Image Maker" program demonstrated inadequate internal controls.

86. There is no basis for finding that there are deficiencies in Pacific's tracking of legal matters and no basis for ordering a specific change.

87. TRI's research expenses are reasonable.

88. Telecommunications advances largely stem from research and technological advances.

89. Overland did not conclude that the accounting and internal controls pertaining to affiliate transactions had a material effect on Pacific's earnings.

90. There was no documented dispute between Pacific and the entities charging Pacific management fees.

91. The management fees SBC Services passed on to Pacific rose from \$30 million in 1999 to \$1.1 billion in 2000.

92. SBC uses a general allocator that passes a majority of costs on to the regulated utility. Dollars are driven to the affiliate with the highest investment – the regulated telephone company, which has years and years of built up investment.

93. Most of SBC's cost allocations to the regulated utility were based not on the first principle of Part 64 requiring direct assignment of costs, but rather were based on a general allocator based on the size of the affiliate's investment. Since the regulated telephone companies have the greatest amount of investment, they bear a large portion of costs.

94. Pacific classified certain expenses to the incorrect Part 32 accounts, but these had no impact on IEMR reported earnings.

95. SBC Operations lost certain documentation supporting the SBC Operations allocation factors for assignment of costs to Pacific Bell.

96. Overland acknowledged that the costs allocated to Pacific from SBC Operations did not have a material impact on Pacific's financial results.

97. Overland concluded that controls used for the charges Pacific assessed on unregulated SBC affiliates “generally functioned to provide the intercompany balance control as intended.”

98. Pacific’s FMV studies meet the FCC standards for FDC rates it charge its affiliates.

99. Pacific’s act of giving the SBC Shared Services organization “access” to its customer database does not constitute a “transfer” of customer records.

100. There is no evidence to support any violation by Pacific of affiliate transaction rules with regard to access to Pacific’s customer database for marketing services on its behalf.

101. Pacific’s affiliate ASI is important because it is the entity in which most of Pacific’s DSL services are housed.

102. There is currently a very active and growing market for DSL in Pacific’s territory, and we can expect DSL to become an even more popular service in the future.

103. The ASI asset transfer proceeding provides an appropriate forum for investigation DSL related issues.

104. Pacific agreed to limit its regulated operations’ exposure for Pacific Bell executive compensation to \$200,000 per year per executive.

105. Pacific made a regulatory adjustment on the IEMR for executive compensation during the audit period. Pacific voluntarily reduced intrastate regulated operating expense by \$20 million, \$8 million, and \$7 million in 1997, 1998 and 1999 respectively.

106. SBC made award payments to certain of its key executives in connection with SBC’s 1998 investment in AMDOCS, a telecommunications software company, and SBC’s merger with Ameritech.

107. During the audit period, the SBC parent organization allocated certain executive compensation to Pacific Bell Directory that exceeded the \$200,000 cap.

108. Pacific Bell Directory bore yet another executive compensation expense in excess of the \$200,000 cap - called "special executive compensation" - based on a general allocator.

109. Pacific also bore the expense of the AMDOCS acquisition/Ameritech merger executive compensation allocated to it by SBC Operations (and not just the parent).

110. Pacific bore executive compensation related to the AMDOCS acquisition/Ameritech merger - this time allocated to it by SBC Services.

111. With regard to SBC's allocation to Pacific of legal fees associated with SBC's work on 1) Constitutional issues regarding the Telecommunications Act of 1996 (1996 Act), 2) Section 271 long distance service applications pursuant to the 1996 Act, and 3) Pacific's participation in the AT&T/Media One merger proceeding, Pacific did not explain the benefit to the regulated utility or demonstrate that the expense directly applied to the utility's regulated activities. It is reasonable to disallow these expenses as proposed by Overland

112. SBC allocated legal expenses to Pacific Bell Directory.

113. As shown in Appendix D hereto, Pacific did not dispute the auditor's non-affiliate-transaction findings in connection with items similar to those which Pacific disputes related to parent expenses for public relations and corporate sponsorship allocated to Pacific Bell and Pacific Bell Directory.

114. Pacific was charged in 1998 and 1999 when an unregulated affiliate, MSI, conducted market research and investigated potential acquisitions throughout the world. These expenses relate to international lines of business and should not be included in the regulated accounts.

115. During the audit period, Pacific and Pacific Bell Directory bore expense related to the SBC parent's strategic planning activities.

116. Pacific failed to demonstrate that SBC parent's strategic planning activities benefited Pacific.

117. The SBC parent company billed Pacific \$7.4 million in 1998 for services rendered in 1997. It is reasonable to correct such an error only to the extent consistent with GAAP.

118. Pacific properly recorded inter-company revenue associated with marketing services provided to affiliates.

119. Pacific claimed that regulated operations were directly billed for only 3.5% of the SBC National-Local IT costs associated with Pacific's effort to expand service into 30 metropolitan areas outside of Pacific's service area. This claim is inconsistent with its discovery response to Overland in which it claimed that Pacific was billed for this work according to a general allocator because Pacific's effort to expand into metropolitan areas outside Pacific's service territory "was thought to benefit the company as a whole rather than a specific regulated or nonregulated area."

120. In 1997, Pacific recorded a portion of the payment it made for the naming rights to Pacific Bell Park above-the-line, which is not appropriate for goodwill advertising.

121. Pacific corrected depreciation expense allocation in December 1999 consisted with its Cost Allocation Manual. This allocation is reasonable and consistent with Commission policy.

122. Pacific allocated its product advertising expense consistent with the Cost Allocation Manual. This allocation is reasonable and consistent with Commission policy.

123. It is reasonable to exclude external relations costs in account 6722 that were assigned to regulated operations. To the extent consistent with GAAP, it is reasonable to correct this error in financial reports. It is also reasonable to require Pacific to stop this practice.

124. Costs associated with applying for interLATA service were properly charged to regulated operating income.

125. Pacific performs fluctuation analyses to show changes from month to month in the assignment of costs to regulated and nonregulated categories. Overland found Pacific's documentation lacking in several respects and recommended that the Commission order Pacific to document its results to provide an adequate audit trail.

126. Pacific's response did not show that its fluctuation analyses provided adequate detail or explained what products or marketing initiatives were causing the resulting monthly fluctuations.

127. Pacific's Commission Cost Allocation Manual (C-CAM) is not up-to-date and certain descriptive information is missing. Responsible Pacific staff acknowledged the need to update the C-CAM.

128. Pacific does not maintain an audit trail translating the trial balances of its individual subsidiaries to Pacific's FR book (the books it uses to derive the IEMR report). Pacific reports the overall financial results of its PBIS and PBNI subsidiaries in the FR books, but does not maintain detail about how it translates the subsidiaries' trial balances to the FR books.

129. PBIS and PBNI may have a significant financial impact on Pacific's business. Therefore, we believe the financial data regarding these subsidiaries' impact on the IEMR should appear in detail so that we have the opportunity to determine how Pacific calculates its IEMR results. Accordingly, we adopt the

audit recommendation and require Pacific to make a compliance filing within 60 days of the effective date of this decision detailing how it will make more transparent and auditable the process it uses for translating PBIS' and PBNI's financial trial balances to its FR books and IEMR reports.

130. Pacific uses its ESTRS system as a statistically valid sampling process to determine the allocation of marketing hours between regulated and nonregulated work activities.

131. Pacific's PBNI personnel hours are reported to a nonregulated tracking code, and there is no need to include them in the ESTRS process.

132. Overland did not conclude that Pacific "impeded" the audit.

133. In discussing the reassignment of audit responsibility from ORA to TD in this case, the Commission noted that, "the transfer of the audit responsibility does not relieve Pacific Bell of its obligation to fully answer any and all data requests received from all Commission staff, and to provide answers on a timely basis."

134. Pacific took an unduly narrow view of Overland's right to have access to Pacific documents, treating the auditors as simply parties to litigation rather than an extension of the Commission with far broader powers to inspect.

135. In at least some instances, Pacific's own conduct delayed and unduly increased the work associated with the audit.

136. Overland propounded over 1,300 data requests, with 1,000 devoted to Phase 2B issues. Many of the data requests included multiple subparts.

137. The Commission's distribution of the wrong version of D.00-02-047 precipitated disputes concerning the scope of the audit.

138. The correction version of D.00-02-047 limited the scope of the audit.

139. While there are small differences among the various ORA proposals, we find that for the most part, ORA recommends that Pacific correct the errors in its IEMR reports and pay an additional 18 percent as either interest or an “incentive” to ensure proper performance in the future.

140. Many of the errors we identify in the 1997-99 IEMR reports also apply to subsequent years. To the extent consistent with GAAP, it is reasonable to correct errors in all future IEMR reports.

141. It is reasonable to address the errors in Pacific’s audit identified herein only to the extent and in a manner consistent with GAAP, with the exception of the LNP and CWC changes ordered to the IEMR accounts.

142. Several of the errors identified herein and the changes we order do not relate to one-time events that will not recur. Rather, we order many changes in the way Pacific keeps its books and reports its revenues and expenses on an ongoing basis. It is therefore reasonable to require Pacific to correct the identified errors in all future IEMR reports.

143. Since no shareable earnings result from this proceeding, it is moot to adopt an interest rate to apply to “shareable” balances.

144. Commission policy is to calculate interest on shareable earnings at the 90-day commercial paper rate.

145. It is not reasonable to develop a regulatory incentive program that applies to accounting practices.

146. It is not reasonable to order the sharing of earnings in 1999.

147. It is not reasonable to impose an 18 percent penalty on under reported earnings because these errors had no consequences for ratepayers.

148. ORA’s expert did not recommend further audits of the years 1997-1999.

149. The audit did not conclude that affiliate transactions materially affected earnings.

150. A further audit of transactions from 1997 through 1999 is not reasonable.

151. At some point the total audit costs will be ascertainable with reasonable certainty and minimal controversy. It is premature to decide whether and how to recover these costs at this time.

152. The rancor that characterized the audit process delayed the completion of this proceeding and added costs to all participants.

153. D.02-10-020 ordered the commencement of a NRF audit for Verizon.

### **Conclusions of Law**

1. Pacific properly maintains its FR and IEMR regulatory books according to GAAP, as directed by this Commission in D.87-12-063 (which also directs a limited list of departures from GAAP procedures).

2. It is reasonable to require limited departures from GAAP procedures. Specifically, it is reasonable to order modifications to the IEMR regulatory books to remove Local Number Portability Costs and to modify the Cash Working Capital amounts in ratebase, as discussed herein and as ordered below.

3. The Commission requires accurate IEMR reporting for many reasons, including:

- To ascertain whether exogenous or limited exogenous factor cost recovery treatment is appropriate and, if so, the amount by which rates should change.
- To decide when individual service rate increases are justified.
- To resolve whether recategorization requests (to move services among the three NRF service categories) should be approved.
- For purposes of universal service proceedings.
- For regulating rates for Category I, such as unbundled network elements.

- To monitor the financial impact of regulation
4. In combination, the audit errors identified herein were not sufficiently “material” to require the retroactive changes in Pacific’s reporting that Overland requested. Such wholesale restatement of FR and IEMR accounts would contravene the regulatory reporting rules adopted in D.87-12-063.
  5. Unless a specific public interest is served, the Commission should follow GAAP accounting practices as it has ordered in D.87-12-063.
  6. Since this audit results in no refunds to ratepayers and has no material impact on Pacific’s accounts, then, pursuant to GAAP and D.87-12-062, Pacific should limit its restatement of its past regulatory books as discussed herein.
  7. Overland’s staff was qualified to perform the audit.
  8. We disallow as unauditible Pacific’s contingent liability accruals, and required Pacific to account for its contingent liabilities on an as-paid basis.
  9. In the context of its contingent liability claims, Pacific did not place the reasonableness of its lawyers’ advice at issue in this proceeding.
  10. There was no implied waiver of the attorney-client privilege by Pacific.
  11. Pacific did provide over 4,900 non-privileged documents to support its contingent liability accruals.
  12. Pacific’s valid objection to disclosing other privileged documents made it impossible for Overland to carry out the audit in accordance with GAAS.
  13. Pacific’s contingent liability accruals were not justified for purposes of this proceeding and should be reduced in accordance with the audit recommendation to reflect the amounts Pacific actually paid in relation to the accrued claims. Adjustments in prior reports, however, Pacific should not be made because this practice is inconsistent with GAAP. The adjustments should be made with the timing and extent of adjustments controlled by GAAP.

14. The FCC only allows utilities to account for contingent liability claims on an as-paid basis.

15. Pacific should have posted accruals in 1996 for estimated bad debts resulting from its RCRMS system, but it is not reasonable to require a retroactive restatement of regulatory books because of this error.

