

(Revised October 20, 2005)

Decision **DRAFT DECISION OF COMMISSIONER KENNEDY** (Mailed 7/26/2005)

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)

DECISION REGARDING PETITIONS TO MODIFY DECISION 02-10-020

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O P I N I O N

1. Summary

Decision (D.) 02-10-020 ordered the Office of Ratepayer Advocates (ORA) to conduct a comprehensive audit of Verizon California Inc. (Verizon) covering the years 1999 through 2002.¹ Today's Decision grants in part and denies in part the joint petition to modify D.02-10-020 filed by ORA and The Utility Reform Network (TURN), and grants in part and denies in part the petition to modify D.02-10-020 filed by Verizon.

In response to these petitions, D.02-10-020 is modified to (1) target ORA's audit of Verizon to the years 2002, 2003 and 2004; (2) set a cap of \$1 million for the cost of ORA's audit; and (3) order ORA to follow the audit guidance provided herein.

2. Procedural Background

On January 19, 2004, ORA and TURN filed a joint petition to modify D.02-10-020 to change the audit period to 1999 - 2004 or, alternatively, 2000 - 2004. Notice of the petition appeared in the Daily Calendar on January 21, 2005. Verizon and Pacific Bell Telephone Company d/b/a SBC California (referred to hereafter as "SBC") filed responses.

Verizon filed a petition to modify D.02-10-020 on February 8, 2005. Verizon's petition asks the Commission to (1) reduce the scope of the audit ordered by D.02-10-020, (2) revise the audit period to include only the most recent three years, and (3) implement these revisions in Phase 3 of this proceeding. Notice of Verizon's petition appeared in the Daily Calendar on

¹ D.02-10-020, *mimeo.*, p. 83 [Ordering Paragraph (OP) 8].

February 10, 2005. Responses were filed by SBC and jointly by ORA and TURN. Verizon filed a reply after obtaining permission to do so from the assigned Administrative Law Judge.

3. Regulatory Background

This proceeding is the fourth triennial review of the New Regulatory Framework (NRF) for SBC and Verizon. The order instituting this proceeding divided the proceeding into three Phases. Phase 1, which is now complete, addressed factual issues related to an audit of Verizon of limited scope. Phase 2, which is now complete, addressed factual issues related to (1) an audit of SBC, and (2) how service quality for SBC's and Verizon's end-users has fared under NRF. The purpose of Phase 3, which has not yet started, is to review and possibly revise NRF based, in part, on the record developed in Phases 1 and 2.²

Phase 1 concluded with the issuance of D.02-10-020. Among other things, D.02-10-020 directed ORA to conduct a comprehensive audit of Verizon covering the years 1999 through 2002. Decision 02-10-020 also required the scope of ORA's audit to include the following³:

- All of Verizon's NRF monitoring reports for 1999 - 2002.
- Any reports that Verizon submitted to the Federal Communications Commission (FCC) that contain information about service quality in California.
- Affiliates' books and records.
- Such other matters that might arise in Phases 2 and 3.

² As explained in more detail, *infra*, many of the key Phase 3 issues will be addressed in Rulemaking (R.) 05-04-005.

³ D.02-10-020, *mimeo.*, pp. 78 - 80 [Conclusions of Law (COLs) 41, 42, 43, 44, and 54] and p. 83 [OPs 8 and 9].

Decision 02-10-020 directed ORA to submit an audit report in the next triennial review of NRF. The Decision also authorized ORA to hire CPAs to conduct the audit, ordered Verizon to pay for the CPAs, and allowed Verizon to seek recovery of these costs.⁴ On January 19, 2005, ORA issued a request for proposal (RFP) to begin the process of hiring CPAs to conduct the audit.

As mentioned previously, the purpose of the upcoming Phase 3 is to review and possibly revise NRF. However, the Commission is presently considering in R.05-04-005 whether to adopt a uniform regulatory framework for most telecommunications utilities, including SBC and Verizon. Thus, many of the key policy issues previously designated for Phase 3 will now be considered in R.05-04-005 and it is uncertain whether the Commission will have a Phase 3 in this instant proceeding.

