

PUBLIC UTILITIES COMMISSION505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298**August 29, 2003****Agenda ID# 2376**

Alternate Agenda ID#2378

Agenda ID # 2636

Alternate Agenda ID# 2637

Ratesetting

TO: PARTIES OF RECORD IN RULEMAKING 01-09-001 and
INVESTIGATION 01-09-002**RE:** NOTICE OF AVAILABILITY OF DRAFT DECISIONS AND ALTERNATE
DRAFT DECISIONS REGARDING PHASE 2A AND 2B AUDIT ISSUES

The following draft decisions and alternate draft decisions, which were issued on the above date, are available to the parties and the public:

- Administrative Law Judge (ALJ) Kenney's draft decision regarding Phase 2A audit issues. ALJ Kenney was previously designated as the principal hearing officer for Phase 2A of this proceeding.
- Commissioner Kennedy's alternate draft decision to ALJ Kenney's draft decision.
- ALJ Thomas's draft decision regarding Phase 2B audit issues. ALJ Thomas was previously designated as the principal hearing officer for Phase 2B of this proceeding.
- Commissioner Kennedy's alternate draft decision to ALJ Thomas's draft decision.

An Internet link to each of the previously identified documents was sent via e-mail to all the parties on the service list who provided an e-mail address to the Commission. An electronic copy of these documents can be viewed and downloaded at the Commission's web site (www.cpuc.ca.gov). A hard copy of these documents can be obtained by contacting the Commission's Central Files Office [(415) 703-2045].

The previously identified draft decisions and alternate draft decisions were issued in a ratesetting proceeding that is subject to Pub. Util. Code § 1701.3(c). Pursuant to Resolution ALJ-180, a Ratesetting Deliberative Meeting to consider these drafts may be held upon the request of any Commissioner. If that occurs, the Commission will prepare and mail an agenda for the Ratesetting Deliberative Meeting 10 days before hand, and will advise the parties of this fact and of the related ex parte communications prohibition period.

The Commission may act on the previously identified draft decisions and alternate draft decisions at its first regular meeting occurring no earlier than 30 days after the date the drafts are issued. The Commission may also postpone action until later. If the Commission acts, it may adopt all or part of a draft as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties may file separate comments on each draft decision and alternate draft decision as provided in Article 19 of the Commission's "Rules of Practice and Procedure." These rules are accessible on the Commission's website (<http://www.cpuc.ca.gov>). Pursuant to Rule 77.3 opening comments on each draft shall not exceed 25 pages. Comments must be served separately on the ALJ and the assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail, or other expeditious method of service. In addition to service by mail, parties should send their comments in electronic form to ALJ Kenney at tim@cpuc.ca.gov, ALJ Thomas at srt@cpuc.ca.gov, Timothy Sullivan at tjs@cpuc.ca.gov, and to those listed in the appearance and state service portions of the service list who provided an electronic mail address to the Commission.

/s/ ANGELA K. MINKIN by PSW
Angela K. Minkin, Chief
Administrative Law Judge

ANG:hkr

Decision **PROPOSED DECISION OF ALJ THOMAS** (Mailed 8/29/2003)

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

TABLE OF CONTENTS

Title	Page
INTERIM OPINION REGARDING PHASE 2B ISSUES	2
I. Summary	2
II. Audit Background	4
A. Audit Scope	4
B. Involvement of Commission’s Telecommunications Division and Office of Ratepayer Advocates	5
C. Audit Findings	6
D. Phase 2A vs. Phase 2B	7
E. Pacific’s Books and Generally Accepted Accounting Principles	8
F. Ratepayer Harm	11
G. Materiality	14
H. Overland’s Qualifications to Perform the Audit	17
1. Certified Public Accountant (CPA) Requirement	17
2. Generally Accepted Auditing Standards	20
3. GAAS and NARUC Requirements	21
4. Policy Discussions	22
5. Overland’s Alleged Errors	23
III. Undisputed Audit Adjustments	23
IV. Disputed Audit Adjustments	24
A. Revenue and Other Operating Income	25
1. Contingent Liabilities	25
a. Withholding of “Privileged” Information	25
i. Was the Information “Privileged?”	26
ii. Did Pacific Waive the Privilege?	28
iii. Did the Limited Waiver Waive the Privilege as to Claimants?	29
b. Standard Practice in Accounting Industry	30
c. Protecting the Confidential Information	32
d. Remedy – Contingent Liabilities	32
2. Uncollectible Revenues and Settlements Expenses	34
3. Other Revenue/Operating Income Issues - Directory Publishing	37

Title	Page
B. Operating Expenses.....	38
1. Local Number Portability Costs	38
a. Introduction	38
b. Criteria for Deferral as a Regulatory Asset – FAS 71	40
c. Jurisdictional Separations	44
d. Conclusion – LNP Costs	44
2. Local Competition Implementation Costs.....	45
3. Merger Savings.....	48
4. Software Buy-Out Agreement.....	49
5. Incentive Pay Accruals	51
6. Other Expense Related Issues – “Royalty Payment”	52
C. Employee Benefits	53
1. Other Post Retirement Costs (FAS 112).....	53
2. Other Employee Benefits Issues.....	53
D. Depreciation Accounting-Intrabuilding Network Cable Amortization	54
E. Income Taxes	55
1. Accumulated Deferred Income Taxes	55
2. Sales and Use Tax Accruals	56
3. Payroll Tax Correction	58
4. Excess Deferred Taxes	58
5. Ameritech Severance Accrual	59
F. Net Plant.....	60
1. Property Records	60
a. FCC Continuing Property Records (CPR) Audit.....	61
b. Pacific’s 1999 Computer Inventory	62
c. SAVR Retirements.....	62
2. Other Net Plant Issues	66
a. Restructuring Reserve Adjustment	66
b. Depreciation Adjustment	67
c. Allowance for Funds Used During Construction (AFUDC)	67
d. PBOP Pre-Funding Plant Adjustment.....	69
G. Other Rate Base Items.....	70
1. Cash Working Capital	70
2. Other Issues – Rate Base	77
a. Prepaid Directory Expense.....	78
b. Prepaid Pension Assets	79
c. Accrued FAS 112 Liability	79
d. Accrued Vacation Pay Liability.....	81
e. Accrued FAS 106 Liability	81
f. Accrued Contingent Liabilities	82

Title	Page
H. Affiliate Transactions.....	83
1. Introduction.....	83
2. Undisputed Affiliate Transactions Adjustments	84
3. Disputed Affiliate Transactions Adjustments	85
a. Internal Accounting Controls.....	85
i. Overview.....	85
ii. Compliance With Time Reporting Document Retention Requirements	90
iii. 1998 Affiliate Oversight Group (AOG) Compliance Review of SBC Operations.....	92
iv. SBC Operations “Image Maker” Program.....	92
v. Centralized Tracking for Legal Matters	93
b. Pacific’s Management Control.....	94
i. Pacific’s Control Over Management Fees	94
ii. TRI Charges	95
c. Compliance With Affiliate Transaction Requirements.....	98
i. Overview.....	98
ii. Parent Costs.....	100
iii. Shared Services Affiliates	101
iv. Services Provided by Pacific Bell to Affiliates.....	101
v. Other Compliance with Affiliate Transaction Rules Issues - AMDOCS	105
d. Transfer or Use of Customer Information, Trademarks and Other Intangible Assets	105
i. Pacific’s Customer Database	105
ii. Transfer of Pacific Bell Directory to Pacific Telesis Group.....	109
e. Advanced Services, Inc.	112
i. Appropriateness of Considering ASI in this Proceeding	113
ii. Ratepayer Funding of DSL Development Costs.....	114
f. Affiliate Transactions Audit Adjustments	117
i. Operating Revenue Adjustments – 1999 Employee Transfer Fee	117
ii. Operating Expense Adjustments.....	117
(a) Executive Compensation	117

Title	Page
1. Executive Compensation Allocated From Parent and MSI-USA to Pacific.....	117
2. Executive Award Payments Allocated to Pacific.....	120
3. Executive Compensation Allocated From Parent to Pacific Bell Directory.....	120
4. Special Executive Compensation Allocated From Parent to Pacific Bell Directory.....	121
5. Executive Compensation Allocated from SBC Operations	121
6. Executive Compensation Allocated from SBC Services	122
(b) Legal Expenses	122
1. Legal Expenses Allocated from Parent to Pacific	122
2. Legal Expenses Allocated From Parent to Pacific Bell Directory.....	123
(c) Public Relations and Corporate Sponsorship Allocated from Parent to Pacific and Pacific Bell Directory	124
(d) Corporate Development.....	125
(e) Strategic Planning	126
(f) Parent Out of Period Expense.....	126
V. Regulated and Nonregulated Cost Allocations	127
A. Marketing Service – Affiliate Billings.....	127
B. Other Regulated and Nonregulated Cost Allocation Issues.....	129
1. National-Local Strategy Implementation Costs	129
a. 1997 Corporate Sponsorship Costs – Pacific Bell Park.....	130
b. Depreciation Expense Allocation.....	131
c. Product Advertising Expense.....	132
d. External Relations	133
e. Customer Service Expense.....	134
f. InterLATA Service Application Costs.....	135
g. Fluctuation Analysis	136
h. C-CAM Updates.....	138
i. Subsidiary Account Translation Data	138
j. Enhanced Sales Time Reporting Systems (ESTRS).....	140
VI. Whether Pacific Impeded the Audit	140
VII. Phase 2B Remedies (Audit – Pacific Bell).....	148
A. ORA’s Proposed Remedies - Summary.....	148
B. Correction of IEMR Reports for 1997-99.....	151
C. Correction of IEMR Reports for 2000-2001.....	151

Title	Page
D. Sharing in 1997 and 1998	153
E. 18 Percent Interest on 1997-98 Shareable Earnings	153
1. Consideration of 18 Percent Figure	153
2. Method of Payment	157
F. Suspension of Sharing in 1999.....	159
G. 18 Percent Interest on All Underreported Earnings	161
H. Reinstating Sharing	164
I. Completion of 1997-99 Audit – Affiliate Transactions	164
J. Audit of Pacific’s 2000-02 Reporting, Including Affiliate Transactions	166
K. Incentive Payment of \$20 Million.....	170
L. Penalty Phase.....	171
M. Revisions to NRF Monitoring Program	172
VIII. Recovery of Audit Costs	173
IX. Comments on Proposed Decision	176
X. Assignment of Proceeding.....	176
Findings of Fact	176
Conclusions of Law	198
ORDER.....	224
APPENDIX A Summary of Adopted Adjustments to Net Operating Income and Rate Base Pacific Bell Intrastate Regulated Operations, Phase 2B 1997, 1998, and 1999	
APPENDIX B Joint Exhibit of Overland Consulting, Inc., ORA, TURN and Pacific Bell Showing Impact of Audit Corrections on Pacific Bell’s Reported EIMR Results for 1997-1999	
APPENDIX C Joint Schedule of Overland Consulting, Inc.’s, ORA’s and TURN’s Position on Adjustments (as requested by ALJ Sarah Thomas)	
APPENDIX D Undisputed Audit Adjustments	
APPENDIX E Topics for Continued Affiliate Transactions Audit	

INTERIM OPINION REGARDING PHASE 2B ISSUES

I. Summary

This decision acts on portions of an audit of Pacific Bell Telephone Company (Pacific)¹ the Commission conducted as part of its oversight of the “New Regulatory Framework” (NRF). The NRF framework, implemented in 1990,² 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 will be the subject of a separate decision. We find that many of the audit findings are justified and that in many instances Pacific over-reported expenses with significant consequences for ratepayers.

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, Overland proposed adjustments in Pacific’s revenues of \$625.3 million and adjustments in Pacific’s ratebase of \$2134.7 million. Of these adjustments, 17 totaling \$118.4 million in revenue adjustments and no ratebase adjustments were uncontested. Of the 51 contested issues, we sustain Overland’s analysis on 48 and reverse their recommendation on 3 based on the evidence submitted at hearing and our analysis of Commission policies. Concerning these contested

¹ 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.

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

issues, we order Pacific to make 35 adjustments in revenue, and 13 adjustments to its ratebase.

As a result of our decision today, we order Pacific to adjust its net operating income in 1997 by \$293.5 million; in 1998 by \$222.5 million; and in 1999 by \$114.6 million. Thus, the adjustment to Pacific's net operating income total \$630.6 million for the three years under review. In addition, we order ratebase adjustments of \$787.0 million in 1997, \$823.7 million in 1998, and \$639.2 million in 1999. Thus, for these three years ratebase adjustments total \$2250.0 million.

In 1997 and 1998, Pacific was under an obligation to share earnings above a certain threshold with ratepayers. However, its excessive reported expenses caused Pacific's reported earnings to be improperly depressed. In combination with the audit decision resulting from Phase 2A of this proceeding, the earnings rose to a level that requires Pacific to share earnings in 1998.