16. The audit does not show that Pacific improperly accounted in 1997 for a change in how it accounts for revenues and expenses resulting from published directories.

17. Pacific should not have deferred LNP costs as a regulatory asset on its IEMR books as of April 1996. The requirements of SFAS 71 were not satisfied.

18. As of May 1998, when the FCC issued its Third Report and Order, Pacific should have recovered all of the expense related to LNP exclusively in the federal jurisdiction and remove all previous expenses recorded in the state regulatory jurisdiction. It is reasonable to require Pacific to revise its regulatory IEMR books for all years affected by this issue.

19. D.96-03-020, D.97-04-083 and D.98-11-066 did not provide Pacific adequate assurance of cost recovery for local competition implementation costs to support the creation of a regulatory asset.

20. Pacific properly accounted for its SBC-Pacific merger savings, with the exception of \$4.2 million in conceded errors for both 1998 and 1999. Since this audit results in no refunds to ratepayers, the Pacific should not restate its past financial books to correct this error because to do so is inconsistent with GAAP, which was adopted as a regulatory standard (with some exceptions) in D.87-12-062.

21. Pacific's 1999 change to the Lucent software right-to-use contract was properly recorded as an expense.

22. We reject as unreasonable Overland's recommended adjustment for the year 1999 related to Pacific's software right-to-use contract with Lucent.

23. We adopt no change based on the audit report in how Pacific accounted for \$30 million in what Overland called a "royalty fee."

24. Pacific should not have made a \$12.6 million entry related to pre-1976 disabilities that Pacific's actuaries had not previously valued in 1997. This expense should be written off or charged below-the-line in a way that does not affect ratepayers. Changes in prior financial reports, however, should be made only to the extent consistent with GAAP.

25. Pacific should be required to provide stand-alone actuarial reports for the Pacific Bell component of SBC benefit plans.

26. Since Pacific lacked depreciation freedom prior to 1997, it was reasonable to correct its IEMR depreciation error in 1997, the year in which it discovered the error and a year in which the Commission granted Pacific depreciation freedom.

27. Pacific's accumulated deferred income taxes (ADIT) should be given flow-through tax treatment in accordance with our Decision in Phase 2A.

28. Pacific properly corrected its error of failing to generate accruals for the employer's portion of payroll taxes, made when it processed certain manual paychecks by making a catch-up accrual in 1999, consistent with GAAP (as adopted for regulatory accounting purposes in D.87-12-063).

29. Pacific should not adjust the IEMRs for 1998 and 1999, the affected years, in response to the audit finding that it overstated its intrastate regulated deferred income tax expenses. Rather, Pacific should correct the error at a time and in a manner consistent with GAAP.

30. Pacific should account for the Ameritech severance accrual and the associated income tax effects on a consistent basis, below-the-line. Since this

audit results in no refunds to ratepayers, the Pacific should correct the error at a time and in a manner consistent with GAAP.

31. Pacific's "reverse retirement" procedure is a reasonable response to the audit finding of equipment not recorded in company accounts.

32. It is reasonable to adopt Overland's proposed adjustment to intrastate net plant. Since this audit results in no refunds to ratepayers, the Pacific should correct the error at a time and in a manner consistent with GAAP.

33. Pacific should adjust its IEMRs to reflect adjustments for accumulated reserve for depreciation for any audit adjustment we adopt related to Pacific's depreciation expense at a time and in a manner consistent with GAAP.

34. Pacific's calculation of its AFUDC complies with the method adopted for Pacific in Resolution RF-4.

35. Pacific should use the FCC's AFUDC rate as soon as practical.

36. The procedures set forth in Standard Practice U-16 guides the calculation of "cash working capital." Pacific followed these procedures.

37. The TURN/ORR proposal to set Pacific's working capital figure at zero is unreasonable because it removes cash working capital from rate base on the basis of alleged errors or complexities in the calculation.

38. Since we find no "special circumstances" that justify a deviation from Standard Practice U-16, it is reasonable to adopt only the rate base changes concerning cash working capital proposed by Pacific and described herein. Moreover, it is reasonable to modify the IEMR regulatory books for each of the years in this audit to reflect the changes as proposed by Pacific.

39. Consistent with D.89-10-031, D.89-12-018, and D.91-07-056, the rate base components are: Telecommunications Plant in Service, plus Plan Held for Future

Use, plus Materials and Supplies, less Depreciation Reserve, less Tax Reserve, plus Cash Working Capital.

40. Pacific's accounting for prepaid directory expense is reasonable.

41. The work Pacific has done thus far to enhance its internal controls is adequate to ensure compliance with our rules.

42. The FCC 1997's Consent Decree required employees of certain SBC parent organizations to keep time records for affiliate transactions.

43. Pacific showed that its "Image Maker" has adequate internal controls at Pacific.

44. Allocating most of TRI's modest research expenses to the regulated utility is reasonable.

45. Pacific has a responsibility to protect its own ratepayers by ensuring that its parent and affiliate organizations only pass costs onto the regulated utility that the utility should bear pursuant to cost causative principles.

46. FCC Part 64 guidelines establish the hierarchy of cost allocation. The first principle of such assignment is that "costs shall be directly assigned to either regulated or nonregulated activities whenever possible." Part 64 only allows reliance on a general allocator after all other, more specific methods of allocation have been tried.

47. There is no requirement that Pacific charge a 10% mark-up to regulated affiliates.

48. Pacific Bell Directory's Fair Market Value (FMV) studies meet the FCC standard of charging FMV to affiliates for services.

49. There is no evidence that Pacific's practices concerning charges to non-regulated affiliates fail to comply with Commission rules.

50. The ASI asset transfer proceeding would be a better docket in which to determine whether ratepayers are entitled to compensation for DSL development costs, and therefore defer this issue to that docket.

51. It was appropriate for Pacific to book on January 1, 2000 \$47 million in transfer fee revenue related to Pacific's transfer of 2,935 employees to SBC Services in December 1999.

52. Pacific's regulated operations should not bear the expense of executive compensation over \$200,000 per year if the executives work for affiliates of Pacific Bell, rather than for Pacific Bell itself.

53. To the extent that Pacific bears the cost of general "management fees" allocated from SBC to Pacific's regulated operations, the accounts show double charges management – once for excess executive salaries, and a second time for the cost of executives rolled into the management fee.

54. The Commission's affiliate transaction rules and the FCC's Part 64 regulations require that there be some benefit associated with an allocated cost. Pacific showed no such benefit for its excess executive compensation costs.

55. For the audit period, SBC entities' executive compensation recorded for regulatory purposes should be capped at \$200,000 per year per executive, regardless of where those executives are employed.

56. The award payments SBC made to certain of its key executives in connection with SBC's 1998 investment in AMDOCS, a telecommunications software company, and SBC's merger with Ameritech exceeded the threshold for executive pay and should not be included in regulated expenses. Pacific should correct this error at a time and in a manner consistent with GAAP.

57. The SBC parent organization should not have allocated any executive compensation to Pacific Bell Directory that exceeded the \$200,000 cap. Pacific should correct this error at a time and in a manner consistent with GAAP.

58. Pacific should not have borne the expense of the AMDOCS acquisition/Ameritech merger executive compensation allocated to it by SBC Operations (and not just the parent) in excess of the \$200,000 cap. Pacific should correct this error at a time and in a manner consistent with GAAP.

59. Pacific should not have borne executive compensation in excess of \$200,000 related to the AMDOCS acquisition/Ameritech merger allocated to it by SBC Services or SBC operations. Such compensation had no direct or obvious benefit for Pacific's regulated operations. Pacific should correct this error at a time and in a manner consistent with GAAP.

60. Pacific's regulated operations should not have borne any of the executive award payments because they exceeded the \$200,000 threshold for executive pay. Such compensation had no direct or obvious benefit for Pacific's regulated operations. Pacific should correct this error at a time and in a manner consistent with GAAP.

61. SBC improperly allocated to Pacific legal fees associated with SBC's work on: 1) Constitutional issues regarding the Telecommunications Act of 1996 (1996 Act); 2) Section 271 long distance service applications pursuant to the 1996 Act; and 3) Pacific's participation in the AT&T/Media One merger proceeding.

62. Pacific did not demonstrate how the legal expenses the parent operation billed to Pacific Bell Directory benefited Directory, and Pacific erred in recording those expenses. Pacific should correct the error at a time and in a manner consistent with GAAP.

63. Since Pacific's regulated operations should not bear the cost of image advertising, then it follows that Pacific should not bear the cost of such advertising carried out by an unregulated parent or affiliate of Pacific, as occurred here.

64. It would create improper incentives to allow SBC to charge to Pacific's regulated operations certain expenses that would not be allowable above-the-line if Pacific itself incurred them.

65. The Commission has disallowed having regulated operations bear the cost of image advertising under NRF.

66. MSI's market research and investigation of potential acquisitions throughout the world do not benefit Pacific. If the allocation does not otherwise benefit Pacific, such benefit does not occur simply because in the future Pacific's share of the allocation will lessen as SBC grows bigger.

67. Pacific did not show that the SBC parent's strategic planning activities benefit the regulated utility. Without such justification, it is improper for the utility to bear the expense. Such activities create potentially anti-competitive cross subsidies.

68. Any cross-subsidy flowing from Pacific's regulated operations to its National-Local competitive local exchange affiliate would be anticompetitive, as unaffiliated competitive local exchange carriers receive no such subsidy.

69. Pacific's regulated operations should not have borne any expense related to Pacific's National-Local affiliate.

70. In D.01-06-077, we stated that "[t]he Commission does not allow recovery from ratepayers of institutional or goodwill advertising.

71. Pacific should not have recorded expense related to its sponsorship of Pacific Bell Park, a baseball stadium, above-the-line.

72. Pacific made an erroneous correction to the December 1999 allocation of depreciation expense, resulting in an understatement of nonregulated depreciation expense.

73. Pacific followed Commission policy in allocating correcting entries using the December 1999 cost allocation ratios for depreciation expenses.

74. Pacific allocated its Product Advertising Expense in accordance with the Cost Allocation Manual.

75. The majority of the external relations costs in Pacific's account number 6722 were improperly assigned directly to regulated operations.

76. In D.94-06-011, the Commission found that Pacific should continue to record dues, donations and political advocacy expenses below-the-line.

77. Pacific's regulated operations should not be charged differently depending upon which entity engages in the legislative and regulatory activities.

78. California regulated operations should not bear the expense of political and legislative influence activities and other external relations expenses.

79. Because PBIS and PBNI have a significant financial impact on Pacific's business, the financial data regarding these subsidiaries' impact on the IEMR should appear in detail so that we have the opportunity to determine how Pacific calculates its IEMR results.

80. If all of the PBNI personnel's hours are reported to a nonregulated tracking code, there is no need to include them in Pacific's ESTRS process. We decline to take any action on the audit recommendation in this regard.

81. The authority of the Commission, its divisions, its staff and its contractors is plenary under Section 314. While the Commission's actions are governed by procedural and substantive due process and fair play, as a matter of investigative authority, it is not limited by the rules governing civil discovery, the

requirements of ALJ Resolution 164 (governing Law and Motion matters at the Commission), or other standard discovery rules, in exercising its right of audit under § 314.

82. It was not within Pacific's discretion to decide whether Overland's data requests were relevant or within the scope of the audit decision.

83. Pacific's conduct contributed significantly to delays in the audit and ultimately made it impossible for Overland to finish the portion of the audit related to affiliate transactions.

84. The data requests of Commission staff or its agents are deemed presumptively valid, relevant and material.

85. Pacific's earnings did not exceed the sharing threshold in 1997, in accordance with the findings of this decision combined with our findings in the Phase 2A decision.

86. Pacific's earnings did not exceed the sharing threshold in 1998, in accordance with the findings of this decision combined with our findings in the Phase 2A decision.

87. Pacific should be required to correct the errors that we have identified herein in a manner consistent with GAAP, with the exception of the two specific modifications to the IEMR concerning Local Number Portability and Cash Work Capital adjustments ordered herein.

88. To the extent the errors identified affect Pacific's ongoing reporting for 2001 forward, it would hurt ratepayers and the regulatory process for us to allow Pacific to continue erroneous practices. We should require Pacific to correct its errors and amend its processes consistent with GAAP, with the exception of the two specific modifications to the IEMR concerning Local Number Portability and Cash Work Capital adjustments ordered herein.

89. We do not find that the Commission erred in suspending sharing in 1999. To do so would require a reexamination of the entire record leading up to D.98-10-026, our decision suspending sharing, to determine the full basis for the Commission's decision and the evidence it had before it. Nor can we state with any certainty that the Commission would have done anything differently had it had the benefit of the Overland audit.