4. ORA & TURN's Joint Petition to Modify D.02-10-020

A. Summary of the Joint Petition

Decision 02-10-020 ordered ORA to conduct a comprehensive audit of Verizon covering the years 1999 - 2002. In their petition to modify D.02-10-020, ORA and TURN ask the Commission to revise the audit period to 1999 - 2004 or, alternatively, 2000 - 2004. ORA and TURN state that it is advisable to revise the audit period so that the audit provides the Commission with current information.

B. SBC's and Verizon's Responses

SBC and Verizon oppose ORA and TURN's petition. SBC and Verizon argue that expanding the audit period will impose unnecessary costs on Verizon

⁴ D.02-10-020, *mimeo.*, pp. 83 - 84 [OPs 11 and 13].

and its ratepayers. SBC also asserts that the audit period should not be expanded because there may be significant changes to Verizon's regulatory framework in R.05-04-005 that obviate the need for the audit.

Verizon states that expanding the audit period will not provide current information as ORA and TURN claim. This is because the audit report will be submitted in the next triennial review of NRF, which will not begin until 2009. Consequently, the data will be 5-10 years old when the audit report is submitted.

Verizon also asserts that ORA and TURN's proposal exceeds the requirements of Pub. Util. Code § 314.5,⁵ which requires the Commission to audit Verizon "at least once in every three years." Thus, an audit limited to three years or less would more than comply with § 314.5.

If the Commission is inclined to grant ORA and TURN's petition, SBC and Verizon recommend that the audit period be revised so that it covers only the three most recent years. Verizon opines that this alternate is preferable because it will provide current information while avoiding unnecessary audit costs.

5. Verizon's Petition to Modify D.02-10-020

A. Summary of Verizon's Petition

In its petition to modify D.02-10-020, Verizon asks the Commission to (1) significantly reduce the scope of the audit ordered by D.02-10-020, (2) revise the audit period so that only the three most recent years are audited, and (3) implement these revisions in Phase 3 of the current NRF proceeding.

Verizon argues that the audit ordered by D.02-10-020 is a sweeping historical review that is inconsistent with Verizon's regulatory framework that

⁵ All statutory references are to the Public Utilities Code unless otherwise indicated.

was in effect during the period covered by the audit. Verizon asserts that the Commission has previously held that audits conducted pursuant to § 314.5 should be based on the regulatory framework of the audited company.

In D.93-02-010, for example, the Commission found that monitoring reports submitted by AT&T were sufficient to fulfill the § 314.5 audit requirement:

At first glance, it appears that the audit requirement of [§ 314.5] is mandatory. However, [§ 314.5] was enacted well before the Commission granted AT&T-C limited rate flexibility. Since that grant of limited rate flexibility...[the Commission] has required AT&T-C to supply additional information on regular intervals as part of the monitoring plan...The purpose of the [§ 314.5] audit is “for regulatory and tax purposes.” The information supplied by AT&T-C allows us to assess how well the interLATA market is working in light of the regulatory flexibility granted to AT&T-C. We believe that this information supplied by AT&T-C fulfills the “regulatory” purpose of [§ 314.5]. (D.93-02-010, 1993 Cal. PUC LEXIS 61, 54-55.)

As was the case for AT&T, Verizon states that it regularly submits monitoring reports to the Commission. Verizon believes that a periodic review of its monitoring reports by Commission staff would satisfy § 314.5.

Verizon claims that the comprehensive audit ordered by D.02-10-020 is inconsistent with several Commission decisions that limited the scope of audits under NRF, including D.04-09-061 (2004 Cal. PUC LEXIS 477, 7), D.98-10-026, (1998 Cal. PUC LEXIS 669, 70, 72), and D.96-05-036 (1996 Cal. PUC LEXIS 657, 11 and 12). Verizon states that the Commission should reduce the scope of the audit based on these past decisions.