In 1999, Pacific also over-reported expenses, but was under no obligation in that year to share earnings with ratepayers. Certain parties participating in this case 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 adjustments that we adopt in this decision are combined with the Phase 2A adjustments and together reflected in Appendices A, D and E to our Phase 2A decision.³ The Phase 2B adjustments appear in Appendix A to this

³ 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'

Footnote continued on next page

decision. In addition, we require Pacific to prepare schedules that identify each of this decision's adopted adjustments and demonstrate that it has properly reflected the ordered adjustments in its financial reporting. Pacific shall file the schedules, along with supporting documentation, as a compliance Advice Letter filing due no later than 60 days after the effective date of this decision.

II. Audit Background

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 stated that the audit should:

- (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 anticompetitive 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

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.

non-structural safeguards adequately protect ratepayer and competitor interests with respect to non-regulated activities. (D.96-05-036, 66 CPUC 2d 274, 278, and OPs 3 and 4; and Executive Director letter dated September 18, 1998).⁴

B. Involvement of Commission's Telecommunications Division and Office of Ratepayer Advocates

The Pacific audit took an unusual turn from the outset. The Commission's Office of Ratepayer Advocates (ORA), which appears as an advocate in Commission proceedings on behalf of ratepayers, was originally assigned to conduct the audit. (ORA also carried out the Verizon audit addressed in Phase 1 of this proceeding. Pacific objected to ORA's involvement, and convinced the Commission to reassign the audit to its Telecommunications Division (TD), an industry division within the Commission that, among other things, advises the Commissioners on telecommunications issues.⁵ In discharging its obligation to oversee the Pacific Bell audit, the TD maintained the contract ORA had previously negotiated with an independent firm, Overland Consulting (Overland), to carry out the audit for the Commission.

Even though it sought TD's involvement in the audit, Pacific has frequently objected to the manner in which TD participated in the proceeding. TD has taken the position that it is not a "party" to the proceeding, but rather that it represents the Commission in an advisory capacity in carrying out the audit.

TD is an arm of the Commission. Therefore, it cannot be the subject of deposition or other routine discovery as would an ordinary party, may consult

⁴ Rulemaking (R.) 01-09-001/Investigaton (I.) 01-09-002, Appendix A.

⁵ See D.00-02-047, 2000 Cal. PUC LEXIS 184.

with Commission decision-makers including the Assigned Commissioner and Administrative Law Judges (ALJ) without being bound by the Commission's *ex parte* rules, and otherwise may act in its normal advisory role *vis-à-vis* the Commission.

ALJ Timothy Kenney, 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.⁶

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 interactions between the auditors and Pacific, and ORA actively pursued various issues raised in the audit.

C. Audit Findings

Overland prepared an audit report covering the years 1997-99 that was admitted into evidence during Phase 2A of this proceeding.⁷ In the report, Overland stated that it:

identified 67 corrections [increased by Overland's Supplemental Audit Report⁸ to 72⁹] to Pacific Bell's regulated

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

⁷ Exhibit (Exh.) 2A:404.

⁸ Exh. 2B:415 (Supplemental Audit Report).

operating 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.¹⁰

D. Phase 2A vs. Phase 2B

We address approximately two-thirds of the audit dollar results – attributable to four issues – in the Phase 2A decision. Therefore, whether the decisions we reach here on the remaining one-third will rise to a level requiring Pacific to share earnings with ratepayers depends on the results of Phase 2A. Because we expect the two decisions to issue at about the same time, this decision addresses each Phase 2B audit claim, but does not reach the ultimate issue of whether sharing is required or the amount of such sharing. The Phase 2A decision performs the calculations for both phases.

⁹ See Exh. 2B:409 at 5:9-13 (Welchlin Opening Testimony).

¹⁰ We explained earnings sharing, and the NRF structure, in our OIR, and incorporate that explanation here.

E. 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 books¹¹ should be restated in the year in which the error occurred. Rather, Pacific claims that, in certain cases, Generally Accepted 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 proper means of reflecting the audit changes, as we discuss below.

Pacific keeps several types of financial records. It uses one set for tax purposes, another for financial accounting and Securities and Exchange Commission (SEC) reporting purposes, and a third set to comply with regulatory accounting requirements the Commission imposes on the company under NRF. Only the third set of accounts is at issue in this decision.

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 SEC purposes, and thus were governed by GAAP. Even though

¹¹ Pacific's California earnings report is entitled the Interstate Earnings Monitoring Report (IEMR).

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.”¹² 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.¹³

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.”¹⁴ And Pacific also

¹² 15 RT 1637:10-14 (Wells). We refer to the Reporter’s Transcript for Phase 2B by its volume, page and line numbers. Thus, 15 RT 1637:10-14 (Wells) refers to Volume 15 of the Reporter’s Transcript, at page 1637, lines 10-14, and to testimony of witness Wells.

¹³ *Id.* at 1638:26-28.

¹⁴ 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.

admits that “where an error occurred outside of the FR books, but in the IEMR calculation process, [Accounting Practices Board Opinion] 20¹⁵ [setting forth the requirement under GAAP that a change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods] does not apply.”¹⁶ 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.”

If the FR books are not used for SEC reporting purposes, and “the Commission has the power to order Pacific to keep its regulatory books in any manner,” and to make changes in the affected year for “material” errors, there is no reason the Commission cannot require Pacific to restate its IEMR for prior periods for California regulatory and ratemaking purposes. The FR books are in essence books the Commission requires Pacific to keep for ratemaking purposes since they have served no other purpose since 1995. Moreover, we find that D.96-05-036 put Pacific on notice that we intended to audit, analyze, and adjust these monitoring reports.

This Commission is not obligated to base its regulatory ratemaking accounting on GAAP or Financial Accounting Standards Board (FASB) pronouncements, and we have rejected the applicability of GAAP and FASB in the past. For example, the Commission contemplated adopting the FCC’s Part 32 Uniform System of Accounts (USOA) for intrastate regulatory accounting in D.87-12-063. One of the perceived benefits of Part 32 was that it accommodated GAAP, while the FCC’s previous USOA Part 32 did not. However, in

¹⁵ Exh. 2B:375.

D.87-12-063, the Commission declined to adopt the Part 32 and GAAP normalization policy, and maintained its own rules. As another example, in D.88-03-072, the Commission found that FASB Statement 87, regarding Employers' Accounting for Pensions, should not be used for intrastate ratemaking purposes and upheld a different methodology - the Aggregate Cost Method (ACM) - as the Commission's pension policy.

For the reasons set forth above, we order Pacific to make changes we require in this decision to its books for the year in which the error occurred and reflect the changes in the IEMRs for the applicable years. With the restated IEMRs, Pacific shall provide schedules that identify each of this decision's adopted adjustments and demonstrate that it has properly reflected the ordered adjustments in its financial reporting for ratemaking purposes.

F. Ratepayer Harm

Pacific claims that even if we find that Overland is correct on many of the disputed audit issues, ratepayers were nonetheless unharmed because NRF severs the link between costs and rates.

Under NRF, services were classified into three categories. Basic monopoly services were classified as Category I services. Discretionary or partially competitive services were classified as Category II services. Fully competitive services were classified as Category III services. The price for each Category I service was fixed except for an annual adjustment equal to the price-cap index. The price for each Category II service could vary within a price ceiling and price floor. The price floor was increased annually by inflation, and the price ceiling

¹⁶ Pacific Opening/Audit at 26.

was revised annually by the price-cap index. Prices for Category III services were provided the maximum flexibility allowed by law.

One of the original elements of the Commission's NRF price cap form of regulation was a sharing mechanism. The sharing mechanism was intended to protect ratepayers from the utility earning excess profits. This was accomplished by establishing a market based rate of return that reflected what a reasonable level of earnings would be, and then adding an additional amount to reflect a "benchmark" rate of return that represented a threshold over which earnings would be shared with, or returned to, ratepayers. The benchmark during the audit period was 11.5 percent. Pacific was required to share profits in excess of its benchmark and up to 15 percent equally between ratepayers and shareholders, and split profits in excess of 15 percent 70-30 between shareholders and ratepayers.

It is true that NRF alters the direct link between a utility's costs and its prices. Under traditional cost-of-service regulation, the Commission calculated Pacific's cost of service, including its cost of capital, and based on that cost determined how much revenue Pacific needed to recover those costs. Costs therefore directly impacted how much revenue Pacific could recover.

However, we still rely on Pacific to maintain accurate expense, revenue and rate of return data and submit correct IEMR information so that we can make many important determinations:

- To ascertain whether exogenous or limited exogenous factor cost recovery treatment is appropriate and, if so, the amount by which rates should change.¹⁷
- To decide when individual service rate increases are justified.
- To resolved 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 1, such as unbundled network elements.¹⁸

Thus, we conclude that TURN is correct in stating that under NRF, “[d]uring a period when revenue sharing is in effect, a reduction in the amount of net revenues shared with ratepayers constitutes a form of economic harm to those ratepayers.”¹⁹ The higher Pacific’s costs as reported in the IEMR, the lower its revenues and ultimately its potentially shareable earnings.

Furthermore, we find that Pacific’s accounting costs do 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. For example, in

¹⁷ We discuss exogenous cost recovery in the section of this decision entitled “Recovery of Audit Costs,” below.

¹⁸ Through purchase of these unbundled network elements (UNEs), Pacific’s competitors are able to use portions of its network to offer their own local telephone service. Pacific’s expert, Dr. Robert G. Harris, claims that the audit pertains to accounting costs and common costs, which do not affect prices. *See* Exh. 2B:350 at 24 (Harris Direct Testimony). However, common costs do impact price-setting, because UNE prices include a mark-up for shared and common costs, and UNE prices in turn affect the prices competitors charge end users. ORA Reply/Audit at 10.

¹⁹ TURN Opening/Audit at 3.

D.99-11-051,²⁰ The Commission increased both price floors and price ceilings for directory assistance and a variety of other services based on studies of the forward-looking cost to provide such services. Thus, even apart from whether expenses are relevant to the issue of sharing, costs directly impact prices in this way.

Finally, it is essential to the regulatory process that we have accurate information regarding the earnings of companies we regulate. Regulated entities often contend that regulations are having an adverse effect on their earnings and their ability to attract capital. We cannot evaluate such claims properly if we lack reliable information regarding utilities' actual earnings, and the expense and revenue figures from which earnings are derived. In addition, regulated utilities may contend that a regulatory scheme is causing their earnings to be so low as to constitute an unconstitutional taking of property. Again, accurate earnings data is essential in order to evaluate such arguments. More generally, although NRF is a scheme in which rates do not necessarily change in response to changes in costs or earnings, accurate earnings reports are a critical tool in our ability to monitor the economic impact of our regulations on NRF carriers.

G. Materiality

Pacific invokes a "materiality" threshold and claims that if a single audit correction is not "material," the Commission essentially should ignore it. However, the only reference to materiality for this audit that we have been able to find appears in the original decision ordering the audit:

The auditor should adhere to generally accepted auditing standards *with the exception that the materiality threshold should*

²⁰ 1999 Cal. PUC LEXIS 776.

be reduced to a scope determined by DRA; the Commission is interested in full compliance with its rules and regulations.²¹

The Commission made clear that it was imposing a low threshold of materiality in order to insure “full compliance with its rules and regulations.” Thus, to the extent ORA found an item to be material, Pacific’s concession allowing “material” restatements to prior years’ financial results²² undermines its argument. Moreover, as TURN points out, even if a single item of adjustment is immaterial, “materiality needs to be considered in context. If the Commission were only considering the impact of a single [small dollar] issue . . . it may not be material. But where, as here, the Commission’s review is likely to result in a cumulative adjustment in an amount that meets anyone’s definition of material, then every issue should be considered, no matter how small in isolation.”²³ We agree.

Overland also discussed the concept of materiality. With regard to affiliate transactions, the audit report stated that it “did not conclude that internal control weaknesses affecting affiliate service transactions had a material impact on Pacific Bell’s Commission-basis financial results during the years 1997 through 1999.”²⁴ By the same token, however, Mr. Welchlin clarified at hearing that an amount not in itself material might rise to the level of materiality if combined with other amounts:

²¹ D.96-05-036, 1996 Cal. PUC LEXIS 657, at *10-11 (emphasis added). DRA is ORA’s predecessor, and this decision predated the Commission’s decision to reassign the audit to TD.

²² Pacific Opening/Audit at 25.

²³ TURN Opening/Audit at 43.

²⁴ Exh. 2A:404 at 12-3 (Audit Report).

Q. And do you believe – and just again focusing on the question of materiality from the standpoint of sharable evenings [sic – should be “earnings”] – . . . that even a \$10 million figure is material if it were to be found?

A. In conjunction with other related issues, a \$10 million or a \$5 million issue, that obviously has to be considered.

Q. How about a \$450,000 issue, would that meet your test of materiality for sharable earnings issues?

A. If it was the only issue in the case, it would not.

Q. 237,000?

A. If it was the only issue in the case, it would not by itself rise to a level of materiality.²⁵

Thus, the auditors recognized that materiality depended on whether one examined an item in isolation or in the context of many other audit adjustments.