90. Under the sharing mechanism, ratepayers share only in earnings above a certain threshold. Ratepayers by definition receive no amount of earnings below the threshold.

91. We do not conclude that Pacific committed fraud in underreporting its earnings or convincing the Commission to suspend sharing in 1999.

92. We do not have a record before us to justify imposing a penalty on Pacific pursuant to Pub. Util. Code § 798, which allows us to impose civil penalties on carriers that willfully make imprudent payments to or receive less than reasonable payments from subsidiaries, affiliates or holding companies.

93. Audits provide a means for the Commission to monitor utility financial performance, to determine if utilities are complying with Commission rules and statutory requirements, and to assess whether the Commission's goals for NRF are being met.

94. Even if no problems are found pursuant to an audit, it is prudent for the Commission to maintain continuous, comprehensive, and vigilant oversight of large utilities like Pacific that provide essential services to millions of Californians.

95. ORA asks us to institute a penalty phase to determine whether Pacific violated the affiliate transaction rules and Pub. Util. Code § 2891 regarding disclosure of residential customers' information, and, if so, whether to order

penalties or other relief. There is no record before us that warrants a penalty phase in this proceeding.

96. Granting access of SBC Operations to Pacific's customer information was consistent with current rules.

97. The Commission noted in D.96-05-036, addressing Pacific's effort to transfer audit responsibility away from DRA, ORA's predecessor, that, "In its petition [to modify D.94-06-011, which prescribed the audit], Pacific sought to have the audit performed under the supervision of the Commission's Advisory and Compliance Division (CACD) [TD's predecessor]. Pacific Bell also indicated its willingness to fund the CACD supervised audit.

98. The total audit costs are ascertainable with reasonable certainty and minimal controversy.

99. It is reasonable to disallow recovery of all of Pacific's audit costs.

**O R D E R**

**IT IS ORDERED** that:

1. Pacific Bell, now known as SBC (Pacific), shall prepare a filing that identifies each of this decision's identified errors and demonstrate that Pacific will correct the identified errors in its financial reporting in a manner consistent with GAAP, or as otherwise directed herein. Pacific shall make this filing, along with supporting documentation, as a compliance Advice Letter filing due no later than 90 days after the effective date of this decision. Consistent with Commission practice regarding IEMR disclosure following an audit, SBC shall report to the Commission the impact of identified errors contained herein, on its IEMR for the period in which the error occurred.

2. Pacific shall make a compliance filing within 90 days of the effective date of this decision listing each finding from this decision that has ongoing effects for

its record-keeping, reporting or other activities, and demonstrating that its practices going forward comply with this decision.

3. We defer to the ASI transfer proceeding, Application 02-07-039, the determination of whether ratepayers are entitled to compensation for DSL development costs.

4. In its compliance filing due 90 days after the effective date of this decision, Pacific shall address the audit's assertions regarding whether Pacific's California Cost Allocation Manual is up-to-date, including those related to the information Overland obtained from staff. Overland states that responsible Pacific staff acknowledged the need to update the C-CAM. Pacific's staff also identified certain listings in the CAM that required updating, although Overland found the listings the staff identified to be inadequate. Further, Overland claims Pacific's staff told its auditors that certain aspects of the C-CAM had not been updated since 1996. We will then address the issue in Phase 3B of this proceeding.

5. Pacific shall make a compliance filing within 90 days of the effective date of this decision detailing how it will make more transparent and auditable the process it uses for translating PBIS' and PBNI's financial trial balances to its FR books and IEMR reports. Pacific shall also implement its proposed course of action, with any change(s) the Commission orders.

6. We deny ORA's request for an order requiring Pacific to refund the earnings that would have been shareable had the Commission not suspended sharing in 1999.

7. We deny ORA's request for an order requiring Pacific to refund 18 percent of all underreported earnings for the audit years, regardless of whether earnings met the sharing threshold for 1997-98, and regardless of the Commission's suspension of sharing in 1999.

8. We deny ORA's request to lift the suspension of sharing and establish a memorandum account to track excess earnings subject to refund.

9. We deny ORA's request to impose a \$20 million annual payment on Pacific as an incentive for Pacific to cooperate with the completion of the 1997-99 affiliate transaction audit and the carrying out of the 2000-02 audit, until it deems Pacific to be cooperating fully with both audits.

10. We deny ORA's request for an order instituting a penalty phase to determine whether Pacific violated the affiliate transaction rules and Public Utilities Code § 2891 regarding disclosure of residential customers' information, and, if so, whether to order penalties or other relief.

11. ORA shall immediately commence a comprehensive audit of SBC covering the years 2000 through 2003. The audit shall include (i) an examination of monitoring reports that SBC submitted to the Commission under the New Regulatory Framework (NRF), (ii) examination of infrastructure investments and expenses assigned to regulated and unregulated activities, (iii) an investigation of affiliate transactions, and (iv) the revenues and expenses associated with SBC's Directory Affiliate. ORA shall modify the scope of the audit, as appropriate, in response to developments in Phase 3 of this proceeding.

12. We defer to Phase 3B ORA's request to revise the Commission's NRF monitoring report program. This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.

**APPENDIX A**

**APPENDIX B**

**R.01-09-001 / I.01-09-002**  
**Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell**  
**Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999**

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
		<b>Income Statement Adjustments</b>										
1	5-13	Unsupported Contingent Liabilities - Revenues (IS)	SUBS	Overland		40,463,493	0.40%	0	0.00%	0	0.00%	40,463,493
				ORA	(4)	40,463,493	0.40%	0	0.00%	0	0.00%	40,463,493
				TURN	(5)	40,463,493	0.40%	0	0.00%	0	0.00%	40,463,493
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
2	5-14	Bellcore Dividends (IS)	NONE	Overland		3,883,507	0.04%	0	0.00%	0	0.00%	3,883,507
				ORA	(2)	3,883,507	0.04%	0	0.00%	0	0.00%	3,883,507
				TURN	(6)							
				Pacific		3,883,507	0.04%	0	0.00%	0	0.00%	3,883,507
3	5-15	Uncollectible Revenues - RCRMS (PacBell flows through) (IS)	SUBS	Overland		53,533,000	0.53%	0	0.00%	0	0.00%	53,533,000
				ORA	(4)	53,533,000	0.53%	0	0.00%	0	0.00%	53,533,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
4	5-19	Gain on Sale of Bellcore (IS)	NONE	Overland		9,122,587	0.09%	0	0.00%	0	0.00%	9,122,587
				ORA	(2)	9,122,587	0.09%	0	0.00%	0	0.00%	9,122,587
				TURN	(6)							
				Pacific	(8)	9,122,587		0	0.00%	0	0.00%	9,122,587
5	6-15	Local Number Portability Costs (IS)	BOTH	Overland		51,313,964	0.51%	27,904,486	0.27%	22,306,761	0.22%	101,525,211
	S6-1			ORA	(4)	51,313,964	0.51%	27,904,486	0.27%	22,306,761	0.22%	101,525,211
				TURN	(5)	51,313,964	0.51%	27,904,486	0.27%	22,306,761	0.22%	101,525,211
				Pacific		0	0.00%	15,645,112	0.15%	22,306,761	0.22%	37,951,873
6	6-19	Local Competition Costs (IS)	SUBS	Overland		40,974,049	0.41%	7,963,946	0.08%	0	0.00%	48,937,995

**R.01-09-001 / I.01-09-002**  
**Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell**  
**Showing Impact of Audit Corrections on Pacific Bell's Reported IEMR Results for 1997 - 1999**

Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
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				ORA	(4)	40,974,049	0.41%	7,963,946	0.08%	0	0.00%	48,937,995
				TURN	(5)	40,974,049	0.41%	7,963,946	0.08%	0	0.00%	48,937,995
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
7	6-22	Merger Savings Allocation (IS)	AMT	Overland		5,327,527	0.05%	23,321,782	0.23%	(7,704,205)	-0.08%	20,945,104
				ORA	(3)	0	0.00%	2,500,000	0.02%	2,470,000	0.02%	4,970,000
				TURN	(6)							
				Pacific		0	0.00%	2,495,834	0.02%	2,470,279	0.02%	4,966,113
8	6-27	Advanced Communications Network (IS)	NONE	Overland		17,846,219	0.18%	4,284,040	0.04%	2,226,486	0.02%	24,356,745
				ORA	(4)	17,846,219	0.18%	4,284,040	0.04%	2,226,486	0.02%	24,356,745
				TURN	(6)							
				Pacific	(8)	17,846,219		4,284,040		2,226,486		24,356,745
9	6-31	Software Buy-Out Agreement (IS)	SUBS	Overland		0	0.00%	0	0.00%	44,465,490	0.45%	44,465,490
				ORA	(2)	0	0.00%	0	0.00%	44,465,490	0.45%	44,465,490
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
10	6-32	Unsupported Contingent Liabilities - Operating Expense (IS)	SUBS	Overland		89,166,316	0.89%	1,913,966	0.02%	11,765,136	0.12%	102,845,418
				ORA	(4)	89,166,316	0.89%	1,913,966	0.02%	11,765,136	0.12%	102,845,418
				TURN	(5)	89,166,316	0.89%	1,913,966	0.02%	11,765,136	0.12%	102,845,418
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
11	6-34	Incentive Pay Accrual (IS)	SUBS	Overland		34,353,665	0.34%	(40,739,899)	-0.40%	35,061,088	0.35%	28,674,854
				ORA	(2)	34,353,665	0.34%	(40,739,899)	-0.40%	35,061,088	0.35%	28,674,854

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				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
12	6-37	ISP-Bound Traffic Separations (IS)	NONE	Overland		(11,329,359)	-0.11%	0	0.00%	0	0.00%	(11,329,359)
				ORA	(2)	(11,329,359)	-0.11%	0	0.00%	0	0.00%	(11,329,359)
				TURN	(6)							
				Pacific		(11,329,359)	-0.11%	0	0.00%	0	0.00%	(11,329,359)
13	6-36	Uncollectible Settlements - RCRMS (IS)	SUBS	Overland		28,038,790	0.28%	13,180,440	0.13%	863,874	0.01%	42,083,104
				ORA	(4)	28,038,790	0.28%	13,180,440	0.13%	863,874	0.01%	42,083,104
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
14	7-9	Pension Expense (IS)	SUBS	Overland		105,280,092	1.05%	108,774,347	1.07%	110,496,463	1.11%	324,550,902
	S7-13			ORA	(4)	105,280,092	1.05%	108,774,347	1.07%	110,496,463	1.11%	324,550,902
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
15a	7-13	SFAS 106 (IS)	SUBS	Overland		29,706,000	0.30%	395,443,000	3.89%	103,470,000	1.04%	528,619,000
				ORA	(4)	29,706,000	0.30%	395,443,000	3.89%	103,470,000	1.04%	528,619,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
15b	7-13	SFAS 106 - Pension Trust Withdrawal (IS)	SUBS	Overland		0	0.00%	0	0.00%	68,749,000	0.69%	68,749,000
	S7-6			ORA	(4)	0	0.00%	0	0.00%	68,749,000	0.69%	68,749,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
16	7-33	SFAS 112 (IS)	SUBS	Overland		9,594,151	0.10%	0	0.00%	0	0.00%	9,594,151
				ORA	(2)	9,594,151	0.10%	0	0.00%	0	0.00%	9,594,151

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				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
17	8-6	Intrabuilding Cable Amortization (IS)	SUBS	Overland		19,473,832	0.19%	16,611,028	0.16%	0	0.00%	36,084,860
				ORA	(4)	19,473,832	0.19%	16,611,028	0.16%	0	0.00%	36,084,860
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
18	8-7	SAVR Delayed Retirements (IS)	SUBS	Overland		5,906,945	0.06%	4,236,207	0.04%	0	0.00%	10,143,152
				ORA	(2)	5,906,945	0.06%	4,236,207	0.04%	0	0.00%	10,143,152
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
19	8-7	SAVR Reverse Retirements (IS)	SUBS	Overland		271,567	0.00%	615,253	0.01%	2,344,456	0.02%	3,231,276
				ORA	(2)	271,567	0.00%	615,253	0.01%	2,344,456	0.02%	3,231,276
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
20	8-8	Equal Access IEMR Ratemaking Adjustment (IS)	NONE	Overland		0	0.00%	(6,477,055)	-0.06%	0	0.00%	(6,477,055)
	S8-1			ORA	(2)	0	0.00%	(6,477,055)	-0.06%	0	0.00%	(6,477,055)
				TURN	(6)							
				Pacific	(7)	0	0.00%	(6,477,055)	-0.06%	0	0.00%	(6,477,055)
21	8-12	Reserve Deficiency Amortization (IS)	SUBS	Overland	(1)	0	0.00%	0	0.00%	362,466,228	3.64%	362,466,228
				ORA	(4)	0	0.00%	0	0.00%	362,466,228	3.64%	362,466,228
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
22	9-22	Ameritech Income Tax Misclass (IS)	SUBS	Overland		0	0.00%	0	0.00%	8,001,866	0.08%	8,001,866