Verizon also contends that its customers will not benefit from a comprehensive audit of 1999 - 2002. This is because there is no possibility that the audit will result in a rate reduction under the regulatory framework that was

in effect during 1999 – 2002. Verizon argues that the absence of any customer benefits is reason enough to reduce the scope of the audit.

Verizon states that if the Commission decides to substantially reduce the scope of the audit as Verizon recommends, the Commission should wait until Phase 3 to establish the parameters of the downsized audit. Verizon believes this approach will ensure that the audit produces useful information. For example, if the Commission eliminates certain monitoring reports in Phase 3, Verizon believes there would be no point in auditing the eliminated reports that Verizon submitted during 1999 – 2002 as currently required by D.02-10-020. Verizon adds that this course of action has the added benefit of allowing the Commission in Phase 3 to advance the audit period to encompass only the most recent years so that more current information is reviewed.

B. ORA & TURN’s Joint Response

ORA and TURN oppose Verizon’s petition. They observe that § 314.5 requires the Commission to audit Verizon. The statute states:

The commission shall inspect and audit the books and records **for regulatory and tax purposes (a) at least once in every three years** in the case of every...telephone [corporation]... serving over 1,000 customers...An audit conducted in connection with a rate proceeding shall be deemed to fulfill the requirements of this section. Reports of such inspections and audits and other pertinent information shall be furnished to the State Board of Equalization for use in the assessment of public utilities. (Emphasis added.)

ORA and TURN dispute Verizon’s claim that § 314.5 allows the Commission to limit an audit of Verizon to a review of monitoring reports. They argue that the statute’s use of the phrase “regulatory purposes” requires the Commission to audit Verizon in a way that reflects Verizon’s status as a

dominant provider of local exchange services with billions of dollars of revenues. ORA and TURN contend that an audit of such an entity cannot be accomplished by reviewing monitoring reports. They note that the most recent audits of SBC and Verizon show that monitoring reports contain significant errors.⁶

ORA and TURN contend that there is no need to reduce the scope of the audit because there might be changes to Verizon's regulatory framework sometime in the future. They state that the Commission in D.02-10-020 found that it was unlikely that future changes to Verizon's regulatory framework would affect the retrospective audit.⁷

Finally, ORA and TURN maintain that the audit ordered by D.02-10-020 will not be unduly costly to Verizon and its ratepayers. They state that the most recent audit of Verizon cost approximately \$1 million, which was charged to Verizon's ratepayers. ORA and TURN believe this cost was not excessive when compared to Verizon's substantial revenues and profits.

C. SBC's Response

SBC supports Verizon's petition to modify D.02-10-020. SBC contends that potential changes to Verizon's regulatory framework may obviate the need for a detailed audit. SBC also asserts that because costs and rates are de-linked under NRF, there is no need for the comprehensive audit ordered by D.02-10-020.

⁶ D.02-10-020, *mimeo.*, p.44; D.04-09-061, *mimeo.*, Appendix H

⁷ D.02-10-020, *mimeo.*, p.58.

6. Discussion

A. ORA & TURN's Joint Petition to Modify D.02-10-020

Decision 02-10-020 ordered ORA to conduct an audit of Verizon covering the years 1999 through 2002. We modify D.02-10-020 so that the audit will cover the years 2002, 2003 and 2004 only.

We conclude that it is appropriate to add recent years to the audit, as recommended by ORA and TURN, in order to obtain more recent audited data with which to make informed decisions regarding NRF and other matters.

We also drop older years from the audit scope as recommended by SBC and Verizon. The Commission needs accurate information for many purposes, but the utility of audited data diminishes with time. Thus, we conclude that it is wise to focus the audit on the three most recent years.

We realize there might be changes to Verizon's regulatory framework in R.05-04-005, and these regulatory changes could affect the usefulness of parts of the audit. Any changes to Verizon's regulatory framework, however, are likely to be applied prospectively, and not retroactively, to the period covered by the audit, but clearly they will affect the relevance of audited material to the regulatory program.