Thus, we find that, in combination, the audit corrections Overland identified were sufficiently material to require the changes in Pacific’s reporting that we order in this decision. A correction is material not only because of its impact on shareable earnings. First, as noted above, we use the IEMR and the data upon which it is based for many reasons, rather than only to determine whether ratepayers will share in Pacific’s earnings. Second, even if the issue does not affect the IEMR at a “material” financial level under Pacific’s definition, there may be reasons related to Commission authority and conformity with applicable law and regulation that would lead us to conclude that Pacific committed error. It is too limiting to claim that our rules are designed solely to prevent financial harm to ratepayers. Third, an error with a current small dollar

²⁵ 10 RT 1009:6-19 (Welchlin).

impact during the audit period could cause a large financial impact in subsequent years if not corrected.

Therefore, we reject Pacific's claim that we cannot act on an audit recommendation unless it "materially" (using a definition of materiality without record support) affects shareable earnings.

H. Overland's Qualifications to Perform 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 the contentions 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,²⁶ which included full disclosure of Overland's qualifications to conduct the audit.²⁷ 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.²⁸ With this knowledge in mind, the Commission explicitly authorized TD to hire Overland.²⁹

²⁶ D.00-02-047, *mimeo.*, at 7-8 and finding of fact 6; 2000 Cal. PUC LEXIS 184.

²⁷ Exh. 2A:407, Sections V and VI (Overland Consulting's Proposal to Perform a Regulatory Audit).

²⁸ D.00-02-047, *mimeo.*, at 3 and 7.

²⁹ *Id.*, *mimeo.*, at 10 and conclusion of law 8.

Thus, the Commission itself determined that Overland met the criteria established by D.96-05-036.

The record in this proceeding supports the Commission's decision in D.00-02-047 that Overland was well qualified to conduct the audit of Pacific. Overland's clients are primarily state public service commissions, other state agencies, and regulated utilities. In addition to the California Public Utilities Commission, Overland's previous clients included the Alaska Public Utility Commission, the Arizona Corporation Commission, the Kansas Corporation Commission, the Kentucky Public Service Commission, the New York Public Service Commission, the Oklahoma Corporation Commission and the Wyoming Public Service Commission. Utility clients included Kansas Pipeline Company, Middle South Utilities, and Tele-Communications, Inc. (TCI).³⁰

Overland has extensive experience in auditing regulated telecommunications utilities. For example, Overland has previously conducted audits of (1) US West Communications, Inc., of Minnesota, (2) GTE Southwest Incorporated, (3) New York Telephone, (4) AT&T Communications, and (5) Roseville Telephone Company.³¹

With respect to California utilities, Overland has 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 associated with Pacific Gas and Electric's (PG&E's) pipeline expansion project.

³⁰ Exh. 2A:400 at 3 (Phase 2A, Welchlin Opening Testimony).

³¹ Exh. 2A:407, Section V, Exhibit V-1, at 1-5 (Overland Consulting's Proposal to Perform a Regulatory Audit).

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.³²

We find no merit in Pacific's allegation that none of the Overland personnel who were primarily responsible for the audit were qualified to conduct the audit. Mr. Lubow, who signed the audit report and thereby took ultimate responsibility for the audit, has participated in over 75 audits and testified as an expert witness in over 100 regulatory proceedings.³³

Mr. Welchlin, who was one of Overland's two lead auditors, has more than 20 years of experience as a utility industry auditor and regulatory consultant. His career includes experience as an internal auditor with Illinois Power Company, as a supervising auditor with the Texas Public Utilities Commission, and as a consultant for a variety of regulatory audits involving companies such

³² Exh. 2A:400 at 3 (Phase 2A, Welchlin Opening Testimony).

³³ Exh. 2A:407, Section V, at 7 (Overland Consulting's Proposal to Perform a Regulatory Audit).

as AT&T, New York Telephone, Western Resources, Southern Union Company, SoCalGas, PG&E, and Roseville Telephone Company.³⁴

Mr. Harpster, the other lead auditor, 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.³⁵

Mr. Oetting, who replaced Overland's Mr. Klote in analyzing data request responses and testifying at hearing, has 14 years of experience as an accountant in public and private industry.

Thus, we are satisfied that Overland and its personnel had the necessary expertise to conduct this audit.

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. Overland and its personnel were well qualified to conduct the audit for the previously stated reasons. The one area in which Overland was unable to meet GAAS was where Pacific failed to give it adequate information to allow the auditors to perform their auditing

³⁴ Exh. 2A:400 at 1-2 (Phase 2A, Welchlin Opening Testimony).

³⁵ Exh. 2A:402 at 1-2 & Attachment GCH-1, at 1 (Phase 2A, Harpster Opening Testimony).

function and form a professional opinion based on verifiable data. We discuss instances where this occurred – and related remedies – in the body of this decision. This was not the fault of Overland, but rather a problem of Pacific’s own creation.

Furthermore, the record shows that Overland went to extraordinary efforts to exercise due professional care. The sufficiency of Overland’s efforts is demonstrated by the extensive analysis of issues contained in its audit report and the 1,297 detailed data requests included in the appendices to the audit report. Indeed, while Pacific accuses Overland of not exercising due professional care, Pacific complains about the large number of questions asked and the volumes of data that Pacific was required to produce to satisfy the auditors.³⁶

Finally, we find no credible evidence that Overland is biased against Pacific. The fact that most of Overland’s audit findings are adverse to Pacific is not an indication of bias, but that they created a report based on extensive analysis.

3. GAAS and NARUC Requirements

Pacific also claims that Overland represented to the Commission that it would perform its audit in conformity with certain standards of NARUC, the National Association of Regulatory Utility Commissioners. However, at hearing, Overland’s witness testified that the reference to NARUC standards in its proposal letter was a word processing error that resulted when Overland reused an earlier proposal draft.³⁷ Since the Commission did not require that the audit

³⁶ Exh. 2A:401 at 7 (Phase 2A, Welchlin Reply Testimony).

³⁷ 10 RT 984:1-986:2.

be carried out consistently with any NARUC standards, Overland's claim is credible.

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.” Because the Commission did not require the auditors to follow the NARUC standard, even if it were true that the “client’s requirements” would have allowed such sharing of drafts, the NARUC standard has no relevance here. In any event, Pacific had ample opportunity to dispute the audit findings, both at hearing and in subsequent briefing.

4. Policy Discussions

Pacific also claims 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”³⁸ 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.”³⁹ We therefore interpret our instructions to include more than simply

³⁸ D.96-05-036, 66 CPUC 2d 274, 279 (1996).

³⁹ *Id.*

pointing out errors; rather, we expected the auditors to suggest means of resolving problems.

Furthermore, many of the items Pacific identifies as “lengthy policy discussions” relate directly to accounting measures 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.”⁴⁰ 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.”

5. Overland’s Alleged Errors

Finally, Pacific criticizes errors in Overland’s audit. While there may have been a few errors, they are inconsequential in an audit of this size. As the body of this decision establishes, we have resolved against Pacific many of the claims with which Pacific takes issue.

III. Undisputed Audit Adjustments

Several of the audit findings are undisputed. 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

⁴⁰ Pacific Opening/Audit at 20-21.

expenditures, its charitable contributions, memberships and foundation expense, to name but a few examples.

A chart listing the undisputed items appears as Appendix D to this decision. Pacific shall make all IEMR changes reflected in that Appendix and reflected more fully in the audit report. Pacific shall include in its compliance Advice Letter filing, due within 60 days of the effective date of this decision, schedules that identify each of the undisputed audit adjustments and demonstrate that Pacific has properly reflected the ordered adjustments in its financial reporting.

IV. 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

a. Withholding of “Privileged” Information

Overland found that Pacific understated revenue and overstated expenses “as a result of unsupported and unauditible contingent liability accruals”⁴¹ According to Overland, it was unable to substantiate Pacific’s accruals for contingent litigation and regulatory liabilities. Such accruals, in which Pacific estimates future anticipated expenses related to lawsuits and regulatory proceedings, increase Pacific’s reported expenses and therefore decrease earnings. Because the accruals were not properly documented, Overland states, earnings subject to sharing should have been higher in 1997 and 1998, as well as in 1999 had there been sharing in that year.⁴²

⁴¹ While this issue relates not only to the accuracy of Pacific’s reported revenue but also to its expenses, we place the issue here because Overland treats it as a “revenue and other operating income” issue in its audit report.

⁴² Both the audit report and the supplemental audit report adjust Pacific’s reporting to account for contingent liability accruals. *See* Exh. 2A:404 at 5-13 (Audit Report) and Exh. 2B:415 at S5-1 (Supplemental Audit Report). Our decision on this issue covers all such accruals.

Pacific states that it was not required to furnish information documenting its decisions on how and why to post accruals for these liabilities, on the grounds such information was covered by the attorney-client privilege. While Pacific gave Overland documents from the underlying proceedings (complaints, answers and other major pleadings), it refused to disclose its reasoning behind the accruals, claiming disclosure would waive the privilege. Overland therefore disallowed all such accruals as unauditable, replacing the accrued amounts with actual payouts where available and with nothing where no such payouts had occurred.

We recognize that the California Supreme Court has limited our access to attorney-client privileged information in furtherance of our regulatory duties.⁴³ However, Overland explains and the parties make several arguments claiming that in this case Pacific should have furnished Overland the allegedly privileged information. TURN and ORA argue alternatively that the relevant information is not actually privileged, that Pacific waived the privilege, and that even if the information was privileged, release of it to Overland would not waive the privilege as to the claimants in the relevant legal and regulatory proceedings. We address each of these arguments below.

i. Was the Information “Privileged?”

TURN claims that the information was not privileged at all. Pacific withheld information explaining how Pacific allocated the contingent liabilities among above-the-line and below-the-line accounts and between the intra- (state) and interstate (federal) jurisdictions. These regulatory decisions could not have

⁴³ *Southern California Gas Co. v. Public Utilities Commission*, 50 Cal. 3d 31 (1990).

involved communications between lawyer and client, TURN claims, because they deal with NRF accounting treatment and jurisdictional separations, rather than with legal analysis of the viability of a particular litigation or regulatory claim. Since decisions about such allocations are not “confidential communication[s] between client and lawyer,”⁴⁴ TURN claims, Pacific should have turned over the materials related to these allocations.⁴⁵

Pacific claims the information is privileged, and that any requirement that it release the information to Overland would waive the privilege. Pacific does not separately address TURN’s argument that the information is not privileged because it relates to regulatory accounting rather than legal analysis of the merits of claims against Pacific.

We agree with TURN that this allocation information was not privileged and that Pacific should have turned it over to Overland. Pacific did not allege that lawyers were involved in deciding whether to account for a particular matter above- or below-the-line, or in the state or federal jurisdiction. The audit report makes clear that Pacific failed to produce this allocation information along with the legal analyses.⁴⁶

⁴⁴ Cal. Evid. Code § 954.

⁴⁵ TURN Reply/Audit at 4.

⁴⁶ Exh. 2A:404 at 6-33 (Audit Report) (“Auditing the impact of the accruals on intrastate earnings also requires verifying the accuracy of intrastate separation of the accrual amounts [between the state and federal jurisdictions] and the classification of the accruals between above-the-line and below-the-line accounts. Pacific has not provided the information needed to assess the accuracy of the intrastate separations and accounting classifications reflected in the contingent litigation and regulatory liability jurisdictional adjustments.”).

ii. Did Pacific Waive the Privilege?

TURN and ORA argue that Pacific waived the attorney-client privilege. They claim that Pacific put the reasonableness of its lawyers' advice at issue in this proceeding, thereby waiving the privilege and requiring production of the relevant advice for the sake of fairness: "The person or entity seeking to discover privileged information can show waiver by demonstrating that the client has put the otherwise privileged communication directly at issue and that disclosure is essential for a fair adjudication of the action."⁴⁷ As ORA put the matter, "the information regarding liability estimates that Pacific has refused to provide is *not* protected by the attorney-client privilege because the privilege can not be used both as a sword and a shield."⁴⁸

Where, as here, a party claims its regulatory position is reasonable based on the advice of counsel, but seeks to preclude discovery about that advice, waiver may be implied.⁴⁹ Here, there is no dispute that Pacific claims its contingent liability accruals are reasonable based on the competence of the management team – including the lawyers – making the decisions about such accruals. As Pacific's Mr. Wells testified, "The support for such an assessment

⁴⁷ TURN Reply/Audit at 6, quoting *Southern California Gas Co. v. Public Utilities Commission*, 50 Cal. 3d 31, 40 (1990), citing *Mitchell v. Superior Court*, 37 Cal. 3d 591, 609 (1984).

⁴⁸ ORA Reply/Audit at 12 (emphasis in original), citing *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1162-63 (9th Cir. 1992) ("The privilege which protects attorney-client communications may not be used both as a sword and a shield. [Citations omitted.] Where a party raises a claim that in fairness requires disclosure of the protected communication, the privilege may be implicitly waived.").