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				ORA	(2)	0	0.00%	0	0.00%	8,001,866	0.08%	8,001,866
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
23	9-11	Income Tax Normalization (IS)	SUBS	Overland		(92,198,238)	-0.92%	(5,569,856)	-0.05%	61,264,694	0.61%	(36,503,400)
	S9-3			ORA	(4)	(92,198,238)	-0.92%	(5,569,856)	-0.05%	61,264,694	0.61%	(36,503,400)
	S9-5			TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
24	9-21	Excess Deferred Income Tax (IS)	SUBS	Overland	(1)	0	0.00%	29,624,000	0.29%	29,671,000	0.30%	59,295,000
	S9-6			ORA	(4)	0	0.00%	29,624,000	0.29%	29,671,000	0.30%	59,295,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
25	9-24	Sales and Use Tax Accrual (IS)	SUBS	Overland		777,410	0.01%	771,297	0.01%	(2,405,419)	-0.02%	(856,712)
				ORA	(2)	777,410	0.01%	771,297	0.01%	(2,405,419)	-0.02%	(856,712)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
26	9-24	Employment Tax Error (IS)	SUBS	Overland		0	0.00%	0	0.00%	7,333,353	0.07%	7,333,353
				ORA	(2)	0	0.00%	0	0.00%	7,333,353	0.07%	7,333,353
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
39	15-18	SBC Ops FAS 106 Merger Conforming Expense (IS)	NONE	Overland		0	0.00%	0	0.00%	1,656,603	0.02%	1,656,603
				ORA	(2)	0	0.00%	0	0.00%	1,656,603	0.02%	1,656,603
				TURN	(6)							
				Pacific	(8)	0	0.00%	0	0.00%	1,656,603		1,656,603
40	15-19	AMDOCS Awards SBC	SUBS	Overland		0	0.00%	0	0.00%	252,655	0.00%	252,655

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		Operations (IS)										
				ORA	(4)	0	0.00%	0	0.00%	252,655	0.00%	252,655
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
41	15-20	Excess Executive Compensation SBC Operations (IS)	SUBS	Overland		0	0.00%	465,193	0.00%	610,568	0.01%	1,075,761
				ORA	(4)	0	0.00%	465,193	0.00%	610,568	0.01%	1,075,761
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
42	15-21	SBC Ops Sec. Alloc of Parent Mgt Fees (IS)	NONE	Overland		0	0.00%	291,835	0.00%	270,743	0.00%	562,578
				ORA	(2)	0	0.00%	291,835	0.00%	270,743	0.00%	562,578
				TURN	(6)							
				Pacific	(8)	0	0.00%	291,835	0.00%	270,743	0.00%	562,578
43	15-22	SBC Ops Call Ctr Depreciation, Merger Implmntatn Exp (IS)	NONE	Overland		0	0.00%	237,025	0.00%	0	0.00%	237,025
				ORA	(2)	0	0.00%	237,025	0.00%	0	0.00%	237,025
				TURN	(6)							
				Pacific	(8)	0	0.00%	237,025	0.00%	0	0.00%	237,025
44	16-18	SBC Svcs "Excess" Executive Comp Exp (IS)	SUBS	Overland		0	0.00%	109,093	0.00%	107,020	0.00%	216,113
				ORA	(4)	0	0.00%	109,093	0.00%	107,020	0.00%	216,113
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
45	16-19	SBC Svcs, CFL, TRI Sec.Alloc. of Parent Mgt Fees (IS)	NONE	Overland		0	0.00%	265,789	0.00%	216,392	0.00%	482,181
				ORA	(2)	0	0.00%	265,789	0.00%	216,392	0.00%	482,181

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				TURN	(6)							
				Pacific	(8)	0	0.00%	265,789		216,392		482,181
46	14-9	Parent "Excess" Executive Compensation Expense (IS)	SUBS	Overland		1,451,564	0.01%	6,534,667	0.06%	6,845,540	0.07%	14,831,771
				ORA	(4)	1,451,564	0.01%	6,534,667	0.06%	6,845,540	0.07%	14,831,771
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
47	14-23	Parent Political and Legislative Influence Expense (IS)	NONE	Overland		8,574,885	0.09%	10,009,837	0.10%	4,186,554	0.04%	22,771,276
				ORA	(2)	8,574,885	0.09%	10,009,837	0.10%	4,186,554	0.04%	22,771,276
				TURN	(6)							
				Pacific	(8)	8,574,885		10,009,837		4,186,554		22,771,276
48	14-26	Parent Legal Expense (IS)	SUBS	Overland		0	0.00%	438,876	0.00%	212,061	0.00%	650,937
				ORA	(4)	0	0.00%	438,876	0.00%	212,061	0.00%	650,937
				TURN	(5)	0	0.00%	438,876	0.00%	212,061	0.00%	650,937
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
49	14-34	Parent Public Relations & Corporate Sponsorship Exp (IS)	SUBS	Overland		1,700,568	0.02%	8,583,357	0.08%	8,818,057	0.09%	19,101,982
				ORA	(4)	1,700,568	0.02%	8,583,357	0.08%	8,818,057	0.09%	19,101,982
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
50	14-33	Parent Corporate Development Expense (IS)	SUBS	Overland		0	0.00%	3,068,824	0.03%	3,506,106	0.04%	6,574,930
				ORA	(4)	0	0.00%	3,068,824	0.03%	3,506,106	0.04%	6,574,930
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0

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51	14-35	Parent Strategic Planning Expense (IS)	SUBS	Overland		1,675,592	0.02%	532,041	0.01%	409,813	0.00%	2,617,446
				ORA	(4)	1,675,592	0.02%	532,041	0.01%	409,813	0.00%	2,617,446
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
52	14-38	Parent Contributions, Memberships, Foundation Exp (IS)	NONE	Overland		161,013	0.00%	657,620	0.01%	(3,067,831)	-0.03%	(2,249,198)
				ORA	(2)	161,013	0.00%	657,620	0.01%	(3,067,831)	-0.03%	(2,249,198)
				TURN	(6)							
				Pacific	(8)	161,013		657,620		(3,067,831)		(2,249,198)
53	14-39	Parent Out of Period Expense (IS)	SUBS	Overland		(3,442,873)	-0.03%	3,360,784	0.03%	0	0.00%	(82,089)
				ORA	(2)	(3,442,873)	-0.03%	3,360,784	0.03%	0	0.00%	(82,089)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
54	14-40	Parent Merger Conforming Expense (IS)	NONE	Overland		0	0.00%	0	0.00%	454,553	0.00%	454,553
				ORA	(2)	0	0.00%	0	0.00%	454,553	0.00%	454,553
				TURN	(6)							
				Pacific	(8)	0	0.00%	0	0.00%	454,553		454,553
55	14-41	Parent Impact of Adjustmts on Billings to PBD (IS)		Overland	(9)	770,974	0.01%	3,914,927	0.04%	4,453,797	0.04%	9,139,698
				ORA	(2),(4)	770,974	0.01%	3,914,927	0.04%	4,453,797	0.04%	9,139,698
55i		PBD Parent Impact Legal Expense (IS)		TURN	(5)	0	0.00%	24,752	0.00%	8,965	0.00%	33,717
55a		PBD Parent Impact Contributions	NONE	Pacific	(8)	75,500		259,236		195,782		530,518

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		Memberships (IS)										
55b		PBD Parent Impact Corporate Acquisitions (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55c		PBD Parent Impact Corporate Sponsorships (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55d		PBD Parent Impact Excess Executive Compensation (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55e		PBD Parent Impact Lobbying (IS)	NONE	Pacific	(8)	389,744		729,081		881,323		2,000,148
55f		PBD Parent Impact Special Executive Payments (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55g		PBD Parent Impact Public Relations Expense (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55h		PBD Parent Impact Strategic Planning Expense (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55i		PBD Parent Impact Legal Expense (IS)	SUBS	Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
55j		PBD Parent Impact Management Fee (IS)	NONE	Pacific	(8)	0	0.00%	1,145,479		1,248,344		2,393,823
55k		PBD Parent Impact Employee Transfer Fees (IS)	NONE	Pacific	(8)	58,754		0	0.00%	0	0.00%	58,754
56	14-41	MSI USA "Excess" Executive Comp Billed Directly (IS)	SUBS	Overland		0	0.00%	0	0.00%	1,833,222	0.02%	1,833,222
				ORA	(4)	0	0.00%	0	0.00%	1,833,222	0.02%	1,833,222
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
57	17-18	Parent PB Employee Trsfr Fees Billed Back to PB (IS)	NONE	Overland		626,616	0.01%	0	0.00%	0	0.00%	626,616
				ORA	(2)	626,616	0.01%	0	0.00%	0	0.00%	626,616

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				TURN	(6)							
				Pacific	(8)	626,616		0	0.00%	0	0.00%	626,616
58	17-18	Fees for Employees Transferred in 1999 (IS)	NONE	Overland	(11)	0	0.00%	0	0.00%	0	0.00%	0
				ORA	(4)	0	0.00%	0	0.00%	0	0.00%	0
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
59	18-2	Nevada Bell Net Directory Revenue (IS)	NONE	Overland		0	0.00%	0	0.00%	(11,253,000)	-0.11%	(11,253,000)
	18-7			ORA	(2)	0	0.00%	0	0.00%	(11,253,000)	-0.11%	(11,253,000)
				TURN	(6)							
				Pacific		0	0.00%	0	0.00%	(11,253,000)	-0.11%	(11,253,000)
ORA	19	ASI - ADSL Development Cost Treatment (IS)	SUBS	Overland		0	0.00%	0	0.00%	0	0.00%	0
				ORA	(3)	2,439,732	0.02%	5,577,046	0.05%	86,291,540	0.87%	94,308,318
				TURN	(5)	2,439,732	0.02%	5,577,046	0.05%	86,291,540	0.87%	94,308,318
				Pacific	(10)	0	0.00%	0	0.00%	0	0.00%	0
60b	20-20	Depreciation Expense Timing Adjustment (IS)	SUBS	Overland	(1)	0	0.00%	0	0.00%	2,917,083	0.03%	2,917,083
				ORA	(2)	0	0.00%	0	0.00%	2,917,083	0.03%	2,917,083
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
61	20-22	Advertising Direct Assignment and Common Allocations (IS)	SUBS	Overland		0	0.00%	1,930,885	0.02%	1,752,588	0.02%	3,683,473
				ORA	(2)	0	0.00%	1,930,885	0.02%	1,752,588	0.02%	3,683,473
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0

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Index #	Report Chapter	Adjustment Description (A) (B)	Status of Dispute	Party	NOTES	1997 Final Adjustments	1997 Individual Adjustment Impact on Rate of Return	1998 Final Adjustments	1998 Individual Adjustment Impact on Rate of Return	1999 Final Adjustments	1999 Individual Adjustment Impact on Rate of Return	Total Audit Period Final Adjustment Amounts
62	20-31	Customer Service Non-Productive Salary Allocations (IS)	SUBS	Overland		(1,039,093)	-0.01%	(3,366,101)	-0.03%	(4,813,537)	-0.05%	(9,218,731)
				ORA	(2)	(1,039,093)	-0.01%	(3,366,101)	-0.03%	(4,813,537)	-0.05%	(9,218,731)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
63	20-37	Affiliate Marketing Services Revenue (IS)	SUBS	Overland		0	0.00%	4,420,889	0.04%	17,936,810	0.18%	22,357,699
				ORA	(3)	0	0.00%	3,235,271	0.03%	13,689,808	0.14%	16,925,079
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
64	20-48	Non-regulated Tracking Code Direct Assignment Errors (IS)	NONE	Overland		7,398	0.00%	4,250,163	0.04%	3,237,874	0.03%	7,495,435
				ORA	(2)	7,398	0.00%	4,250,163	0.04%	3,237,874	0.03%	7,495,435
				TURN	(6)							
				Pacific	(7)	7,398	0.00%	4,250,163	0.04%	3,237,874	0.03%	7,495,435
65	20-48	National-Local Strategy Implementation (IS)	SUBS	Overland		0	0.00%	0	0.00%	3,695,373	0.04%	3,695,373
				ORA	(2)	0	0.00%	0	0.00%	3,695,373	0.04%	3,695,373
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
66	20-25	1997 Corporate Sponsorship Costs (IS)	SUBS	Overland		1,014,546	0.01%	0	0.00%	0	0.00%	1,014,546
				ORA	(2)	1,014,546	0.01%	0	0.00%	0	0.00%	1,014,546
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
67	20-50	Customer Premise Equipment Costs (IS)	NONE	Overland		0	0.00%	10,097,537	0.10%	3,467,830	0.03%	13,565,367
				ORA	(2)	0	0.00%	10,097,537	0.10%	3,467,830	0.03%	13,565,367