Verizon's out-of-pocket costs for the audit should be minimal, since D.02-10-020 authorized Verizon to seek recovery of the audit costs incurred by ORA to hire CPAs.⁸ To ensure that the audit costs borne by ratepayers are reasonable, we cap the costs incurred by ORA to \$1 million, the cost of the audit when

⁸ Verizon will undoubtedly incur some internal costs for the audit, such as responding to data requests and meeting with auditors. SBC and Verizon's argument that Verizon's internal costs will be unduly burdensome is speculative at this point and ignores the fact that regulatory compliance costs were built into Verizon's start-up revenue requirement.

sharing was in place. Now that sharing is not in place, it is not reasonable to expect the costs of an audit to exceed this amount. Furthermore, we urge that ORA work to keep costs substantially below \$1 million.

B. Verizon's Petition to Modify D.02-10-020

Verizon's petition asks the Commission to (1) significantly reduce the scope of the audit ordered in D.02-10-020, (2) revise the audit period to include only the most recent three years, and (3) determine the scope of the downsized audit in Phase 3. We address each of Verizon's requests below.

i. Scope of the Audit

We decline to grant Verizon's request to reduce the scope of the audit ordered by D.02-10-020 at this time. In particular, we believe that limiting the scope of the audit by Commission ruling on specific audit issues could result in an inappropriate micromanagement of ORA's investigation by the Commission and we decline to do so.

Although we decline to reduce the scope of the audit,⁹ we will provide guidance regarding some of our expectations for the audit so that ORA can plan and conduct successfully the audit that the Commission has ordered and ratepayers will fund.

First, we believe that the audit should not be resource intensive. We anticipate that the audit will not affect rates because during the period covered by the audit, the earnings sharing mechanism was suspended and prices for Verizon's services were de-linked from costs. Consequently, there is no obvious way that any errors or irregularities discovered by ORA's audit could have

⁹ Even if we did reduce the scope of the audit ordered by D.02-10-020, ORA has independent statutory authority to use its own resources to conduct a comprehensive audit of Verizon.

affected rates. Since we see no way that the audit can affect rates, those advocating an extensive audit will need to show clearly why the expenditure of significant resources on a traditional audit makes sense in today's regulatory environment. Absent such a showing, we expect that an audit will be modest in scale, and in any event cost no more than \$1 million.

Second, since the absence of sharing eliminates many of the financial motives that could lead to aggressive accounting, we do not anticipate that ORA's audit will result in fines or other sanctions. Fines and sanctions are appropriate only if ORA discovers a violation of a statute or Commission decision and not an appropriate response to errors that arise simply from the complexity or ambiguity of regulatory rulings.

Third, consistent with D.04-09-061, any errors in Verizon's monitoring reports and accounting records discovered by ORA's audit should be corrected in a manner consistent with generally accepted accounting principles (GAAP).¹⁰ If corrections are required by GAAP, we expect Verizon to (i) file corrected monitoring reports, and (ii) correct errors that extend beyond the audit period. In most situations, GAAP does not require a retrospective restating of financial reports and it is difficult to envision scenarios that would require such a restatement. Therefore, we do not believe an audit that seeks to require modifications of old financial statements would constitute an appropriate expenditure of ratepayer resources.

Fourth, although audited information for every year can be valuable, it is the information concerning the most recent years will be most useful for Commission decision-making purposes. Therefore, we have directed ORA to

¹⁰ D.04-09-061, *mimeo.*, p. 165 [OP 1].

plan an audit for only the three most recent and prohibit ORA from seeking reimbursement for expenses incurred on auditing books and transactions from outside the years 2002, 2003 and 2004. If ORA wishes to audit additional years or to spend more than \$1 million on this audit, it should use its own resources to do so.