⁴⁹ *Id.*

[of Pacific’s accruals for contingent liabilities] is management’s professional judgment, nothing more, nothing less.”⁵⁰ When asked to explain who “management” was in this instance, Mr. Wells explained that, “The primary people making those judgments at Pacific would be the controller and one or two other members of the senior finance staff in conjunction with our legal counsel”⁵¹ It is not reasonable for Pacific to claim the Commission should accept “management’s professional judgment, nothing more, nothing less,” without allowing examination of the basis for that judgment. Thus, we agree with TURN and ORA that a limited waiver of the attorney-client privilege occurred here.

iii. Did the Limited Waiver Waive the Privilege as to Claimants?

Pacific claims it would have waived the attorney-client privilege for all purposes had it given its own analyses to Overland. That is, it claims that the parties suing it or pressing regulatory claims against it would be able to obtain the same contingent liability analyses in discovery if Pacific gave them to Overland.

Pacific cites no authority for the proposition that disclosure to auditors for the express purpose of auditing accruals waives the privilege as to all claimants. Indeed, as TURN and ORA point out, waiver under these circumstances need not be presumed. While the general rule is that disclosure of protected information to any third party constitutes waiver, some courts have created a

⁵⁰ Exh. 2B:334 at 7:16-17 (Wells Direct Testimony).

⁵¹ 15 RT 1657:28-1658:3 (Wells).

“selective waiver” exception under which corporate disclosure of privileged materials to a government agency waives the privilege only as to that agency.⁵²

Thus, we find that Pacific should have turned information about its contingent liability accruals over to Overland. Some information – relating to allocation of dollars above- and below-the-line and across jurisdictions – was not privileged at all. Pacific waived the privilege as to the remaining information by asking the Commission simply to accept the judgment of its management, “nothing more, nothing less,” in making contingent liability accruals. Finally, it is far from clear that disclosure of the information to independent auditors, particularly those auditing on behalf of the Commission, waives the privilege as to claimants. Indeed, as we show next, disclosure to auditors is a standard practice.

b. Standard Practice in Accounting Industry

The evidence at hearing established that auditors normally receive such privileged information as a matter of course. This is standard practice in the accounting industry. During the hearing, a representative of Pacific’s own auditor witness, Deloitte & Touche (Deloitte), made clear that Deloitte generally has access to the client’s privileged information when evaluating contingent liability accruals:

Q. If Deloitte & Touche is auditing a client’s books and is presented with contingent liability, is it Deloitte &

⁵² See *Fox v. California Sierra Financial Services*, 120 F.R.D. 520, 527 (N.D. Cal. 1988); *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1977); *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289 (6th Cir. 2002) (citations omitted). See TURN Reply/Audit at 4 n.8.

- Touche's practice to ask for the underlying documentation supporting the accrual of those contingent liabilities?
- A. If . . . that's necessary to support the accrual, they would ask from the company's attorneys to be able to look at that type of information.
- Q. And would, under certain circumstances, . . . your firm obtain such information under a confidentiality agreement if there is an issue about attorney-client privilege?
- A. Well, we are independent accountants, and . . . we . . . have that confidentiality agreement with . . . the client.
- Q. And so in reviewing these accruals, you, in at least certain cases, obtain attorney-client privileged information in order to verify the appropriateness of the accruals.
- A. Yes.⁵³

Here, by contrast, Pacific concedes it did not give Overland access to such information. Rather, it claims that it was adequate to give Overland publicly available case information (*e.g.*, complaints, answers and other pleadings) and for Overland to do its own independent legal analysis of whether Pacific properly set its accrual amounts.⁵⁴ Pacific claims it made its Controller, Dennis Wells, available for an interview, but Overland states that during that interview, Mr. Wells indicated he had been instructed not to answer questions concerning the substance of the accruals.⁵⁵ Pacific's conduct made it impossible for Overland to carry out the audit in accordance with GAAS.

⁵³ 16 RT 1774:10-1775:22 (Uffelman).

⁵⁴ Pacific Opening/Audit at 41-46.

⁵⁵ *Id.* at 41; Exh. 2B:412 at 6:8-11 (Harpster Reply Testimony).

c. Protecting the Confidential Information

There are adequate means of protecting the confidentiality of the information at this Commission. We routinely hold confidential documents under seal, even if they are admitted at hearing. Pub. Util. Code § 583 makes it a misdemeanor for Commission staff to release information held under seal to third parties. Thus, this is not a case such as *Westinghouse Elec. Corp. v. Republic of the Philippines*, 951 F.2d 1414 (3d Cir. 1991), which Pacific relies on for the proposition that disclosure of privileged information to a government agency waives the privilege. In that case, the information would have been part of the public record, whereas here, it clearly would have been held under seal.

d. Remedy – Contingent Liabilities

Without the privileged information, Overland was unable to verify the correctness of the contingent liability accruals. Indeed, Overland contends it would have violated GAAS for it simply to accept Pacific's claimed accruals without adequate documentation. Nor is there other information in the record justifying those accruals. Indeed, as Mr. Harpster testified, the accruals appeared to be unjustified in the few cases in which he had details.⁵⁶

Thus, we agree with Overland that Pacific's contingent liability accruals were improper for purposes of this proceeding and should be reduced in accordance with the audit recommendation. The unauditable accruals improperly increased intrastate regulated operating expenses by almost

⁵⁶ Exh. 2B:412 at 8:6-9:17 (Harpster Reply Testimony).

\$103 million on an intrastate pre-tax basis during the audit period, with the majority of the accruals occurring in 1997, when sharing was in place.⁵⁷

We note that Pacific did not recognize contingent liabilities for FCC accounting purposes during the audit period because carriers must petition the FCC for permission to record such liabilities and Pacific did not do so.⁵⁸ Thus, our refusal to recognize such liabilities does not place Pacific on a different footing with this Commission from the one it was on with the FCC during the audit period.

In its Supplemental Report, Overland also identified revenue overstatements of \$14.7 million and \$23.1 million for two liability accruals (the percentage of interstate use, or PIU accrual, and the Uniform System of Accounts Rewrite, or USOAR) in 1997 on an intrastate pre-tax basis.⁵⁹ Overland also states that “[i]ntrastate regulated operating revenues are understated by \$40.5 million in 1997 as a result of unsupported and unauditible accruals for regulatory contingent liabilities.”⁶⁰ We also adopt these adjustments for the reasons stated above.

Because FCC rules did not allow contingent liability accruals (absent petition and pre-approval) during the audit period, Pacific’s FCC books contain only claims actually paid. Thus, as ORA points out, the audit adjustment

⁵⁷ Exh. 2A:404 at 6-33 (Audit Report).

⁵⁸ Exh.2A:404 at 6-8 (Audit Report).

⁵⁹ Exh. 2B:415 at S5-1 (Supplemental Audit Report).

⁶⁰ Exh. 2A:404 at 5-13 (Audit Report).

disallowances still allow substantial costs to remain in Pacific's IEMR reports, on the same cash basis the FCC allows.

As shown in Appendix A, we adopt the intrastate regulatory after-tax adjustments of \$52.8 million in 1997, \$1.1 million in 1998, and \$7.0 million in 1999 for Contingent Liabilities-Operating Expense. We also adopt the audit adjustments 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.

2. Uncollectible Revenues and Settlements Expenses

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 settlements with contract billing customers⁶¹ were overstated during the audit period. 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, when Pacific recognized and corrected the problem, rather than in subsequent years, Pacific would have had higher

⁶¹ This discussion appears in the revenue section of this decision because Overland included it in the revenue portion of the audit report.

potentially shareable earnings in 1997, 1998 and 1999. Overland states that intrastate uncollectible revenues were overstated by \$53.5 million in 1997.⁶²

In addition, because Pacific Bell failed to accrue additional uncollectibles for AT&T, MCI, Sprint and other contract billing customers in the year it recognized the RCRMS problems, intrastate uncollectible settlement expenses were overstated by \$42.1 million in 1997, 1998 and 1999.⁶³ In total, according to Overland, audit period net operating income was overstated by \$78.5 million as a result of Pacific's failure to properly account for uncollectibles caused by problems with RCRMS.⁶⁴

The dispute is over when Pacific should have accrued the additional uncollectible revenue and settlement expenses – in 1996, when the RCMRS 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 1996,⁶⁵ 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.

While Pacific's bad debt write-offs rose significantly in November and December 1996 – a fact ORA's witness Michael Brosch found to be evidence that

⁶² Exh. 2A:404 at 5-17 (Audit Report).

⁶³ *Id.*

⁶⁴ This amount represents uncollectible revenues of \$53.5 million, which Pacific Bell reports on a flow through basis for tax purposes, plus settlement expenses of \$42.1 million, less income tax expense of \$17.1 million.

⁶⁵ Pacific Opening/Audit at 47.

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.

We find Pacific's claim unpersuasive. It assumes that Pacific only paid attention to its uncollectibles figure annually rather than focusing on month-by-month performance. We cannot believe that Pacific took such a casual approach to its uncollectibles, which are bad debts that it will never recover. Were it to only examine these figures annually, we would have real concerns about the extent to which Pacific is monitoring its bad debts.

Moreover, 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 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.

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.⁶⁶

In contrast, the rate of bad debt increased 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

⁶⁶ See Exh. 2B:369.

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.⁶⁷

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. Pacific should make the recommended audit adjustment and restate its 1996 books as well. The adopted intrastate regulatory after-tax amounts are \$16.6 million in 1997, \$7.8 million in 1998 and \$512,000 in 1999. We also adopt the audit adjustment of \$53.5 million in 1997 for uncollectible revenues on an intrastate regulatory after-tax basis.

3. Other Revenue/Operating Income Issues - 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,"⁶⁸ and began recognizing revenue and expense when the directory is issued. Overland stated it could not determine whether the change

⁶⁷ Exh. 2B:120 at 14:3-19 (Brosch Opening Testimony, citing Pacific's discovery responses).

⁶⁸ Pacific Opening/Audit at 50.

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, but we do not find that the audit establishes there were effects in 1997 for which Pacific did not 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, 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, rather than charging such costs to expense.⁶⁹ 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.⁷⁰

Overland also 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

⁶⁹ 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).

⁷⁰ Exh. 2B:415 at S6-2 (Supplemental Audit Report).

interstate jurisdiction.”⁷¹ Overland cited a May 1998 FCC order in support of its conclusion.⁷² Using a jurisdictional separations approach, Overland found that Pacific never should have reported LNP costs as intrastate expenses on its IEMR.

Pacific contends the issue only involves state-federal jurisdictional separations: “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].”⁷³ Once the FCC decided that LNP costs should be characterized as 100% interstate, Pacific contends, the costs should have moved off the IEMR books and onto the federal books. Pacific agrees that the FCC’s May 1998 order should have triggered this change.⁷⁴

We find that both arguments have merit, and adopt a hybrid approach. Consistent with Statement of Financial Accounting Standards (FAS) No. 71,⁷⁵ which relates to deferral of costs as a regulatory asset, we find that Pacific should have deferred the LNP costs as a regulatory asset as of April 1996. In that month, the Commission issued D.96-04-052, promising Pacific a true-up for recovery of past costs related to interim number portability (INP). We find that this decision

⁷¹ *Id.* at S6-1.

⁷² *In the Matter of Telephone Number Portability*, CC Docket No. 95-116, *Third Report and Order*, FCC 98-82 (rel. May 1998).

⁷³ Pacific Opening/Audit at 53.

⁷⁴ *Id.*

⁷⁵ 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.

gave Pacific adequate certainty of future cost recovery to trigger an obligation to defer LNP expenses as a regulatory asset at that time.

Moreover, Pacific never should have reported any LNP expenses in the intrastate portion of its IEMR, because as of May 1998, the FCC provided that carriers could recover such costs entirely from interstate (non-California) rates. Any later expense recovery should have happened exclusively at the federal level, and never should have affected Pacific's California expenses.

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

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 no impact on earnings, the difference between an expense and a regulatory asset is significant in terms of Pacific's IEMR.

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 order⁷⁶ concluding its investigation of the long-term number portability tariff transmittals.

Pacific also claims that to defer LNP costs would have violated FAS 71's two-part requirements for deferring costs as a regulatory asset. Paragraph 9 of the FAS 71 requirements provides that a regulated enterprise shall capitalize

⁷⁶ 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*, CC Docket No. 95-35, *Memorandum Opinion and Order*, FCC 99-158, ¶ 1 (rel. July 16, 1999).

(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.

Pacific appears to contend that FAS 71 requires not only that the costs being deferred be “probable” of recovery, but also that the precise amount of recovery be known at the time of deferral. 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.