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28	11-28	Prepaid Directory Expense (RB)	SUBS	Overland		93,805,000	-0.06%	83,904,000	-0.07%	71,382,000	-0.07%	249,091,000
				ORA	(2)	93,805,000	-0.06%	83,904,000	-0.07%	71,382,000	-0.07%	249,091,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
29	11-30	SFAS 112 Liability (RB)	SUBS	Overland		(213,204,405)	0.14%	(236,462,847)	0.22%	(255,430,427)	0.25%	(705,097,679)
				ORA	(2)	(213,204,405)	0.14%	(236,462,847)	0.22%	(255,430,427)	0.25%	(705,097,679)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
30	11-31	Vacation Liability (RB)	SUBS	Overland		(51,867,976)	0.03%	(51,359,429)	0.05%	(45,735,145)	0.04%	(148,962,550)
				ORA	(2)	(51,867,976)	0.03%	(51,359,429)	0.05%	(45,735,145)	0.04%	(148,962,550)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
31	11-31	SFAS 106 Accrued Liability (RB)	SUBS	Overland		124,000	0.00%	(5,998,000)	0.01%	5,352,000	-0.01%	(522,000)
				ORA	(2)	124,000	0.00%	(5,998,000)	0.01%	5,352,000	-0.01%	(522,000)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
32	11-34	Accrued Contingent Liability (RB)	SUBS	Overland		(28,039,000)	0.02%	(20,106,000)	0.02%	(7,800,000)	0.01%	(55,945,000)
				ORA	(4)	(28,039,000)	0.02%	(20,106,000)	0.02%	(7,800,000)	0.01%	(55,945,000)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
33	11-28	Prepaid Pension Costs (RB)	SUBS	Overland		52,640,046	-0.03%	159,667,092	-0.14%	269,302,092	-0.25%	481,609,230
	S11-6			ORA	(2)	52,640,046	-0.03%	159,667,092	-0.14%	269,302,092	-0.25%	481,609,230
				TURN	(6)							

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				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
34	10-22	SFAS 106 Plant (RB)	SUBS	Overland		4,892,000	0.00%	(7,621,000)	0.01%	(90,167,000)	0.09%	(92,896,000)
				ORA	(2)	4,892,000	0.00%	(7,621,000)	0.01%	(90,167,000)	0.09%	(92,896,000)
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
35	10-22	Restructure Reserve (RB)	AMT	Overland		(29,070,727)	0.02%	(29,024,711)	0.03%	(28,975,159)	0.03%	(87,070,597)
	S10-3			ORA	(2)	(29,070,727)	0.02%	(29,024,711)	0.03%	(28,975,159)	0.03%	(87,070,597)
				TURN	(6)							
				Pacific		(4,374,000)	0.00%	(4,350,000)	0.00%	(4,350,000)	0.00%	(13,074,000)
36	10-23	Accumulated Reserve for Depreciation (RB)	SUBS	Overland	(1)	14,069,957	-0.01%	36,308,845	-0.03%	244,868,120	-0.23%	295,246,922
				ORA	(2)	14,069,957	-0.01%	36,308,845	-0.03%	244,868,120	-0.23%	295,246,922
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
37	9-23	Accumulated Deferred Income Tax (RB)	SUBS	Overland		(57,788,323)	0.04%	(11,713,582)	0.01%	89,052,818	-0.09%	19,550,913
				ORA	(4)	(57,788,323)	0.04%	(11,713,582)	0.01%	89,052,818	-0.09%	19,550,913
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
38	9-21	Excess Deferred Income Tax (RB)	SUBS	Overland	(1)	0	0.00%	12,800,000	-0.01%	38,400,000	-0.04%	51,200,000
				ORA	(4)	0	0.00%	12,800,000	-0.01%	38,400,000	-0.04%	51,200,000
				TURN	(6)							
				Pacific	(7)	0	0.00%	0	0.00%	0	0.00%	0
ORA	19	ASI - ADSL Development Cost Treatment (RB)	SUBS	Overland		0	0.00%	0	0.00%	0	0.00%	0
				ORA	(3)	0	0.00%	(10,600,000)	-0.10%	(209,176,000)	-2.10%	(219,776,000)



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		On Pac Bell IEMR						922,472,419		962,198,083		
		Net Income Effect of Audit Corrections		Overland		431,399,621		639,617,502		911,081,711		
		Audit-Corrected Net Income		Overland		1,083,898,949		1,562,089,921		1,873,279,794		
		0										
		Rate Base As Reported On Pac Bell IEMR				10,057,147,720		10,170,676,085		9,963,602,286		
		Rate Base Effect of Audit Corrections		Overland		(609,143,885)		(610,423,795)		(258,874,205)		
		Audit-Corrected Rate Base		Overland		9,448,003,835		9,560,252,290		9,704,728,081		
		Rate of Return As Reported By Pacific Bell				6.49%		9.07%		9.66%		
		Rate of Return Impact of Audit Adjustments		Overland		4.98%		7.27%		9.65%		
		Audit-Corrected Rate of Return		Overland		11.47%		16.34%		19.30%		
		Net Income Effect of Audit Corrections		ORA		428,511,826		623,187,148		1,003,300,454		2,054,999,428
		Net Rate Base Effect of Audit Corrections		ORA		(729,319,885)		(638,336,795)		(338,552,205)		(1,706,208,885)
		Net Income As Reported On Pac Bell IEMR				652,499,328		922,472,419		962,198,083		
		Net Income Effect of Audit Corrections		ORA		428,511,826		623,187,148		1,003,300,454		
		Audit-Corrected Net Income		ORA		1,081,011,154		1,545,659,567		1,965,498,537		
		Rate Base As Reported On Pac Bell IEMR				10,057,147,000		10,170,675,000		9,963,602,000		
		Rate Base Effect of Audit Corrections		ORA		(729,319,885)		(638,336,795)		(338,552,205)		
		Audit-Corrected Rate Base		ORA		9,327,827,115		9,532,338,205		9,625,049,795		

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		Rate of Return As Reported By Pacific Bell				6.49%		9.07%		9.66%		
		Rate of Return Impact of Audit Adjustments		ORA		5.10%		7.14%		10.76%		
		Audit-Corrected Rate of Return		ORA		11.59%		16.21%		20.42%		
		Net Income Effect of Retroactive Audit Corrections		PACIFIC	(12)	(7,438,454)		26,011,591		20,229,744		38,802,881
		Net Income Effect of Audit Corrections in Year 2002		PACIFIC	(12)	36,855,318		17,879,942		8,268,949		63,004,209
		Net Rate Base Effect of Audit Corrections		PACIFIC		(146,543,000)		(95,670,000)		(95,453,000)		(337,666,000)
		Net Income As Reported On Pac Bell IEMR				652,499,328		922,472,419		962,198,083		
		Net Income Effect of Audit Corrections		PACIFIC		(7,438,454)		26,011,591		20,229,744		
		Audit-Corrected Net Income		PACIFIC		645,060,874		948,484,010		982,427,827		
		Rate Base As Reported On Pac Bell IEMR				10,057,147,000		10,170,675,000		9,963,602,000		
		Rate Base Effect of Audit Corrections		PACIFIC		(146,543,000)		(95,670,000)		(95,453,000)		
		Audit-Corrected Rate Base		PACIFIC		9,910,604,000		10,075,005,000		9,868,149,000		
		Rate of Return As Reported By Pacific Bell				6.49%		9.07%		9.66%		
		Rate of Return Impact of Audit Adjustments		PACIFIC		0.02%		0.34%		0.30%		
		Audit-Corrected Rate of Return		PACIFIC		6.51%		9.41%		9.96%		

KEYS TO PRESENTATION:

- A The impact of the CPUC's income tax flowthrough policy on each adjustment is reflected with the

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B            adjustment.  
 The rate of return impact of individual adjustments is calculated using Pacific's reported rate base and operating income.

**STATUS OF DISPUTE:**

- NONE      Adjustments recommended by Overland that are NOT disputed by Pacific.
- AMT        Adjustments recommended by Overland that are disputed by Pacific in AMOUNT.
- SUBS      Adjustments recommended by Overland that are disputed by Pacific in SUBSTANCE.
- BOTH      Adjustments recommended by Overland that are disputed by Pacific BOTH in AMOUNT and in SUBSTANCE.

**FOOTNOTES:**

- 1            This adjustment, as proposed by Overland, has both an income and rate base impact.
- 2            Because ORA did not affirmatively address this issue in filed testimony, ORA is not contesting the adjustment quantification presented by Overland and supported by the Audit Report.
- 3            ORA has presented an alternative adjustment quantification.
- 4            ORA presented testimony on this issue, but did not propose an alternative adjustment.
- 5            TURN's calculated adjustment includes only those issues TURN has addressed in its opening and reply brief.

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6	TURN is not presenting total intrastate income, rate base and rate of return impacts for the limited set of issues TURN addressed. On those issues TURN has not affirmatively addressed in briefs, TURN does not dispute the adjustment quantification presented by Overland on behalf of the Telecommunications Division.
7	Because Pacific disputes the need for any adjustment for this issue, Pacific has not confirmed Overland's calculation.
8	Pacific's position is that this adjustment should be not be made retroactively, but rather in the current period (2002). Accordingly, no rate of return impact is shown.
9	Pacific breaks this adjustment into eleven components, disputing some portions of the adjustment, but not all. There is no disagreement on the break out.
10	Because Pacific disputes the need for any adjustment for this issue, Pacific has not confirmed ORA's calculation.
11	Based on information Pacific Bell provided for the first time in written testimony, the adjustment is no longer appropriate.
12	Pacific's position segregates the adjustments between those which should be applied retroactively to the IEMR

**APPENDIX C**

**ALTERNATE DRAFT**

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**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's  
Position on Adjustments (as requested by ALJ Sarah Thomas)  
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
<b>Income Statement Adjustments</b>								
1	IS	REG-01	5 - 13	GH Reply 5	Unsupported Contingent Liabilities - Revenues (IS) - Increase revenues to eliminate unsupported and unauditible contingent liability accruals.	Pacific Bell did not provide the information needed to audit the contested accruals. The limited information provided by Pacific Bell demonstrated the accrual amounts were not reasonable.	Concur with Overland. Also concur with TURN re waiver of privilege and that liabilities should be accounted for on an as-paid basis.	Pacific Bell failed to demonstrate that providing the information needed to audit the contested accruals would constitute waiver of any privilege. Therefore, these liabilities should be accounted for on an as-paid basis.
2	IS	REG-02	5 - 14		Bellcore Dividends (IS) - Increase 1997 revenues to correct an error in an IEMR ratemaking adjustment.	Pacific Bell admits this accounting error occurred and accepts the correction. Pacific Bell posted the Bellcore Dividends IEMR ratemaking adjustment in the wrong direction.	Concur with Overland	
3	IS	REG-03	5 - 15	GH Reply 16	Uncollectible Revenues - RCRMS (PacBell flows through) (IS) - Reduce 1997 uncollectible accounts provision to eliminate costs that should have been accrued in 1996.	The information available at the end of 1996 was sufficient to support an accrual of the costs.	Concur with Overland	

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Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
4	IS	REG-04	5 - 19		Gain on Sale of Bellcore (IS) - Increase 1997 other operating income to correct an accounting error.	Pacific Bell accepts this correction. The CPUC allocated 50% of the gain on the sale of Bellcore to ratepayers and required a refund. Pacific Bell recorded the refund above the line. Therefore, 50% of the gain should have been recorded above-the-line. Pacific Bell recorded the entire gain below the line.	Concur with Overland	
5	IS	REG-05	6 - 15, S6 - 1	GH Reply 2	Local Number Portability Costs (IS) - Reduce expense to correct a separations error.	Pacific Bell accepts the correction for periods after April 1998. The costs incurred prior to May 1998 are exclusively interstate costs that are recovered through an FCC tariff. IEMR reports should be revised when subsequent information reveals the separations treatment used in the original report was incorrect. In addition, Pacific Bell should have deferred the costs as a regulatory asset.	Concur with Overland	The costs incurred prior to May 1998 should have been deferred as a regulatory asset pursuant to FAS 71 requirements. Pacific Bell had sufficient information to estimate the probable amount of cost recovery in early 1996.