In addition to the guidance offered above, we believe that specifying the years covered by the audit and capping the amount of resources that ORA can spend offers a way of limiting the audit and encouraging thoughtful planning by ORA.

ii. The Years Covered by the Audit

We have granted Verizon's request to modify the audit period to include only the most recent three years. Verizon's arguments for doing so mirror its reasons for opposing ORA and TURN's petition. We have accepted Verizon's arguments for the reasons described previously, which we will not repeat here.

iii. Revisions to the Audit Scope in Phase 3

In today's Decision, *supra*, we deny Verizon's request to reduce the scope of the audit ordered by D.02-10-020 at this time. As a result, Verizon's request to establish the scope of a downsized audit in Phase 3 is moot.

Nevertheless, ORA should develop audit plans that have the flexibility to adjust for changes. First, D.02-10-020, as modified by today's Decision, limits the scope of the audit to the years 2002 through 2004. The next triennial NRF

review, if one is held,¹¹ will start in 2008 or 2009, assuming the instant proceeding ends in 2005 or 2006.

Second, we may adopt substantial changes to Verizon's regulatory framework in R.05-04-005. In that proceeding, we may also consider the related issues of (1) how to tailor the audits, to the extent that there is an audit, to reflect the regulatory framework in effect during 2005 and later years, and (2) the appropriate proceeding for ORA's next audit report if NRF is replaced by another regulatory framework.

We note that ORA has not yet commenced the audit ordered by D.02-10-020. At this point, we believe it would be most efficient to postpone the audit until after completion of the merger of Verizon, Inc and MCI, Inc (or its abandonment). This transaction is now under consideration in A.05-04-020 and already scheduled for Commission consideration. Postponement of the audit until resolution of this matter and/or completion of the merger will enable ORA to plan and conduct an audit that takes into account developments in the VCI-MCI merger.

In addition, since we have capped audit expenses, we advise ORA to ensure that any steps taken now to plan or contract for an audit should be able to accommodate a cap on audit expenses substantially below the \$1 million spent on the audit when sharing was in place.

7. Comments on the Draft Decision

The draft decision of the assigned Commissioner in this matter was mailed to the parties in accordance with Section 311(g)(1) and Rule 77.7. Comments

¹¹ There may not be another triennial review if NRF is replaced by another regulatory framework in R.05-04-005.

were filed by ORA and TURN (filing jointly) and Verizon on August 15, 2005. Reply comments were filed by ORA and TURN (filing jointly), SBC, and Verizon.

A. Comments and Reply Comments

The Joint Comments of ORA and Turn raise a series of issues. First, ORA and TURN argue that the Commission should adopt a set schedule for the commencement of an audit that does not permit substantial delay. In addition, they argue that capping costs of the audit is “inadvisable,” claiming that it is “likely to impede the ability of ORA and its consultant to exercise independent professional judgment.”¹² Furthermore, ORA and TURN object to the guidance offered by the Commission concerning the audit.

Verizon objects to any consideration of extending the audit to include 2005 in the scope of the current audit and objects to the possible combination of this audit with a possible audit following action in the MCI acquisition proceeding, A.05-04-020. SBC argues that the Commission should reject the changes proposed to the draft decision by ORA and TURN. In addition, SBC counters that the guidance offered to ORA is consistent with Commission precedents.

B. Discussion

Consistent with the Comments of ORA and TURN, we have amended this decision to ensure that the audit commences in a timely way and to reflect that in D.05-11-029, we have authorized the merger of Verizon and MCI.

The request of ORA and TURN for an audit open-ended in both cost and scope, however, is unreasonable. If the Commission is directing Verizon to collect from ratepayers funds to pay for a Commission ordered audit, then it

¹² Comments of the Office of Ratepayer Advocates and The Utility Reform Network on Draft Decision of Commissioner Kennedy, August 15, 2005

would be irresponsible to neither set a cap on costs nor provide guidance concerning issues of interest to the Commission. For this reason, we have adopted a cap on costs of \$1 million and restricted it to the years 2002, 2003, and 2004. If ORA wishes to spend more resources on the audit or audit outside the years 2002, 2003 and 2004, we note that it has a substantial budget and it can use these resources to audit issues of interest to it. We do not think that a cost cap would impair professional judgment; we think the opposite – a failure to set a cap on costs could provide an incentive that makes professional judgment concerning audit costs and benefits irrelevant.