TURN contends that since the term “probable” only appears in paragraph (a) of FAS 5, only paragraph (a) should be read into FAS 71. Since paragraph (a) of FAS 5 only requires that it be probable that an asset has been impaired or a liability incurred, it follows that FAS 71 only requires that it be probable that all

or part of the cost recovery will be allowed. FAS 71 does not require that it be probable that the full amount of costs incurred will be recoverable. Rather, TURN contends, “if *any* amount is probable of recovery, [FAS] 71 mandates creation of a regulatory asset.”⁷⁷

Pacific, on the other hand, contends that FAS 71 also requires that management be able reasonably to estimate the amount of loss. If it was never probable from the FCC decisions or other regulatory action that Pacific would recover *all* of its costs, Pacific claims, it was never appropriate to defer a regulatory asset of any amount. Indeed, Pacific claimed it could only make such deferral once it had a “rate order” specifying precisely the amount it would recover.

TURN contends that a rate order is not the only assurance of recovery, and that Pacific’s own cited reference provides four types of evidence – and not just a rate order – that could support future recovery and thus establishment of a regulatory asset.⁷⁸ It also asserts that Pacific’s approach would effectively write the “all or part” language out of FAS 71, which provides that, “a regulated

⁷⁷ TURN Opening/Audit at 9.

⁷⁸ See Pacific Opening/Audit at 63. Pacific also cites an SEC staff “frequently asked questions” (FAQ) sheet regarding deferral of regulatory assets in support of its claim that a utility must have assurance of complete cost recovery for each element of costs before it may defer a regulatory asset. Pacific Opening/Audit at 60, citing *SEC Division of Corporate Finance, Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*, March 31 2001, cited in Exh. 2B:337 (Uffelman Reply Testimony). As TURN points out, this document, identified as staff guidance that does not bind the SEC, applies on its face only to electric utilities, and contains ambiguous language (“[A] utility may defer certain costs of providing services if the rates established by its regulators are designed to recover the utility’s specific costs . . .”). TURN Reply/Audit at 11-14. The document does not change our conclusion.

enterprise shall capitalize *all or part* of an incurred cost” Thus, even if only “part” of the cost was probable of recovery, that “part” should be capitalized.

We agree with TURN’s analysis. It was not necessary under FAS 71 that every single dollar of cost, and every single cost category, be probable of recovery. Rather, the more sensible interpretation of FAS 71, and the related pronouncements in FAS 90 and FAS 5, is that once it became probable that Pacific would be able to recover a category of LNP costs, it should have deferred those costs as a regulatory asset. Pacific’s approach – that it should assume it would recover zero costs and record no asset as long as it was not guaranteed recovery of 100% of the costs – is unreasonable.

As for timing, we agree with TURN 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.”⁷⁹ In April 1996, our D.96-04-052⁸⁰ ordered Pacific to file tariffs for the wholesale provision of “interim number portability” (INP), set wholesale rates for INP and promised a true-up of past billings – including a surcharge benefiting Pacific – if, once rates were set, revenues did not match the associated costs. We directed Pacific to establish a memorandum account to facilitate the future true-up. While we changed the method for calculating such costs over time,⁸¹ our 1996 decision set up a framework making clear that Pacific would recover its costs of number portability.

⁷⁹ TURN Opening/Audit at 15.

⁸⁰ 65 CPUC 2d 542 (1996), 1996 Cal. PUC LEXIS 272.

⁸¹ See D.97-10-029, 76 CPUC 2d 11, 18-19 (1997) (modifying INP rates adopted in

We find that all the prerequisites for Pacific to defer the LNP costs as a regulatory asset were in place no later than April 1996.

c. Jurisdictional Separations

Because we adopt a hybrid approach, the foregoing conclusion does not conclude the inquiry. We also 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.

As noted previously, 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. . . .”⁸² Thus, Pacific should not have reported any intrastate LNP costs on its IEMR after issuance of the May 1998 FCC order.

d. Conclusion – LNP Costs

In summary, Pacific should have: 1) deferred LNP costs as a regulatory asset as of April 1996, when this Commission issued D.96-04-052, and 2) charged all LNP expense to the federal jurisdiction as of the FCC’s May 1998 order on LNP cost recovery. 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 \$14.5 million in 1997, \$32.8 million in 1998 and \$43.5 million in 1999. The adjustment for LNP

D.96-04-052 [1996 Cal. PUC LEXIS 272] to reflect total service long run incremental costs (TSLRIC) rather than direct embedded costs).

⁸² 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. Removing such cost from expense would have raised the amount of earnings subject to sharing in those years. As with the LNP issue, a FAS 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 FAS 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 FAS 71 regulatory asset deferral requirement was met even earlier than does the audit. The audit relies on a 1998 Commission decision, D.98-11-066,⁸³ as the basis for creating a regulatory asset. TURN, on the other hand, claims that earlier Commission decisions are as least as relevant as the 1998 decision. TURN states that “[a]s of the issuance of D.96-03-020⁸⁴ [in 1996], it was probable that Pacific Bell would recover some amount greater than zero.

⁸³ 1998 Cal. PUC LEXIS 978.

⁸⁴ 1996 Cal. PUC LEXIS 257.

And under SFAS 71, a regulatory asset should have been established.”⁸⁵ 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. . . .⁸⁶

In D.97-04-083, the Commission established Pacific’s opportunity to recover the incremental costs of implementing intraLATA equal access – the ability to place local toll calls through another telephone carrier without having to dial additional numbers – using cost categories described in an FCC order.⁸⁷ The Commission approved Pacific’s cost estimate, subject to subsequent true-up and reduction if Pacific’s estimates turned out to be excessive or unreasonable.⁸⁸

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.⁸⁹

We agree that each of the decisions TURN cites should have caused Pacific to defer a regulatory asset for local competition implementation costs incurred

⁸⁵ TURN Reply/Audit at 17-18.

⁸⁶ D.96-03-020, 1996 Cal. PUC LEXIS 257, 65 CPUC 2d 156, 167 (1996).

⁸⁷ D.97-04-083, 1997 Cal. PUC LEXIS 495, 72 CPUC 2d 290, 303 (1997).

⁸⁸ *Id.* at 305-06.

⁸⁹ D.98-11-066, 1998 Cal. PUC LEXIS 978, 83 CPUC 2d 183, 193-94 (1998).

during the audit period. By contrast, Pacific never did so, and left all local competition costs on its books as expenses. Pacific argues, much the same as it did with regard to LNP expenses, that until it is guaranteed complete recovery of all of its costs, it should expense those costs rather than deferring them as a regulatory asset.⁹⁰

Pacific claims that D.96-03-020,⁹¹ D.97-04-083⁹² and D.98-11-066⁹³ provided it no assurance of cost recovery. It also claims that a later decision – D.00-09-037⁹⁴ – approving a settlement regarding the actual costs Pacific would recover, likewise 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.

We reject Pacific’s position, as it would render FAS 71 a nullity, and would cause a utility to expense every possible regulatory liability until it was guaranteed recovery of every cent it spent on the project at issue. By its terms, FAS 71 is broader than that; it does not require certainty and anticipates that a utility should project future events in appropriate cases. We reject Pacific’s overly narrow construction.

⁹⁰ Pacific Opening/Audit at 63-64.

⁹¹ 1996 Cal. PUC LEXIS 257.

⁹² 1997 Cal. PUC LEXIS 495.

⁹³ 1998 Cal. PUC LEXIS 978.

⁹⁴ 2000 Cal. PUC LEXIS 697.

Under the FAS 71 standard we discuss in connection with LNP costs, we find that Pacific should not have expensed the audit amount of \$49 million on an intrastate pre-tax basis for the audit period. As a result, actual earnings in 1997 and 1998 were higher than Pacific reported. We direct Pacific to restate its 1997 and 1998 IEMRs to remove local competition implementation costs of \$24.3 and \$4.7 million respectively on an intrastate regulatory after-tax basis as shown in Appendix A.

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. 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 Bell Total Company basis both in 1998 and 1999,⁹⁵ 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 ratepayer 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

⁹⁵ See Pacific Opening/Audit at 67; ORA Opening/Audit at 31.

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 approach to the accruals. Overland assumed that Pacific would have realized 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.⁹⁶

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 adjustments for both 1998 and 1999, respectively, on an intrastate after-tax regulatory basis as shown in Appendix A.

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

⁹⁶ For a detailed discussion of these issues, *see* Exh. 2B:120 at 16-25 (Brosch Opening Testimony).

obligation to make quarterly payments for the contract period (October 1, 1999 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.⁹⁷

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. Overland recommends reducing Pacific's 1999 expenses by \$44.5 million on an intrastate pre-tax basis.

Pacific contends that it canceled that 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 32,⁹⁸ 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.⁹⁹ We find Overland's opinion on this issue more credible than Pacific's. Overland provides

⁹⁷ Exh 2A:404 at 6-31 (Audit Report).

⁹⁸ 47 C.F.R. § 32.1330.

⁹⁹ Exh. 2B: 336 at 14 (Uffelman Opening Testimony).

a direct citation to FCC Part 32 rules, whereas Pacific makes only a general reference to FCC Part 32.

Moreover, we agree with Overland's view that Pacific should have recorded a prepayment rather than an expense. The buy-out was made through an amendment to the contract. Pacific did not enter into a new contract, but rather restructured its original contract, retaining all essential details of the original deal except the payment term.

Therefore, we adopt the Pacific Total Company audit adjustment amount (pre intrastate separation and pre-tax) of \$55.7 million. The intrastate regulatory after-tax audit adjustment adopted is \$26.3 million for the year 1999 as shown in Appendix A. We direct Pacific to restate its 1999 Commission regulatory books to reflect the proper accounting for this transaction.

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." 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. Because we have already decided that GAAP does not preclude retroactive changes to the

IEMR books,¹⁰⁰ we agree with Overland that the books for the years in which Pacific made accruals should be changed to reflect actual payout amounts. The sum of the intrastate before-tax audit adjustments for the audit period totaled \$29 million. The adopted intrastate regulatory after-tax audit adjustments are \$20.4 million in 1997, -\$24.1 million in 1998, and \$20.8 million in 1999 as shown in Appendix A.

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.”¹⁰¹ 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.”¹⁰²

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.

¹⁰⁰ See Section entitled “Pacific’s Books and Generally Accepted Accounting Principles,” above.

¹⁰¹ Exh. 2A:404 at 6-13 (Audit Report).

¹⁰² Pacific Opening/Audit at 73.

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 employee 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. 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 1997."¹⁰³ 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. Rather, this expense should be written off or charged below-the-line in a way that does not affect ratepayers. We adopt Overland's recommendation to reduce 1997 expenses by \$5.7 million on an intrastate after-tax basis as shown in Appendix A.

2. Other Employee Benefits Issues

Overland suggests that the Commission require Pacific 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

¹⁰³ ORA Reply/Audit at 24.

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, especially in view of evidence in the record that SBC inappropriately loads many administrative costs onto Pacific's ratepayers. 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-Intrabuilding Network Cable Amortization

The audit report proposes an adjustment to correct errors admitted by Pacific in its accounting for amortization of its intrabuilding network cable investment. 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.¹⁰⁴ He claimed Pacific did not have "depreciation freedom" that would have allowed it to make the depreciation adjustments in prior years.¹⁰⁵ He claimed that Pacific only gained depreciation freedom in connection with D.98-10-026,¹⁰⁶ in which the Commission "chose to discontinue reviewing depreciation rates and accruals."¹⁰⁷ However, he cited no prior Commission authority that would have prohibited Pacific from coming to the Commission, revealing its error, and seeking permission to restate prior years' IEMRs in order to reflect depreciation expense accurately in the affected years.

We adopt the audit's approach, and find that Pacific overstated expenses in 1997 as a result of its catch-up accrual. Pacific shall also adjust and refile its IEMRs for 1994-96 within 60 days of the effective date of the decision. We do not find that GAAP is relevant to our requirement that Pacific restate its IEMR retroactively. As shown in Appendix A, the intrastate regulatory after-tax audit adjustments are \$19.5 million in 1997 and \$16.6 million in 1998.

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

¹⁰⁴ 12 RT 1263:2 – 1265:3 (Hayes).

¹⁰⁵ *Id.* at 1271:11 – 1272:3.

¹⁰⁶ 1998 Cal. PUC LEXIS 669.

¹⁰⁷ 12 RT at 1282:18-26 (Hayes).

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. 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 adopt 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 1999 as shown in Appendix A.

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. As it did with its contingent liability accruals, Pacific contends its accruals depend only on “management’s professional judgment - nothing more, nothing less.”¹⁰⁸

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. It is not acceptable for Pacific simply to say “trust us” and to ask us to accept on faith that Pacific has complied with our rules and policies and not harmed ratepayers.

¹⁰⁸ Pacific Opening/Audit at 80.

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.”¹⁰⁹ Pacific should amend its books for the period in which the transaction occurred if the transaction was “material,” as we define that term in this decision. Even Pacific does not disagree with this premise; it only disagrees as to the meaning of the term “material.” As we stated in the order commencing the audit, materiality was in the eyes of ORA, but ultimately up to the Commission to decide.