**ALTERNATE DRAFT**

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Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
6	IS	REG-06	6 - 19	GH Open 4	Local Competition Costs (IS) - Reduce expense to correct an accounting error. Pacific Bell failed to recognize a regulatory asset.	The costs should have been deferred as a regulatory asset in November 1998 pursuant to FAS 71 requirements. Pacific Bell had sufficient information to estimate the probable amount of cost recovery in November 1998.	ORA generally concurs with Overland that these costs should be removed from the audit period. The Commission has established a mechanism to allow SBC Pacific to recover these costs through intrastate rates, beginning in 2001. Absent these adjustments, the Company could over-recover these costs from ratepayers.	The costs incurred during the audit period should have been deferred as a regulatory asset pursuant to FAS 71 requirements. Pacific Bell had sufficient information to estimate the probable amount of cost recovery no later than early 1996.
7	IS	REG-07	6 - 22	GH Reply 10	Merger Savings Allocation (IS) - Modify IEMR ratemaking adjustment to correct errors and reflect the SBC/Pacific Telesis merger savings forecast adopted by the CPUC.	The timing of the IEMR ratemaking adjustments should reflect the merger savings forecast adopted by the CPUC in the Merger Decision.	Concur with Pacific Bell	
8	IS	REG-08	6 - 27		Advanced Communications Network (IS) - Reduce expense to eliminate plant abandonment costs that should have been charged below-the-line.	Pacific Bell accepts this correction. Pacific Bell recorded part of the abandonment costs for this project above-the-line. The costs should have been charged to below-the-line accounts.	Concur with Overland	

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Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
9	IS	REG-09	6 - 31	GH Reply 9	Software Buy-Out Agreement (IS) - Reduce expense to correct accounting for restructuring of contract payment obligations.	The substance of the contract buy-out was the advance payment of an operating expense in exchange for a price reduction. Advance payments of operating expenses should be charged to prepaid asset accounts under the FCC's Uniform System of Accounts. Pacific Bell charged the buy-out payment obligation directly to expense. Pacific Bell should have deferred the buy-out payment as a prepaid asset and amortized the prepayment over the payment period specified in the original contract.	Concur with Overland	
10	IS	REG-10	6 - 32	GH Reply 5	Unsupported Contingent Liabilities - Operating Expense (IS) - Reduce expenses to eliminate unsupported and un-auditable contingent liability accruals.	Pacific Bell did not provide the information needed to audit the contested accruals. The limited information provided by Pacific Bell demonstrated the accrual amounts were not reasonable.	Concur with Overland	Pacific Bell failed to demonstrate that providing the information needed to audit the contested accruals would constitute waiver of any privilege. Therefore, these liabilities should be accounted for on an as-paid basis.

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11	IS	REG-11	6 - 34		Incentive Pay Accrual (IS) - Adjust TEAM award accruals to equal actual payouts.	Team award accrual amounts and payout levels are both completely within the control of management. Therefore, audit adjusted expenses should reflect the actual payout level rather than the estimates accrued by Pacific Bell.	Concur with Overland	
12	IS	REG-12	6 - 37		ISP-Bound Traffic Separations (IS) - Increase 1997 expense to correct separations error.	Pacific Bell accepts this correction. The FCC determined that Pacific Bell's separations treatment of internet bound traffic was improper and required Pacific Bell to retroactively revise its 1997 FCC IEMR. Pacific Bell did not revise its 1997 CPUC basis IEMR.	Concur with Overland	

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13	IS	REG-13	6 - 36		Uncollectible Settlements - RCRMS (IS) - Reduce expense to eliminate contract billing settlements that should have been accrued in 1996.	The information available at the end of 1996 was sufficient to support an accrual of the costs.	Concur with Overland	
14	IS	REG-14	7 - 9,	S7- 13	Pension Expense (IS) - Reduce expense to reflect the CPUC's pension accounting policy.	Phase 2A issue	Concur with Overland	
15	IS	REG-15,16,17	7 - 13		SFAS 106 (IS) - Reduce expense to reflect the CPUC's PBOP accounting policy.	Phase 2A issue	Concur with Overland	
15	IS	REG-15,16,17	7 - 13,	S7 - 6	SFAS 106 - Pension Trust Withdrawal (IS) - Reduce PBOP expense to reflect the CPUC's policy concerning pension trust withdrawals	Phase 2A issue	Concur with Overland	

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16	IS	REG-18	7 - 33	GH Reply 18	SFAS 112 (IS) - Reduce 1997 FAS 112 expense to eliminate impact of a prior period accounting error.	Pacific Bell admits the accounting error occurred. Audit corrected expenses should reflect compliance with CPUC accounting rules in all periods, including periods prior to the audit period. Recorded expenses should be adjusted to eliminate the impact of accounting errors made in prior periods.	Concur with Overland	
17	IS	REG-19	8 - 6	GH Reply 17	Intrabuilding Cable Amortization (IS) - Reduce 1997 and 1998 depreciation expense to eliminate impact of a prior period accounting error.	Pacific Bell admits the accounting error occurred. Audit corrected expenses should reflect compliance with CPUC accounting rules in all periods, including periods prior to the audit period. Recorded expenses should be adjusted to eliminate the impact of accounting errors made in prior periods.	Concur with Overland	
18	IS	REG-20	8 - 7		SAVR Delayed Retirements (IS) - Reduce depreciation expense to reflect corrected plant balances. Pacific Bell failed to record retirements on a timely basis.	The failure to record retirements on a timely basis is an accounting error. Audit corrected expenses should reflect compliance with CPUC accounting rules.	Concur with Overland	

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19	IS	REG-21	8 - 7		SAVR Reverse Retirements (IS) - Reduce depreciation expense to reflect corrected plant balances. The reverse retirements recorded by Pacific Bell were improper.	Pacific Bell's decision to record reverse retirements was not reasonable. Pacific Bell's contention that the book to physical inventory differences were caused by accidental premature book retirements of equipment is not plausible.	Concur with Overland	
20	IS	REG-22	8 - 8, S8 - 1	GH Open 3	Equal Access IEMR Ratemaking Adjustment (IS) - Increase 1998 Depreciation expense to correct an error made in an IEMR ratemaking adjustment.	Pacific Bell accepts this correction. Pacific Bell made a computational error when calculation this IEMR ratemaking adjustment for 1998.	Concur with Overland	
21	IS	REG-23	8 - 12		Reserve Deficiency Amortization (IS) - Reduce 1999 depreciation expense to eliminate reserve deficiency amortization.	Phase 2A issue	Concur with Overland	
22	IS	REG-24	9 - 22		Ameritech Income Tax Misclass (IS) - Reduce 1999 current income tax expense to correct an accounting error. The provision should have been charged below-the-line.	Pacific Bell charged Ameritech merger severance accrual to below-the-line accounts for book purposes. Therefore, the resulting book/tax temporary difference should be classified as a nonoperating temporary difference. This correction only addresses the current income tax treatment of the	Concur with Overland	

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						temporary difference. The deferred income tax treatment of the temporary difference is addressed in the Phase 2A income tax normalization correction.		
23	IS	REG-25	9 - 11, S9 - 3 & 5		Income Tax Normalization (IS) - Reduce deferred income tax expense to reflect the CPUC's flow-through income tax accounting policy.	Phase 2A issue	Concur with Overland	
24	IS	REG-26	9 - 21, S9 - 6		Excess Deferred Income Tax (IS) - Reduce deferred income tax expense to correct an accounting error.	Pacific Bell admits this accounting error occurred and does not contest the amount of the correction. Pacific Bell failed to record amortization of excess deferred income taxes in 1998 and 1999.	Concur with Overland	
25	IS	REG-27	9 - 24		Sales and Use Tax Accrual (IS) - Increase sales and use tax expense to eliminate unsupported accruals.	Pacific Bell did not provide the information needed to audit the accruals.	Concur with Overland	

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26	IS	REG-28	9 - 24	GH Reply 18	Employment Tax Error (IS) - Decrease 1999 payroll taxes to eliminate impact of prior period accounting error.	Pacific Bell admits the error occurred. Audit corrected expenses should reflect compliance with CPUC accounting rules in all periods, including periods prior to the audit period. Recorded expenses should be adjusted to eliminate the impact of accounting errors made in prior periods.	Concur with Overland	
39	IS	AFF-01	15 - 18		SBC Ops FAS 106 Merger Conforming Expense (IS) - Removes a post-retirement benefits accrual incurred as a result of the Ameritech merger from Pacific Bell's regulated accounts.	Consistent with the discussion concerning AFF-16, an adjustment has been proposed for amounts charged by SBC Operations which were not caused by and did not benefit Pacific Bell. This is a baseline requirement for regulated cost recovery per D.86-01-026 (p. 36).	Concur with Overland	
40	IS	AFF-02	15 - 19	RW Reply 4	AMDOCS Awards SBC Operations (IS) - Removes identifiable portions of AMDOCs and Ameritech merger executive awards charged to Pacific Bell by SBC Operations.	Consistent with the discussion concerning AFF-08, an adjustment has been proposed for amounts charged by SBC Operations which were not caused by and did not benefit Pacific Bell. This is a baseline requirement for regulated cost recovery per D.86-01-026 (p. 36).	Concur with Overland	

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41	IS	AFF-03	15 - 20	RW Reply 2, 3; GO Reply 2	Excess Executive Compensation SBC Operations (IS) - Removes amounts exceeding the inflation-adjustment CPUC limit for regulated recovery of executive compensation expense, including salaries and certain severance charged to Pacific Bell by SBC Operations.	Consistent with the discussion concerning AFF-08, an adjustment has been proposed for amounts charged by SBC Operations that were in excess of the inflation-adjusted executive compensation limits established in D.86-01-026 (p. 163).	Concur with Overland	
42	IS	AFF-04	15 - 21		SBC Ops Sec. Alloc of Parent Mgt Fees (IS) - Removes parent company "management fees" charged to Pacific Bell indirectly through SBC Operations.	The SBC "management fees" are unsupported by cost and are additional to the parent company's recovery of fully distributed costs through corporate allocations. They should not have been charged to Pacific Bell (according to the auditors performing the FCC Cost Allocation Manual audit) and are not recoverable through regulated expense.	Concur with Overland	
43	IS	AFF-05	15 - 22		SBC Ops Call Ctr Depreciation, Merger Implmntatn Exp (IS) - Removes certain call center costs, including depreciation, charged by SBC Operations to Pacific Bell's regulated accounts.	SBC Operations allocated excessive call center depreciation expense and costs associated with centralizing the telemarketing function to Pacific Bell in 1998. This reduces Pacific Bell's call center cost allocation to a level consistent with that used to allocate 1998 recurring costs related to the call centers.	Concur with Overland	

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44	IS	AFF-06	16 - 18	RW Reply 2, 3; GO Reply 2	SBC Svcs "Excess" Executive Comp Exp (IS) - Removes identifiable portions of AMDOCs and Ameritech merger executive awards charged to Pacific Bell by SBC Services.	Consistent with the discussion concerning AFF-08, an adjustment has been proposed for amounts charged by SBC Operations which were not caused by and did not benefit Pacific Bell. This is a baseline requirement for regulated cost recovery per D.86-1-026 (p. 36). In addition, these costs were in excess of the inflation-adjusted executive compensation limits established in D.86-01-026 (p. 163).	Concur with Overland	
45	IS	AFF-07	16 - 19		SBC Svcs, CFL, TRI Sec.Alloc. of Parent Mgt Fees (IS) - Removes parent company "management fees" charged to Pacific Bell indirectly through charges from SBC Services, Technology Resources and Center for Learning.	The SBC "management fees" are unsupported by cost and are additional to the parent company's recovery of fully distributed costs through corporate allocations. They should not have been charged to Pacific Bell (according to the auditors performing the FCC Cost Allocation Manual audit) and are not recoverable through regulated expense.	Concur with Overland	

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46	IS	AFF-08	14 - 9	RW Reply 2	Parent "Excess" Executive Compensation Expense (IS) - 1) Removes identifiable portions of AMDOCs and Ameritech merger executive awards charged to Pacific Bell by the parent company. 2) Removes parent company executive compensation exceeding the inflation-adjustment CPUC limit for regulated recovery, including salaries, certain severance and post-retirement "consulting" fees and supplemental retirement income plan (SRIP) expense.	D.86-01-026 established certain baseline requirements for regulated cost recovery of parent and affiliate costs. One of these requirements was that to be recoverable as a regulated cost, parent company charges must provide a "direct and primary benefit" to telephone company customers (p. 36). The executive awards charged to Pacific Bell were not caused by and did not benefit Pacific Bell. One was attributable to affiliate Ameritech and the other to affiliate AMDOCs. In addition, the salaries and severance amounts adjusted were amounts exceeding the inflation-adjustment limit for regulated recovery of executive compensation expense established in Decision 86-01-026 (p. 163) Finally, in addition to exceeding the CPUC compensation limit, the SRIP expense, limited to a few top executives, was charged to Pacific Bell, but a much greater amount of offsetting SRIP income (the funding for the plan) was retained by SBC.	Concur with Overland	