Finally, we agree with SBC that the guidance that we have given ORA concerning the scope of the audit is consistent with prior precedents and does not prejudice any issue.

Concerning Verizon's comments, we have clarified this opinion to make clear that we are not including 2005 within the scope of the audit, but have limited the audit to the years 2002, 2003 and 2004. In general, the costs billed to Verizon for this audit should not include expenses for auditing books or transactions outside these years. The only exception should be audit procedures that examine books and transactions outside the audit period for the purpose of verifying the accuracy of amounts recorded during the audit period (e.g., determining if transactions recorded in a subsequent period properly belong in that period and not in the audit period).

In conclusion, we note that the comments and replies, even if not explicitly discussed, have been reflected, as appropriate, in the final decision adopted by the Commission.

8. Assignment of Proceeding

Susan P. Kennedy is the Assigned Commissioner for this proceeding and Timothy Kenney is the assigned Administrative Law Judge.

Findings of Fact

1. Decision 02-10-020 ordered ORA to conduct a comprehensive audit of Verizon covering the years 1999 - 2002. ORA has not yet started the audit.
2. ORA and TURN's joint petition to modify D.02-10-020 seeks to expand the audit to include 1999 through 2004 or, alternatively, 2000 through 2004.
3. Verizon's petition to modify D.02-10-020 seeks to (1) reduce the scope of the audit ordered by D.02-10-020, (2) revise the audit to include only the most recent years, and (3) implement these revisions in Phase 3 of this proceeding.
4. Limiting the audit to the three most recent years assures the validity and timeliness of the data.
5. Audits can prove helpful to the design and assessment of specific regulation programs. Under NRF, they have provided a means for the Commission to monitor Verizon, to determine if Verizon is complying with Commission rules and statutory requirements, and to assess whether the Commission's goals for NRF are being met.
6. Verizon should incur minimal out-of-pocket costs for a comprehensive audit covering 2002 through 2004 because (i) D.02-10-020 authorized Verizon to seek recovery from ratepayers of the audit costs billed by ORA or the Commission, and (ii) some regulatory compliance costs were built into Verizon's startup revenue requirement.
7. A "cap" on the audit expenses that ORA can incur will control the burden of regulatory costs placed on ratepayers.

8. The Commission authorized a proposed merger of Verizon and MCI in D.05-11-029.

9. If there is another triennial review of NRF, it will not commence until 2008 or 2009, assuming the instant proceeding ends in 2005 or 2006.

Conclusions of Law

1. ORA and TURN's petition to modify D.02-10-020 should be granted in part consistent with the discussion herein for the reasons set forth in Findings of Fact (FOFs) 4 through 8.

2. Verizon's petition to modify D.02-10-020 should be granted in part and denied in part consistent with the discussion herein for the reasons set forth in FOFs 4 through 8.

3. It is reasonable to cap the costs of the audit that ORA can require Verizon to reimburse at \$1 million because such a cap protects ratepayers from excessive audit costs.

4. It is reasonable to restrict the audit to the years 2002, 2003 and 2004.

5. The following order should be effective immediately.

O R D E R

IT IS ORDERED that:

1. The petition to modify Decision (D.) 02-10-020 filed by Verizon California Inc. (Verizon) is granted in part and denied in part as set forth herein.

2. The petition to modify D.02-10-020 filed by the Office of Ratepayer Advocates (ORA) and The Utility Reform Network is granted in part and denied in part as set forth herein.

3. ORA's audit of Verizon shall include the years 2002, 2003 and 2004.

4. The cost of the ORA audit to be reimbursed by Verizon shall in no event exceed \$1,000,000. None of the costs billed to Verizon for this audit shall cover expenses for auditing books or transactions outside these years.

5. The audit shall follow the guidance provided herein.

6. This proceeding remains open.

This order is effective today.

Dated _____, at San Francisco, California.