Moreover, even if the change was not material in the period in which the transaction occurred, we do not agree with Pacific that GAAP prohibits the Commission from making a retroactive change to Pacific’s regulatory books in the prior period. These IEMR books are regulatory accounting records required by the Commission, and if a catch-up transaction in a later year skews earnings inappropriately in that year, we believe it is more appropriate to amend the books in the year in which the transaction first occurred.

Thus, in this instance, we agree with Overland that Pacific should have reversed out the sales and use tax accruals in the period in which it originally recorded them, rather than in later periods. We adopt the intrastate regulatory pre-tax audit amount of \$857,000 for the audit period. The intrastate after tax audit adjustments are \$461,000 in 1997, \$457,000 in 1998, and -\$1.4 million in 1999 as shown in Appendix A.

¹⁰⁹ *Id.* at 81.

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.

Once again, Pacific corrected an error from a prior period in a subsequent year and skewed actual earnings in the later year. While we have decided that we cannot reopen the issue of whether Pacific should have been sharing earnings with ratepayers in 1999, we still believe it is consistent with our decision in other respects to require Pacific to make the change to the pre-1999 books. This change will result in the recording of greater expense amounts in 1998 and prior periods. As we have said in other contexts, the Commission may require retroactive changes to the IEMR books, which serve Commission regulatory purposes, regardless of GAAP. The \$9.7 million is the Pacific Bell Total Company amount. The corresponding amount on an intrastate regulatory after-tax basis is \$4.3 million as shown in Appendix A.

4. Excess 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.¹¹⁰

The parties agree there was an error in Pacific's Excess Deferred Tax amortization, so again the only disagreement is over how to account for the

¹¹⁰ Exh. 2A:404 at 9-22 (Audit Report); Exh. 2B:415 at 9-6 (Supplemental Audit Report).

error. Once again, Overland suggests reflecting the change in the affected year, while Pacific supports making the correction in the year it discovered the error. (Pacific made a correcting entry in November 2000.) As we discuss in several other places in this decision, we disagree with Pacific that GAAP prohibits us from requiring it to make adjustments in the affected year.¹¹¹ This adjustment lowers Pacific's 1998 and 1999 intrastate after-tax expense by an average of \$29.6 million per year as shown in Appendix A. We will require Pacific to adjust the IEMR for the pertinent years to reflect this change. The rate base adjustments are \$12.8 million in 1998 and \$38.4 million in 1999.

5. Ameritech Severance Accrual

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. The severance accrual occurred when SBC terminated Pacific Bell employees as a result of SBC's merger with Ameritech.¹¹² 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 \$8.0 million because Pacific should have booked these expenses below-the-line. Overland recommends that Pacific's 1999 IEMR income tax expense be reduced by \$8.0 million. Overland also recommends that Pacific's 1999 intrastate operating deferred income tax expense be reduced by \$8.0 million.

¹¹¹ See Section entitled "Pacific's Books and Generally Accepted Accounting Principles," above, for the most detailed discussion.

¹¹² Exh. 2A:404 at 9-22 (Audit Report).

Pacific agrees with Overland that it overstated its 1999 current intrastate operating income taxes by \$8.0 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 effects on a consistent basis, below-the-line. We direct Pacific to restate its 1999 Commission books to remove the current period and deferred income tax effects associated from the severance accrual from its above-the-line accounts. The intrastate regulatory after-tax amount is \$8.0 million as shown in Appendix A.

F. Net Plant

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.

We agree with Overland that Pacific's practices reflect internal control problems and also skewed Pacific's financial reporting. We base this conclusion on the three documents in combination, rather than on any one standing alone, as we explain in detail below.

**a. 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 audit findings were significant: 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 continuing 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.¹¹³

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.

¹¹³ 12 RT 1288:18-1289:14 (Hayes).

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.

Nonetheless, the fact remains that the FCC did not pursue the audit. Therefore, we decline to use the FCC audit alone as a basis to adopt the audit recommendation. However, the audit provides corroborative evidence of a serious problem with Pacific's record-keeping, as the next two documents reveal.

b. 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."¹¹⁴

Once again, the 1999 computer inventory provides evidentiary support for Overland's conclusion that Pacific lacks adequate controls over its plant and property records. While Overland notes that its supposition that Pacific is failing to record property retirements is "unproven," the audit nonetheless reveals a serious mismatch between the property Pacific reported and the property it actually had in inventory.

c. SAVR Retirements

A third document also corroborates Overland's concerns with Pacific's plant internal controls. In May 1997, Pacific carried out its own Statewide Asset

¹¹⁴ Exh. 2A:404 at 10-17 (Audit Report).

Verification and Retirement Project (SAVR) to audit its central office property records.¹¹⁵ 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.

We find the SAVR audit provides the most compelling evidence for Overland's conclusion that 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. We adopt Overland's audit recommendations discussed below on this basis.

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

¹¹⁵ See *id.* at 10-12.

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. 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 throughout this decision. Thus, we reject Pacific's position and adopt Overland's adjustments in connection with SAVR delayed retirements.

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.¹¹⁶

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 believed Pacific either charged the equipment to expense when it acquired it or originally lumped it in with other continuing property record items.¹¹⁷ According to Overland, it was also inappropriate for Pacific to record depreciation expense on the "reverse-retired assets" when Pacific could not show that it incurred any costs

¹¹⁶ *Id.* at 10-13.

¹¹⁷ *Id.* at 10-15.

for these assets. We agree that unless Pacific can show what the costs of the assets are, Overland's approach is more reasonable.

Based on Overland's logical explanations for the plant failing to appear in Pacific's records, allowing Pacific to depreciate the assets anew would double depreciation expense. Overland proposed disallowing this additional depreciation expense altogether. We agree with Overland's approach, and adopt its recommendation on reverse retirements.

We also agree with Overland that Pacific's "reverse retirement" procedure has no basis in the FCC Uniform System of Accounts (USOA) and thus was improper. Pacific contends that it may make an accounting adjustment – even if not spelled out in the USOA – as long as the "USOA does not preclude such accounting."¹¹⁸ While it is ultimately up to the FCC to decide this, for our purposes we question Pacific's decision – without FCC consultation or other authoritative basis – to allow itself an accounting device not written down in any approved rule or procedure.

Nor are we persuaded that Pacific's "reverse retirement" process is defensible simply based on Pacific's claim that it was "systematic and rational." When asked to explain what it meant by this phrase, Pacific's witness stated merely that it "didn't just pick a number at random," and that the reversal was "tied to the value of the asset [and] . . . to the appropriate depreciation rates that were in effect at that time."¹¹⁹ While this may be true, it does not change the fact that Pacific took it upon itself to create an accounting adjustment based on its

¹¹⁸ Pacific Opening/Audit at 89.

¹¹⁹ *Id.* at 87, citing 12 RT 1290 (Hayes).

own subjective assessment that the adjustment was appropriate. Because we do not believe this is an appropriate policy for California regulatory purposes, we deny Pacific's "reverse retirement" accounting adjustments.

Therefore, we adopt all audit recommendations with regard to Pacific's property records. The intrastate regulatory after-tax audit adjustment of \$5.9 million in 1997 and \$4.2 million in 1998 for the SAVR delayed retirements and \$272,000 in 1997, \$615,000 in 1998 and \$2.3 million in 1999 for the SAVR reverse retirements are adopted as shown in Appendix A. We also agree with the audit's conclusion that Pacific demonstrates problems with plant internal controls. The parties should address how to remedy these problems in Phase 3B.

2. Other Net Plant Issues

a. Restructuring Reserve Adjustment

Overland states that intrastate net plant is overstated by an average of \$29.0 million as a result of an error in Pacific Bell's Restructuring Reserve IEMR ratemaking adjustment. 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."¹²⁰

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

¹²⁰ Exh. 2B:415 at S10-3 (Supplemental Audit Report).

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 amounts were keyed in with the wrong sign,"¹²¹ 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 that intrastate net plant be reduced by \$29.0 million in each of the three audit years as shown in Appendix A.

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. We agree. Pacific should reflect this adjustment in the compliance Advice Letter filing it is to make within 60 days of the effective date of this decision.

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 and does not logically implement the method adopted for Pacific in Resolution RF-4, which the Commission adopted on November 18, 1980.¹²² As a result, 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.

¹²¹ Pacific Opening/Audit at 90.

¹²² A copy of the Resolution is included in Overland's Audit Report (Exh. 2A:404) as Attachment 10-9.

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.

Pacific agrees that perhaps the intrastate AFUDC rates used by Pacific are overstated but maintains that it has consistently applied the Commission's methodology for the past 20 years. However, Pacific did not provide any Commission ruling or order authorizing the methodology Pacific employs to implement the Resolution RF-4 AFUDC calculations. Pacific contends that if the Commission now determines that this historic method is no longer appropriate, it may only apply the change prospectively, and not retroactively. Pacific maintains that under D.98-10-026,¹²³ authorizing economic depreciation, the

¹²³ 1998 Cal. PUC LEXIS 669.

Commission could prospectively allow Pacific to use the same AFUDC rates for intrastate purposes that it uses for interstate and external reporting.

We agree with Overland and find that Pacific's implementation of Resolution RF-4 AFUDC calculation methodology does not comply with the Resolution, has led to unreasonable AFUDC rates, and has overstated Pacific's intrastate telephone plant in service. The AFUDC calculation form in Resolution RF-4 requires a capital ratio equal to 100 percent. Pacific's calculations that result in a capital ratio in excess of 100 percent are unreasonable and do not comply with the Resolution.

We adopt Overland's recommendation to adjust Pacific's intrastate rate base downward by \$2.3 million in 1997, \$8.4 million in 1998, and \$13.0 million in 1999 and depreciation expense downward by \$105,000 in 1997, \$389,000 in 1998 and \$507,000 in 1999. Pacific shall restate its Commission financial statements for the affected periods to reflect the adopted adjustments. Pacific shall also use the Resolution RF-4 AFUDC methodology, as clarified in this decision, for the years 2000-02. We adopt Pacific's recommendation to use the FCC's AFUDC rate beginning with the year 2003.¹²⁴

d. PBOP Pre-Funding Plant Adjustment

Overland states that Pacific's intrastate net plant is understated 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. Overland states Pacific should have expensed the contributions as it did for FCC

¹²⁴ 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).

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 2A, where we find that Pacific should have expensed PBOP pre-funding contributions in accordance with Overland's audit recommendation. We find that the PBOP pre-funding contributions raised here should receive the same treatment as the PBOP pre-funding contributions we address in Phase 2A, on the same grounds as set forth in the Phase 2A decision. Therefore, we adopt Overland's recommendation of a rate base adjustment of 13.3 million for each of the three audit years as shown in Appendix A.

G. Other Rate Base Items

1. Cash Working Capital

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 Pacific 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.) 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.¹²⁵

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 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.¹²⁶ 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.¹²⁷

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

¹²⁵ TURN Opening/Audit at 30-31; Exh. 2A:404 at 11-5 (Audit Report).

¹²⁶ 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.

¹²⁷ Exh. 2B:415 at S11-5 (Supplemental Audit Report).

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.”¹²⁸

Given Overland’s changed conclusion that the working capital averaged \$3 million per year (rather than \$149 million), the audit recommendation and the ORA/TURN position advocating a figure of zero are no longer that far apart. TURN believes that zero is the more reasonable figure “given the considerable doubt that the record creates as to the accuracy or reasonableness of the utility’s cash working capital calculations.”¹²⁹

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, a 1968 Commission document, precludes the changes the audit, ORA and TURN advocate for the audit period. 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.”¹³⁰ Moreover, in D.94-02-042, the Commission pointed out that, “The procedures set forth in

¹²⁸ TURN Opening/Audit at 31.

¹²⁹ *Id.*

¹³⁰ D.95-12-055, 63 CPUC 2d 570 (1995), 1995 Cal. PUC LEXIS 965, at *120.

Standard Practice U-16 serve only as a guide. They do not preclude deviations appropriate to special circumstances.”¹³¹

Thus, the Commission has clarified that both a regulated entity and the Commission itself may find that “special circumstances” exist to deviate from Standard Practice U-16. We find that such special circumstances exist here. Pacific’s lead-lag studies are seriously out-of-date. None of the approximately 20 items of expense lag have been updated since 1988.¹³² Pacific conceded that the volume of relevant transactions was substantially higher in 1997-99 than in 1988, which may affect the lead lag calculations.¹³³

There are several other reasons why the current Pacific cash working capital calculation is flawed and it is appropriate under these special circumstances to set Pacific’s cash working capital requirement at zero. First, Pacific assumed unreasonably lengthy periods for payments to it by its affiliates, from 669 days in 1997 to 115 days in 1999.¹³⁴ That is, it assumed that its own affiliates would take, *on average*, at least four months, and as much as twenty-two months, to pay Pacific. Pacific’s witness on the subject stated he believed he had the data available to calculate the lag if Pacific disagreed with

¹³¹ D.94-02-042, 53 CPUC 2d 215, 1994 Cal. PUC LEXIS 82, at *42.

¹³² 16 RT 1808:17-21, 1809:5-8 (Ellis).

¹³³ *Id.* at 1809:9-1810:9.