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47	IS	AFF-09	14 - 23	RW Reply 6	Parent Political and Legislative Influence Expense (IS) - Removes political and legislative influence costs incurred by the California External Affairs department of SBC / PTG and charged to Pacific Bell's regulated accounts.	The CPUC adopted the FCC Uniform System of Accounts (USOA) in D.87-12-063. The USOA specifically requires "lobbying" expenditures to be recorded below-the-line in account 7370 - Special Charges. This adjustment brings the accounting for political and legislative influence costs into compliance with CPUC accounting requirements. In addition, contrary to the requirements of D.86-01-026 for regulated cost recovery (p. 36), these costs are incurred for the benefit of SBC executives and SBC shareholders, not Pacific Bell customers.	Concur with Overland	
48	IS	AFF-10	14 - 26	RW Reply 7	Parent Legal Expense (IS) - Removes minor amounts of allocated corporate legal costs associated with entry into the non-regulated, interLATA long distance service market and SBC's intervention to slow down / prevent the approval of a merger of two potential local exchange competitors (AT&T and Media One).	Pacific Bell's allocation of corporate legal cost increased dramatically after SBC took over PTG. Overland was unable to audit corporate legal costs because SBC did not maintain, or would not provide, information regarding the nature of most of the costs. The amounts adjusted were associated with specific cases handled by outside attorneys and were exceptions in which we had cost descriptions. The costs were adjusted because they were not attributable to Pacific Bell's regulated operations. We made no	Concur with Overland	Pacific Bell failed to demonstrate that the legal costs in question were appropriately assigned to its regulated operations, particularly for the AT&T/Media One merger.

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						attempt to adjust amounts from the majority of corporate legal expenses that we were unable to evaluate.		
49	IS	AFF-11	14 - 34	RW Reply 2, 4	Parent Public Relations & Corporate Sponsorship Exp (IS) - This adjustment removes public relations consulting and corporate sports and cultural expenses allocated by SBC to Pacific Bell's regulated accounts.	The CPUC noted in D.86-01-026 that institutional or image building advertising would not be allowed for regulated cost recovery (p. 41) In the same decision, the CPUC determined that public relations expense was a form of "institutional advertising" which did not warrant ratemaking recognition (pp. 41-42). As such, CPUC policy prohibits regulated recovery of both of these costs.	Concur with Overland	
50	IS	AFF-12	14 - 33	RW Reply 8	Parent Corporate Development Expense (IS) - Removes "corporate development" costs of investigations and due diligence on potential foreign investments and various projects unrelated to providing regulated telephone service charged	D.86-01-026 established a baseline requirement that parent company charges must provide "direct and primary benefit" to telephone company customers in order to be recoverable as a regulated cost (p. 36). These costs were not attributable to Pacific Bell and provided no contribution or benefit to regulated local	Concur with Overland	

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					telephone service charged by SBC to Pacific Bell and recorded in Pacific Bell's accounts.	exchange telephone operations. The costs were not attributable to Pacific Bell's regulated operations; rather they were incurred for the benefit of SBC and its shareholders.		
51	IS	AFF-13	14 - 35	RW Reply 2, 4	Parent Strategic Planning Expense (IS) - Removes corporate "strategic planning" expense.	The CPUC's policy to exclude corporate "strategic planning" expense from regulated customer recovery was set forth in Decision 86-01-026 (pp. 46-47). Pacific Bell / SBC refused to provide the materials necessary to evaluate these costs so that a determination could be made as to the extent they might have benefited Pacific Bell's regulated local exchange operations.	Concur with Overland	
52	IS	AFF-14	14 - 38	RW Reply 9	Parent Contributions, Memberships, Foundation Exp (IS) - Removes contributions and membership costs incorrectly included in Pacific Bell's regulated accounts.	The FCC Uniform System of Account (USOA) as adopted by the CPUC in D.87-12-063 prohibits these costs from being recorded in above-the-line regulated accounts.	Concur with Overland	

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53	IS	AFF-15	14 - 39	RW Reply 9	Parent Out of Period Expense (IS) - Reclassifies 1997 corporate allocations incorrectly charged to 1998 expense back to 1997 expense.	Although recorded on the 1998 books, journal vouchers for the cost clearly indicate that the cost was associated with 1997. Inclusion in 1998 would result in 13 months of corporate allocations charged for 1998, and only 11 for 1997. The costs should be placed in the proper period.	Concur with Overland	
54	IS	AFF-16	14 - 40		Parent Merger Conforming Expense (IS) - Removes a post-retirement benefits accrual incurred as a result of the Ameritech merger from Pacific Bell's regulated accounts.	D.86-01-026 requires that parent company charges must provide "direct and primary benefit" to telephone company customers to be recoverable as a regulated cost (p. 36). Most amounts SBC incurred in consummating the Ameritech merger were correctly retained by the corporation. This amount, which represents a cost to conform Pacific's and Southwestern Bell's post-retirement benefits accounting with that of Ameritech, was improperly charged to Pacific Bell instead of being retained even though it provided no benefit to Pacific Bell's telephone company customers.	Concur with Overland	
55	IS	AFF-17	14 - 41		Parent Impact of Adjustmts on Billings to PBD (IS) - This adjustment removes corporate allocations from SBC discussed in AFF-08 through AFF-16 above that were indirectly charged to	SBC charged costs to Pacific Bell Directory as well as to Pacific Bell. Both sets of allocations impact Pacific Bell's IEMR earnings. This adjustment reflects the effect of the sum of adjustments to corporate allocations that flow	Concur with Overland	

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					Pacific Bell's IEMR earnings because they were charged to Pacific Bell Directory.	to Pacific Bell's IEMR earnings indirectly through allocation to Pacific Bell Directory.		
56	IS	AFF-18	14 - 41	RW Reply 2	MSI USA "Excess" Executive Comp Billed Directly (IS) - Removes the identifiable portion of corporate executive compensation associated with executives assigned to affiliate MSI USA.	See the discussion of executive compensation for adjustment AFF-08 above. MSI-USA was a corporate entity created to employ former Southwestern Bell region executives and managers in the Pacific Bell region after the merger. Their separation from other Pacific region entities was done to enable them to maintain their Southwestern region benefits packages.	Concur with Overland	
57	IS	AFF-19	17 - 18	RW Reply 10	Parent PB Employee Trsfr Fees Billed Back to PB (IS) - This adjustment removes CPUC employee transfer fees charged by Pacific Bell to SBC that SBC charged back to Pacific Bell.	In D.87-12-067 (Conclusion of Law 35), the CPUC concluded that SBC affiliates are required to pay Pacific Bell a 25 percent-of-salary fee when employees are transferred from Pacific Bell to affiliates. SBC incorrectly charged the cost of some of these fees back to Pacific Bell, effectively canceling them. This adjustment reverses the charge back.	Concur with Overland	

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58	IS	AFF-20	17 - 18	RW Reply 10	Fees for Employees Transferred in 1999 (IS) - Adds employee transfer fee revenue for a large transfer of employees from Pacific Bell to SBC Services that Pacific Bell reported to the CPUC in 1999.	Subsequent to the audit report, Pacific Bell provided evidence to show that the transfers it reported to the CPUC as having occurred in 1999 actually occurred in 2000. The evidence provided showed that the transfer fee revenue was recognized in 2000. Based on the additional evidence, this adjustment is no longer necessary.	Concur with Overland	
59	IS	AFF-21	18 - 2 & 7		Nevada Bell Net Directory Revenue (IS) - This adjustment reduces Pacific Bell Directory's IEMR earnings contribution by correcting the allocation of PBD's earnings between Pacific Bell and Nevada Bell.	Pacific Bell is required to reflect the California earnings of Pacific Bell Directory in its CPUC IEMR earnings calculation. The Directory earnings were improperly overstated on the IEMR report due to an improper allocation of Directory earnings between Nevada and California Directory operations in the IEMR directory earnings calculation. This adjustment corrects the calculation mistake.	Concur with Overland	

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ORA	IS				ADSL Development Costs - This adjustment removes ADSL development costs and increases Pacific Bell's IEMR net earnings.		The net ADSL development costs should be moved below-the-line. A corresponding ratebase adjustment should be made as well.	Pacific Bell should not be allowed to recover development costs through NRF rates, then transfer the ADSL service so that future revenues from that service are not reflected in the IEMR. Instead, the ADSL development costs should be removed from the IEMR during the audit period.
60b	IS	NR-01	20 - 20	GO Reply 10	Depreciation Expense Timing Adjustment (IS) - The allocation between regulated and non-regulated activities was not correct on a year-to-date basis. This entry corrects this error.	When correcting a depreciation expense error in December 1999, Pacific Bell employed current regulated / non-regulated allocation ratios which were not reflective of the actual ratios in use at the time when the errors were originally recorded.	Concur with Overland	
61	IS	NR-02	20 -22	GO Reply 10	Advertising Direct Assignment and Common Allocations (IS) - Directly assigns and allocates these costs to the appropriate regulated and non-regulated activities to the extent possible.	Instead of allocating product advertising expense billed by the Parent to the Pacific Bell service or customer category for which it was incurred, Pacific Bell allocated these costs based on the regulated and non-regulated time assignments of a very small number of Pacific Bell administrative employees. As a result, these costs were not allocated between regulated and non-regulated activities in accordance with attributable cost principles as set out in	Concur with Overland	

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						FCC Part 64 (adopted by the CPUC in D.91-07-056).		
62	IS	NR-03	20 - 31	GO Reply 10	Customer Service Non-Productive Salary Allocations (IS) - Corrects the allocation of service labor to non-regulated activities.	Non-productive customer service labor was not allocated to non-regulated activities in the same proportion as productive labor costs.	Concur with Overland	
63	IS	NR-04	20 - 37	RW Reply 14; GO Reply 9	Affiliate Marketing Services Revenue (IS) - Increases affiliate marketing services revenue to the same level as the associated expenses.	Pacific Bell employed two different systems to account for the revenues and expenses associated with the sales functions performed by Pacific Bell customer service representatives on behalf of its affiliates. Although the revenues should have been at least equal to the expenses for these services, expenses were significantly greater than revenues. Pacific Bell could not provide a credible explanation for this discrepancy.	Concur with Overland. Additionally, adjustment should recognize 10% markup of FDC pursuant to CPUC affiliate rules.	

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64	IS	NR-05	20 - 48		Non-regulated Tracking Code Direct Assignment Errors (IS) - Corrects the allocation of costs between regulated and non-regulated activities.	Tracking codes were a primary tool used by Pacific Bell in allocating costs between regulated and non-regulated activities. During our review, we noted several instances in which tracking codes identified as non-regulated in nature were actually allocated on a different basis. By disregarding the true nature of the costs when allocating between regulated and non-regulated activities, Pacific Bell was in non-compliance with D.91-07-056 (Finding of Fact 11).	Concur with Overland	
65	IS	NR-06	20 - 48	GO Reply 9	National-Local Strategy Implementation (IS) - Corrects the allocation of costs associated with offering competitive local exchange services.	D.91-07-056 (Finding of Fact 11) establishes a cost-attribution hierarchy beginning with direct assignment of costs when possible. Pacific Bell chose to jointly allocate the implementation costs of offering competitive local exchange service outside of the Pacific Bell franchise territory between regulated and non-regulated activities. However, a Pacific Bell affiliate is responsible for this initiative and should have been allocated all of these costs.	Concur with Overland	

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66	IS	NR-07	20 - 25		1997 Corporate Sponsorship Costs (IS) - Corrects the below-the-line treatment of corporate advertising and sponsorship payments associated with the naming rights of Pacific Bell Park.	Corporate advertising and sponsorship payments associated with the naming rights of Pacific Bell Park were charged to regulated activities. CPUC policy established in Decision 86-01-026 (p. 41) prohibits regulated expense recovery of these expenses.	Concur with Overland	
67	IS	NR-08	20 - 50		Customer Premise Equipment Costs (IS) - Corrects the allocation of certain costs associated with customer premise equipment.	Certain costs associated with customer premise equipment was not appropriately identified by tracking code. As a result, these costs incorrectly defaulted to regulated operating expense rather than non-regulated expense as intended by the FCC and CPUC.	Concur with Overland	
68	IS	REG-41; Supp 5	S5 - 1	GH Open 2	PIU Accrual (IS) - Reduce 1997 revenues to eliminate settlement amount that should have been accrued in 1996.	Pacific Bell had sufficient information to accrue the settlements in 1996.	Concur with Overland	
69	IS	REG-42; Supp 5	S5 - 2	GH Open 2	USOAR Turnaround Accrual (IS) - Reduce 1997 revenues to correct over-accrual of regulatory liability in 1996. The reversal of the recorded liability in 1997 overstated 1997 revenues.	The entries recorded in 1997 to reverse the prior-period over-accrual distort 1997 operating revenues. The correction reduces 1997 revenues to eliminate that distortion.	Concur with Overland	