¹³⁴ Exh. 2A:404 at 11-13 (Audit Report).

Overland, but he did not make the calculation.¹³⁵ Nonetheless, he claims, based on no contrary evidence, that Overland is incorrect.¹³⁶

We find that Pacific failed to refute Overland's audit finding that the assumed revenue lag for affiliate payments to Pacific was far too great. This fact calls into question the usefulness of Pacific's claimed lag, and provides further evidence in support of setting the cash working capital requirement at zero during the audit period.

Second, Overland found that Pacific overstated Directory's cash working capital requirements due to a 1996 change in the way Pacific accounted for the costs of publishing directories. Prior to 1996, Directory amortized the publishing costs over the directory billing period, and also recognized revenues as they were billed. Thus, there was a fairly close match between revenues and expenses. After the change, Directory began charging all publishing costs to expense when the directory was issued, and also accrued all of the revenues for the directory on the issue date. However, the revenue recognized on the issue date exceeds the publishing costs by a significant margin because publishing costs represent only approximately 20 percent of Directory's total revenues. Overland concluded that it was more reasonable to continue treating the directory revenues consistent with a service rendered to customers on a monthly basis, rather than on directory issue date.

Pacific claimed that "when the directory is published, the service has been delivered," and as a result it was logical to assume the customer is obligated to

¹³⁵ 16 RT 1811:24-27, 1813:10-12 (Ellis).

¹³⁶ See Exh. 2B:338 at 22:1-7 (Ellis Direct Testimony).

pay the full amount at publication. However, Pacific's witness acknowledged that directories do not always remain in service for the period anticipated, and that customers are obligated to pay only as long as the directory is active.¹³⁷ Moreover, Pacific recognizes the revenue at publication even though the vast majority of customers do not pay their bills at that time. Rather, customers pay month-by-month after the directory is issued, and for the full in-service life of the directory, regardless of how long Directory initially intended for it to be in service.¹³⁸

Thus, it is not always correct for Pacific to assume that it knows – or receives – the full amount of the revenue stream at publication, and to record that revenue at that time. Once again, then, Pacific's lag assumptions prove to be wrong, favoring TURN's conclusion that we assume Pacific's cash working capital requirement to be zero.

Third, as ORA points out, there are problems in including “non-cash” items such as depreciation in cash working capital, since these expenses do not actually require Pacific to make a cash outlay. If “[t]he reason for allowing cash working capital in the rate base is to compensate investors for funds provided by them which are permanently committed to the business for the purpose of paying operating expense in the advance of receipts of offsetting revenues,”¹³⁹ it is not at all clear that non-cash expenses such as depreciation qualify for such treatment. As ORA explains, “[d]epreciation expenses and other non-cash items

¹³⁷ 16 RT 1817:6-22, 1822:1-1823:24 (Ellis).

¹³⁸ *Id.* at 1820:2-1822:4.

¹³⁹ ORA Reply/Audit at 29, quoting Standard Practice U-16 at 1-2.

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.”¹⁴⁰

Excluding non-cash items from cash working capital requirements actually brings that requirement to a negative (below zero) figure. As ORA explains, “[a]fter recognizing the various Audit Report adjustments, the elimination of these non-cash items would reduce Overland’s \$3 million average [cash working capital] requirement by about \$183.3 million to a negative \$181 million.”¹⁴¹ ORA therefore claims – and we agree – that its proposal to set the requirement at zero is actually quite conservative, since it reduces the working capital requirements by less than the amount required to make the working capital figure a negative number.

Pacific relies only on lead-lag studies it concedes are out-of-date to refute the conclusion that the lead-lags should be set at zero. In the end, both Overland and ORA conclude that the actual cash working capital requirement for the audit period is close to zero.

This is not to say that we should not take a different approach to the cash working capital requirement in the future. It may well be that Standard Practice U-16 is far too complex and requires examination. Pacific may also be able to support its assumptions in future periods. However, we find that for the audit period, it has not done so, and that the more accurate assumption is that its cash

¹⁴⁰ ORA Reply/Audit at 29, 32, citing Exh. 2B:122, Q&A 20 (Carver Direct Testimony).

¹⁴¹ ORA Reply/Audit at 33, citing Exh. 2B:122 at 17 (Carver Direct Testimony) (emphasis omitted).

working capital is zero. Furthermore, we will assume that Pacific's cash working capital requirement should remain at zero in the years after the audit period (commencing in 2000) until Pacific can demonstrate that it has updated each of its lead-lag studies. Once it does so, it may file an advice letter seeking revision of the working capital requirement. The adopted adjustment is \$511.6 million for 1997, \$530.7 million for 1998 and \$378.9 million in 1999 on an intrastate after-tax basis as shown in Appendix A.

2. Other Issues – Rate Base

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.91-07-056.¹⁴² In D.91-07-056, the Commission ordered that the method and components used to determine the rate base in the

¹⁴² 1991 Cal. PUC LEXIS 439.

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.89-12-048.¹⁴³

However, D.89-12-048 never specifies what elements comprise rate base. 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, but this interpretation does not come from D.89-12-048.

We find that the record is not sufficiently specific on what was in the start-up rate base, and neither D.91-07-056 nor D.89-12-048 provide a detailed listing of the components of it. Rate base must by definition be dynamic in order to accord consistent regulatory treatment to broad categories of rate base, recognizing that the components of each broad category of rate base (*e.g.*, plant in service, materials and supplies) change over time. Even Pacific “does not support the proposition that rate base should be permanently limited to the rate base items included in the 1989 NRF start-up revenue adjustment”¹⁴⁴

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

a. Prepaid Directory Expense

Overland seeks to add prepaid directory expense to rate base. Currently, Pacific charges its prepaid directory publishing costs when the directory is published. Overland recommends that the prepaid publishing costs be

¹⁴³ 1989 Cal. PUC LEXIS 633.

¹⁴⁴ Pacific Opening/Audit at 113.

capitalized, included in rate base and amortized over the 12-month life of the published directory.¹⁴⁵

As we discuss in the Cash Working Capital section above, Pacific's method of charging all publishing costs to expense when the directory is issued is based on erroneous assumptions about when Pacific incurs the expense. Thus, we agree with Overland's recommendation to capitalize and amortize prepaid directory expense.

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.

c. Accrued FAS 112 Liability

Overland seeks to remove this liability from the balance sheet. This change would reduce rate base by the amount of the liability so removed. We agree with Overland that the FAS 112 liability should be removed from rate base.

FAS 112 relates to accounting for post-employment benefits. In Pacific's case, these benefits primarily include disability, workers compensation, and disability pension expenses. For other companies, they could include severance pay, outplacement expenses and insurance coverage for laid-off employees.

Post-employment benefits are distinguished from post-retirement benefits, which are covered by FAS 106. In general, FAS 112 relates to benefits for laid-off employees, while FAS 106 relates to benefits for retired employees.

¹⁴⁵ Exh. 2A:404 at 11-28 (Audit Report).

Pacific recorded its FAS 112 liability in Account 4310.¹⁴⁶ The FCC requires amounts in that account to be removed from interstate rate base.¹⁴⁷ Although FCC accounting methodology is not controlling for our purposes, the Commission often looks to the FCC for guidance. Since there is no controlling precedent of this Commission on the treatment of FAS 112 liabilities, we find it appropriate to follow the FCC's guidance and exclude the liabilities from rate base.

Our approach achieves a reasonable result. Rate base consists of investments made by utility shareholders on which they are entitled to earn a reasonable return. However, the FAS 112 liability is a zero-cost source of funds, rather than a shareholder investment. The approach is also consistent with D.92-12-015, where the PBOP regulatory asset was removed from rate base for the same reason.¹⁴⁸ Therefore FAS 112 liability is inappropriate for inclusion in rate base.¹⁴⁹ Pacific's rate base is overstated by \$213.2 million in 1997, \$236.5 million in 1998, and \$255.4 million in 1999 as shown in Appendix A.

¹⁴⁶ Exh. 2A:404 at 7-34, table 7-12 (Audit Report).

¹⁴⁷ *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.

¹⁴⁸ D.92-12-015, finding of fact 53, conclusion of law 15, ordering paragraph 5, 46 CPUC 2d 499, 531, 133 (1992).

¹⁴⁹ *See* Exh. 2A:404 at 11-30 (Audit Report); FCC Order 97-56, ¶ 19.

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.¹⁵⁰ In accordance with the discussion in the previous section, we agree with the audit recommendation, because vacation pay liability, like FAS 112 liability, represents cost-free capital to the company. Thus, like FAS 112 liability, accrued vacation pay liability should not form part of the rate base on which Pacific is entitled to a return. Therefore, we adopt Overland's rate base adjustment of \$51.9 million in 1997, \$51.4 million in 1998 and \$45.7 million in 1999.

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. We agree that the liability should be excluded from rate base for the following reasons. First, D.92-12-015 required utilities to exclude their FAS 106 regulatory assets from rate base. The related liabilities should be excluded for the same reason.

Second, our Phase 2A decision requires Pacific to record below-the-line much of its 1998 FAS 106 costs. To be consistent, an amount of the FAS 106 liability should be removed from rate base in an amount equal to the FAS 106 costs recorded below-the-line.

Third, the Phase 2A decision also finds that ratepayers were not liable in 1999 and subsequent years for FAS 106 costs that Pacific chose not to fund. These unfunded accruals should be removed from rate base.

¹⁵⁰ Exh. 2A:404 at 11-31 (Audit Report).

Fourth, the FCC has determined that FAS 106 liability should be removed from interstate rate base.¹⁵¹ While the FCC's accounting approach is not controlling here, again, we often look to the FCC for guidance. Since Commission authority is consistent with the FCC approach, it is appropriate to follow the FCC approach in this instance. As is true for the FAS 112 accruals we discuss above, it is reasonable to follow the FCC approach, since the FAS 106 liability represents cost-free capital and, therefore, should not be included in rate base. Pacific's rate base is mis-stated by \$124,000 for 1997, -\$6.0 million in 1998 and \$5.4 million in 1999 as shown in Appendix A.

f. Accrued Contingent Liabilities

Finally, Overland recommends that contingent liabilities be excluded from rate base.¹⁵² We agree with Overland's recommendation in this instance, because we have disallowed as unauditable Pacific's contingent liability accruals, and required Pacific to account for its contingent liabilities on an as-paid basis. (See Section entitled "Contingent Liabilities," above.) Because we disallow accruals of these liabilities, there is nothing to add to rate base. Further, as is the case with several of the other items, contingent liabilities are cost-free sources of funds, and should not be included in rate base that is used to determine Pacific's rate of return and shareable earnings. Therefore, we adopt Overland's recommended rate base adjustments of \$28.0 in 1997, \$20.1 in 1998 and \$7.8 million in 1999.

¹⁵¹ FCC Order 97-56 ¶ 19.

¹⁵² Exh. 2A:404 at 11-34 (Audit Report).

H. Affiliate Transactions

1. Introduction

The audit found problems with the internal controls necessary to ensure that when Pacific transacts business with SBC affiliates, regulated operations are adequately compensated and do not subsidize unregulated aspects of the business. The audit concluded that, “2000 was a watershed year for SBC Pacific’s affiliate transactions. There was significant movement of employees from the telephone company to the unregulated shared services affiliates at the end of 1999. . . . The absolute value of reported income statement transactions between SBC Pacific and affiliates doubled between 1999 to 2000, from \$1.3 billion to \$2.5 billion.”¹⁵³ In addition, “[t]ransactions between Pacific Bell and affiliates grew seven-fold between 1996 (the year before the SBC/[Pacific Telesis Group] merger) and 2000.”¹⁵⁴

The audit recommends adjustments during the audit period that increase Pacific’s net income by \$97 million during the audit period.¹⁵⁵ In response to the audit, ORA also recommends continued audits of Pacific’s affiliate transactions on the ground that Pacific hindered the auditors’ initial efforts. The audit makes regular reference to instances in which Pacific resisted the auditors’ attempts to acquire documents and information necessary to their analysis. As we discuss in the Section entitled “Whether Pacific Impeded the Audit,” below, we agree with Overland’s findings and the parties’ assertions that Pacific did not fully cooperate with the audit.

¹⁵³ Exh. 2A:404 at 12-3 – 12-4 (Audit Report).

¹⁵⁴ *Id.* at 12-1.

¹⁵⁵ *Id.*

After addressing the undisputed affiliate transactions issues, we discuss below the deficiencies in Pacific's affiliate transactions practices, and find that the work Pacific has done thus far to enhance its internal controls is inadequate to ensure compliance with our rules. We also order that Overland complete the affiliate transactions audit on the ground that Pacific did not allow the auditors access to the documentation they needed to finish their work.