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Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
70b	IS	REG-43; Supp 6	S6 - 1	GH Open 2	LNP Depreciation (IS) - Reduce depreciation expense to correct a separations error.	The depreciation expense for the plant costs recovered through the FCC LNP tariff should be directly assigned to the interstate jurisdiction.	Concur with Overland	The costs incurred prior to May 1998 should have been deferred as a regulatory asset pursuant to FAS 71 requirements. Pacific Bell had sufficient information to estimate the probable amount of cost recovery in early 1996.
71b	IS	REG-44; Supp 10	10 - 17, S10 - 1		AFUDC Depreciation Expense (IS) - Reduce depreciation expense to reflect corrected plant balances. The AFUDC recorded by Pacific Bell during the audit period was overstated.	The CPUC basis AFUDC charged to plant during the audit period was excessive. Pacific Bell's AFUDC rate calculations violated Resolution RF-4. Pacific Bell's practice of imputing negative capital sources in its AFUDC rate calculations does not have any basis in regulatory, finance or accounting theory. This correction is directly related to the AFUDC rate base correction.	Concur with Overland	

**ALTERNATE DRAFT**

R.01-09-001 / I.01-09-002

**Joint Schedule of Overland Consulting, Inc.'s, ORA's, and TURN's  
Position on Adjustments (as requested by ALJ Sarah Thomas)  
9/20/2002**

Index #	Rate Base or Income Stmt	Adjust Ref.	Report Chapter	Testimony Reference	Adjustment Description	Overland Position	ORA Position	TURN Position
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**Rate Base Adjustments**

27	RB	REG-29	11 - 5, S11 - 5	GH Reply 13	Cash Working Capital (RB) - Reduce cash working capital allowance to correct errors and to reflect audit adjusted expenses.	Adjusts cash working capital allowance to correct 20 errors made in Pacific Bell's lead-lag studies and to reflect audit adjusted expenses.	Concur with most of Overland's adjustments. Also note that Pacific Bell included non-cash items, such as depreciation expense, in CWC calculation, which results in overstatement of rate base. The CWC would be negative if the non-cash items were removed. ORA recommends that CWC instead be set equal to zero. The result is similar to the three-year average rate base effect presented by Overland, and greatly simplifies the IEMR process.	The cash working capital allowance should be set equal to zero for IEMR purposes, the most reasonable option given the considerable doubt as to the accuracy or reasonableness of the utility's cash working capital calculations.
28	RB	REG-30	11 - 28	GH Open 12	Prepaid Directory Expense (RB) - Include prepaid directory expense in rate base.	Rate base should reflect Pacific Bell's actual investment in providing service. Prepaid directory expense represents an investment in providing service that should be included in rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	

**ALTERNATE DRAFT**

29	RB	REG-31	11 - 30	GH Open 12, GH Reply 19	SFAS 112 Liability (RB) - Deduct SFAS 112 liability from rate base.	The accrued SFAS 112 liability represents non-investor supplied capital that should be deducted from rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	
30	RB	REG-32	11 - 31	GH Open 12, GH Reply 19	Vacation Liability (RB) - Deduct accrued vacation liability from rate base.	The accrued vacation liability represents non-investor supplied capital that should be deducted from rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	
31	RB	REG-33	11 - 31	GH Open 12	SFAS 106 Accrued Liability (RB) - Deduct accrued SFAS 106 liability from rate base. Amount depends on resolution of SFAS 106 expense correction.	The accrued SFAS 106 liability represents non-investor supplied capital that should be deducted from rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	
32	RB	REG-34	11 - 34	GH Open 12	Accrued Contingent Liability (RB) - Deduct accrued contingent liabilities from rate base. Amount depends on resolution of expense correction for unauditable contingent liabilities.	Accrued contingent liabilities represent non-investor supplied capital that should be deducted from rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	
33	RB	REG-35	11 - 28, S11 - 6	GH Open 12, GH Reply 19	Prepaid Pension Costs (RB) - Include prepaid pension asset in rate base. Amount depends on resolution of Phase 2A pension expense correction.	Prepaid pension assets represent an investment in providing service that should be included in rate base. D.91-07-056 does not prohibit the correction.	Concur with Overland	

**ALTERNATE DRAFT**

34	RB	REG-36	10 - 22	GH Open 3	SFAS 106 Plant (RB) - Reduce 1998 and 1999 plant to reflect CPUC PBOP accounting policy.	Directly related to Phase 2A PBOP expense correction. Pacific Bell wrote-off PBOP regulatory asset in 1998. That write-off included the elimination of a large rate base credit. The Phase 2A PBOP correction reverses the expense impact of the write-off. This correction eliminates the rate base impact of the write-off. The rate base correction should be adopted if the Phase 2A PBOP expense correction is adopted.	Concur with Overland	
35	RB	REG-37	10 - 22, S10 - 3		Restructure Reserve (RB) - Reduce net plant to eliminate unsupported and unreasonable jurisdictional adjustment.	Pacific Bell's recorded plant balances include a jurisdictional adjustment for the impact of a 1993 restructuring reserve. The FCC and CPUC accounting treatment of the restructuring reserve was identical. Therefore, there is no basis for the recorded jurisdictional adjustment. Pacific Bell admits it cannot support the jurisdictional adjustment recorded on its books or explain what the adjustment represents..	Concur with Overland	
36	RB	REG-38	10 - 23		Accumulated Reserve for Depreciation (RB) - Adjust depreciation reserve to reflect depreciation expense corrections.	Directly related to depreciation expense corrections. This correction adjusts rate base to reflect impact of depreciation expense corrections on accumulated reserve for depreciation.	Concur with Overland	

**ALTERNATE DRAFT**

37	RB	REG-39	9 - 23		Accumulated Deferred Income Tax (RB) - Adjust accumulated deferred income taxes to reflect the CPUC's flow-through income tax accounting policy.	The rate base correction should reflect the resolution of the income tax normalization issue in Phase 2A.	Concur with Overland	
38	RB	REG-40	9 - 21		Excess Deferred Income Tax (RB) - Adjust Accumulated deferred income taxes to correct accounting error.	This correction is directly related to the income statement correction for excess deferred income tax amortization. The rate base correction should be made if the income statement correction is adopted.	Concur with Overland	
ORA	RB				Remove ADSL Development Costs		See corresponding description of income statement adjustment above.	Pacific Bell should not be allowed to recover development costs through NRF rates, then transfer the ADSL service so that future revenues from that service are not reflected in the IEMR. Instead, the ADSL development costs should be removed from the IEMR during the audit period.
60a	RB	NR-01	20 - 20	GO Reply 10	Depreciation Expense Timing Adjustment (RB) - The allocation between regulated and non-regulated activities was not correct on a year-to-date basis. This entry corrects this error.	Contrary to the cost attribution hierarchy adopted by the CPUC in D.91-07-056 (Finding of Fact 11), when correcting a depreciation expense error in December 1999, Pacific Bell employed current regulated / non-regulated allocation ratios which were not reflective of the actual ratios in use at the time when the errors were originally recorded.	Concur with Overland	

**ALTERNATE DRAFT**

70a	RB	REG-43; Supp 6	S6 - 1	GH Open 2	LNP Capital Costs (RB) - Reduce net plant to correct a separations error.	The plant costs recovered through the FCC LNP tariff should be directly assigned to the interstate jurisdiction.	Concur with Overland	The costs incurred prior to May 1998 should have been deferred as a regulatory asset pursuant to FAS 71 requirements. Pacific Bell had sufficient information to estimate the probable amount of cost recovery in early 1996.
71a	RB	REG-44; Supp 10	10 - 17, S10 - 1	GH Open 3	AFUDC (RB) - Reduce net plant to correct an accounting error. The AFUDC rates used by Pacific Bell were overstated.	The CPUC basis AFUDC charged to plant during the audit period was excessive. Pacific Bell's AFUDC rate calculations violated Resolution RF-4. Pacific Bell's practice of imputing negative capital sources in its AFUDC rate calculations does not have any basis in regulatory, finance or accounting theory. This correction is directly related to the AFUDC depreciation correction.	Concur with Overland	
72	RB	REG-45; Supp 10	S10 - 2	GH Open 3	PBOP Pre-Funding Plant Adj. (RB) - Reduce net plant to eliminate unsupported and unreasonable jurisdictional adjustment.	Pacific Bell's recorded plant balances include a jurisdictional adjustment for the capitalized portion of contributions it made to its PBOP trusts in 1989 and 1990, prior to the adoption of FAS 106. The proper FCC and CPUC basis accounting for the contributions was identical. Therefore, there is no basis for the jurisdictional adjustment and it should be eliminated. Pacific Bell properly charged the contributions to expense for FCC purposes. Pacific Bell improperly accounted	Concur with Overland	

						for contributions as prepaid PBOP assets for CPUC purposes. Pacific Bell's CPUC basis accounting violated CPUC accounting policy and was inconsistent with its accounting for similar contributions made to other PBOP trusts.		
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**APPENDIX D**

## APPENDIX D

<b>UNDISPUTED AUDIT ADJUSTMENTS</b>			
<b>Issue</b>	<b>Amount of Adjustment<sup>253</sup></b>		
	<b>1997</b>	<b>1998</b>	<b>1999</b>
<b>Revenues and Other Operating Income Adjustments</b>			
Bellcore Dividends Index #2 <sup>254</sup>	\$3,883,507		
Gain on Sale of Bellcore Index #4	9,122,587		
<b>Operating Expenses</b>			
ACN Shutdown Costs Index #8	17,846,219	4,284,040	2,226,486
ISP-Bound Traffic Separations Index #12	(11,329,359)		
<b>Depreciation Accounting</b>			
Equal Access IEMR Ratemaking Adjustment Index #20		(6,477,055)	

<sup>253</sup> Positive numbers represent additions to income (in the case of “Revenues and Other Operating Income”) or to expense (in the case of “Operating Expenses,” “Depreciation Accounting,” “Affiliate Transactions,” and “Regulated and Nonregulated Cost Allocations”), and negative numbers (in parentheses) indicate decreases in income or expense.

<sup>254</sup> Index numbers cross-reference to the chart entitled “Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell Showing Impact of Audit Corrections on Pacific Bell’s Reported IEMR Results for 1997-1999,” Appendix A hereto.

<b>Affiliate Transactions<sup>255</sup></b>			
SBC Operations Merger Conforming Expense Index #39			1,656,603
SBC Operations Secondary Allocation of Parent Management Fees Index #42		291,835	270,743
SBC Operations Call Center Depreciation and Merger Implementation Expense Index #43		237,025	
SBC Services, CFL and TRI Allocation of Parent Management Fees Index #45		265,789	216,392
Parent Political and Legislative Influence Expense Index #47	8,574,885	10,009,837	4,186,554
Parent Contributions, Memberships and Foundation Expense Index #52	161,013	657,620	3,067,831

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<sup>255</sup> Undisputed affiliate transactions issues also appear in Pacific's Exh. 2B:362A.

Parent SFAS 106 Merger Conforming Expense Index #54			454,553
Parent Impact on Pacific Bell Directory – Contributions and Memberships Index #55a	75,500	259,236	195,782
Parent Impact on Pacific Bell Directory – Lobbying Expense Index #55e	389,744	729,081	881,323
Parent Impact on Pacific Bell Directory – Parent Management Fees Index #55j		1,145,479	1,248,344
Parent Impact on Pacific Bell Directory – Employee Transfer Fees Index #55k	58,754		
Parent Employee Transfer Fees Billed Back to Pacific Index #57	626,616		
Nevada Bell Net Directory Revenue Index #59			(11,253,000)

<b>Regulated and Nonregulated Cost Allocations</b>			
Nonregulated Tracking Code Assignment Error Index #64	7,398	4,250,163	3,237,874
Customer Premises Equipment Costs Index #67		10,097,537	3,467,830

**APPENDIX E**

**Intentionally left blank.**

## **APPENDIX F**

## **APPENDIX G**

# APPENDIX H

# APPENDIX I

## APPENDIX J

**APPENDIX K**

# APPENDIX L