2. Undisputed Affiliate Transactions Adjustments

Pacific agrees with 13 of Overland's affiliate transaction-related adjustments, and we thereby adopt them.¹⁵⁶ Pacific also acknowledges that it should improve some existing internal controls, related to classification of costs among its FCC Part 32¹⁵⁷ accounts; retention of certain data to support allocations to Pacific; and revision to certain portions of the SBC Operations cost apportionment methodology.¹⁵⁸

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.¹⁵⁹

¹⁵⁶ See Exhs. 2B:362A (revised chart, "Affiliate Transactions-Overland," listing disputed and "nondisputed" issues) and 2B:344 at 6-7 (Henrichs Direct Testimony).

¹⁵⁷ 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).

¹⁵⁸ Exh. 2B:344 at 9 (Henrichs Direct Testimony).

¹⁵⁹ *Id.*

We turn to a discussion of disputed issues.

3. Disputed Affiliate Transactions Adjustments

The auditors based their conclusions on a large number of issues, related to 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

i. Overview

The audit found several weaknesses in Pacific's internal controls in the area of affiliate transactions. The audit report contains the following findings:

- 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 Bell's transfer price calculations appear to be seriously flawed and lack cost support.
- Neither Pacific Bell nor SBC could supply information accurately depicting the affiliate organization as it was constructed for inter-company accounting and billing purposes.
- 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 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.¹⁶⁰

With regard to Pacific's customer data system, Pacific maintained 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."¹⁶¹ 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. We order additional investigation into the issue in that Section.

With regard to Pacific's transfer price calculations, 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. . . ." ¹⁶² However, one of the items Pacific 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 adequate for Overland to determine how Pacific made its transfer price

¹⁶⁰ See ORA Opening/Audit at 43-44.

¹⁶¹ Pacific Reply/Audit at 59.

¹⁶² *Id.* at 60.

calculations, but we have no reason to believe Overland could not have figured out the calculations if Pacific had provided it adequately specific documentation. Pacific's claim that "[i]t appears that Overland simply failed to examine [the] materials" Pacific provided it¹⁶³ is inconsistent with what the record reveals about the care Overland took in other aspects of the audit.¹⁶⁴

Regarding the organization of Pacific's affiliates, Pacific claimed that, "the type of organizational chart Overland desires serves no business function and is burdensome to maintain."¹⁶⁵ This response is so dismissive of Overland as to raise a concern that Pacific was being willfully unhelpful to Overland's efforts.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.* at 61.

All it appears Overland was trying to do was to trace how Pacific's organizational structure functioned. Rather than be cooperative by mapping out the organizational structure, Pacific appears to have dumped on 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."¹⁶⁶

We are concerned at how casual the organization of SBC's centralized functions appears to be, and the lack of information Pacific was willing or able to furnish the auditors on the organizational structure and financial operation of these entities. 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.*"¹⁶⁷ 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."¹⁶⁸

Even if we assume Pacific is entirely correct and that Overland had all necessary documentation, the Commission is left without a proper record on which to assess how Pacific deals with affiliate transactions. We cannot simply ignore that void and give Pacific the benefit of the doubt. Rather, we must conclude that if Overland could not verify Pacific's means of doing business with the information it was provided, further work is necessary. For this reason, among others, we require further auditing in this area.

¹⁶⁶ *Id.*

¹⁶⁷ Pacific Opening/Audit at 136 (emphasis added).

¹⁶⁸ *Id.*

Affiliate transactions are one of the more difficult areas of regulatory accounting to understand. It may well be that when Pacific 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. If the record of the proceeding in this area is any indication, Pacific's witnesses did not fully explain themselves, but rather assumed a great deal of knowledge that the auditors may not have had. This is not the fault of the auditors; the onus is on Pacific to act cooperatively with the auditors to break through these barriers in "translation." We expect such full cooperation by Pacific during the remainder of the audit.

We question how much of the consolidation of centralized functions into SBC was done for the good of the regulated utility, Pacific Bell. While Pacific might argue that consolidation of functions in one entity was efficient, it is clear that Pacific also paid SBC dearly for such "efficiency." As we discuss in the Section entitled "Pacific's Management Control," below, it is also clear that Pacific Bell had little ability to object to the management fees SBC passed its way. Under these circumstances, it is essential that the auditors be able to find out fundamental and often rudimentary information about how the SBC affiliates are structured and how they determine the amount of the expense to pass on to the regulated utility.

Thus, as we discuss more fully in the "Remedies" section of this decision, we order completion of the audit of Pacific's affiliate transactions for the 1997-99 period, under TD's supervision. Pacific shall cooperate fully with this effort, and the auditors or TD may bring concerns regarding any alleged uncooperativeness by Pacific to the Administrative Law Judge for this proceeding - or to such other

person as the Assigned Commissioner may designate – early in the process so as to avoid last-minute discovery battles late in the audit process.

We now turn to Overland’s specific recommendations on Pacific’s internal controls related to affiliate transactions.

**ii. 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.¹⁶⁹ 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 Overland’s interpretation. Pacific in fact required employees of SBC Operations and SBC Services to comply with the time reporting requirement. It claims it did so “voluntarily.” This claim is counterintuitive; time reporting is labor intensive, and we cannot imagine these entities doing it voluntarily. Thus, we agree with Overland that all three entities – SBC Communications (referred to in the audit as MSI), SBC Operations and SBC Services – were required to comply with the FCC Consent Decree.

¹⁶⁹ Exh. 2B:363 (FCC Consent Decree 97-9, AAD No. 95-32, Feb. 7, 1997).

Moreover, as TURN points out, if Pacific agreed to do the time reporting “voluntarily,” it was not free to break the rules related to such reporting: “The utility should not be heard to claim that there is no ‘lack of compliance’ issue here. It cannot both set the rules and excuse itself for subsequent violation thereof.”¹⁷⁰

The next issue in this regard is whether these entities actually complied. This issue took on greater significance during the hearing than it otherwise would have due to Overland’s admitted mistake in conducting the review. Overland initially contended that a large number of time reporting records were missing, and concluded there was a lack of compliance. On cross-examination, Overland acknowledged that it had taken only samples of the records provided. While the hearing was still taking place, Overland went back to Pacific to review the other documents. While in its audit it claimed that MSI had only 26% compliance with the Consent Decree requirement in 1998 and only 18% compliance in 1999, Overland revised these figures after the re-review to 87% in each year.

The audit found that SBC Operations had “less than half” of the required reports for 1998 and 1999, but on review the auditors changed these percentages to 66% and 65%, respectively. By the same token, Overland believed it had inadequate time to review all of the new documents, so it is possible these figures were not accurate. Pacific’s own figures showed compliance rates of 73% and 72%, respectively, for SBC Operations in 1998 and 1999.

¹⁷⁰ TURN Reply/Audit at 27.

The real question, of course, is how all of this matters. Overland's focus on this issue was in furtherance of its examination of whether the company had adequate internal controls in place so that Pacific's regulated operations did not subsidize the actions of the unregulated SBC entities mentioned above. We find based on the totality of the circumstances that Pacific lacked adequate controls. While we might debate whether – taking Pacific's figures – 73% and 72% compliance was adequate, we agree with Overland that our conclusion on that issue alone does not matter. Even if one omits Consent Decree compliance as an issue relevant to how well SBC ensures that Pacific's regulated operations do not subsidize the unregulated affiliates, Pacific still has many internal control problems, as the other sections of this discussion reveal.

iii. 1998 Affiliate Oversight Group (AOG) Compliance Review of SBC Operations

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."¹⁷¹ 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. . . ." We find the draft report more credible, since it examined actual results rather than relying on what would happen in a future year end true-up.

Thus, we concur with Overland that Pacific's own internal documents help bolster Overland's conclusion that Pacific lacked adequate internal controls.

iv. SBC Operations "Image Maker" Program

¹⁷¹ Exh. 2A:404 at 15-3 (Audit Report).

Overland believes that Pacific's "Image Maker" program also provides evidence of inadequate internal controls at Pacific. However, at hearing, Pacific refuted 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 declarations¹⁷² 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.

v. 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 expense which is 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 64.¹⁷³

There are substantial differences between Overland's opinion and Pacific's statements, and we do not have enough information about the deficiencies in Pacific's tracking of legal matters to know whether change is appropriate. As Overland points out, Pacific did not furnish it enough information about the process it uses for Overland to determine whether that process is adequate to ensure that the regulated utility is only paying appropriate legal bills. We therefore direct Overland to further audit legal expenses allocated from SBC to Pacific during its completion of the affiliate transactions audit we order herein. Pacific shall provide the auditors full access to SBC's and Pacific's existing process, records and personnel. If the continued audit uncovers problems, we will consider remedies, if appropriate, once we consider the supplemental audit in its entirety.

b. Pacific's Management Control

i. Pacific's Control Over 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

¹⁷² Exh. 2B:630.

¹⁷³ 47 C.F.R. § 64 *et seq.* Pacific Opening/Audit at 126.

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.¹⁷⁴

Pacific claimed 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 of the “informal process” for resolving disputes among the entities.¹⁷⁵ However, its own witness admitted that Pacific did not negotiate the management fee, but rather the corporate level controlled the fees that were charged.¹⁷⁶

We find that Pacific’s management had little control over SBC decisions on the type and amount of management fees to assess on the regulated utility. We discuss the specific charges in more detail below. However, this concern is a general one that relates to each instance in which centralized SBC entities charge Pacific, the regulated entity, for their services. We invite proposals in Phase 3B addressing how we can oversee and control how SBC’s unregulated businesses charge the regulated utility for their “management” contributions.

ii. TRI Charges

Technology Resources Inc. (TRI) is responsible for research and development (R&D) for SBC and its affiliates. Overland expressed concern that

¹⁷⁴ ORA Reply/Audit at 37.

¹⁷⁵ 16 RT 1912:4-22 (Henrichs).

¹⁷⁶ ORA Opening/Audit at 49, citing 16 RT 1854-55 (Henrichs; emphasis added).

it could not determine whether TRI's billings to Pacific were appropriate. Pacific's only attempted justification was that the regulated utility is 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. As such, Pacific is not in the position to make the sort of determinations Overland suggests it should."¹⁷⁷

This response tends to confirm Overland's finding that Pacific had little control over how much it paid for TRI's research and development activities. However, SBC uses a general allocator that passes a majority of costs on to the regulated utility, such as Pacific (*see* next section, entitled "Compliance with Affiliate Transactions Requirements"). Thus, it is not even clear that TRI's billings were allocated based on TRI's determinations as the "technology expert." Rather, TRI simply followed this same general allocation process, rather than truly attempting to bill Pacific based on a determination of whether its R&D expenses actually benefited the utility.

We are concerned that Pacific bore the lion's share of expenses not because it most benefited from them, but because of a pre-set allocation over which Pacific had no control. As Overland observed and ORA emphasized, R&D costs allocated on the basis of size-based allocators such as historical investment and customer count are not designed to match costs with the affiliates receiving the benefit of such endeavors.¹⁷⁸

Overland's witness stated that "the primary finding in this chapter related to TRI is that allocations are being handled based on the investments and the

¹⁷⁷ Pacific Opening/Audit at 130.

customer accounts of all the affiliates. *And . . . the dollars are driven to those affiliates which have the highest investments which are the telephone companies which have years and years of built up investments.* So you are looking at allocating cost to those particular affiliates and in actuality the R&D being done is forward looking.”¹⁷⁹

In our view, allocating most of TRI’s expense to the regulated utility makes no sense because, as Overland pointed out, TRI’s forward-looking research and development efforts “would benefit those affiliates such as the ASI [Pacific’s advanced services affiliate] or the voice mail affiliates or the internet affiliates.”

Even if the allocation was based on cost causative principles and TRI determined how to bill for its services based on a determination of which entity benefited from them, we find troubling Pacific’s stance that it “is not in a position to make the sort of determinations Overland suggests it should.” The TRI billings to Pacific during 1998-99¹⁸⁰ were \$44.4 million on a Pacific Bell Total Company basis. Not only does Pacific’s statement concede the point that its management had little control over SBC billings, it also represents an abrogation of responsibility by Pacific to protect its own ratepayers. We cannot approve of a system in which costs of this magnitude are passed on to the regulated utility with no review whatsoever by the utility itself.

Pacific tried to justify the TRI billings on the basis that the FCC audited these transactions and found nothing wrong with them. However, Overland

¹⁷⁸ ORA Reply/Audit at 41, citing Exh. 2B:414 at 7 (Oetting Reply Testimony).

¹⁷⁹ 12 RT 1244:21-27 (Oetting) (emphasis added).

¹⁸⁰ Exh. 2A:404 at 16-12 (Audit Report).

pointed out that Pacific was not part of SBC during the period of the FCC's joint audit.¹⁸¹

Therefore, we disallow Pacific's claimed TRI expenses based on the audit findings. The intrastate regulatory after-tax adjustment is 11.1 million in 1998 and \$9.2 million in 1999 as shown in Appendix A.

c. Compliance With Affiliate Transaction Requirements

i. Overview

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."¹⁸² Elsewhere in this decision, we discuss Pacific's affiliate transaction problems that caused ratepayers financial harm.

However, even if the internal control problems Overland found hypothetically did not materially affect Pacific's financial statements, we still believe we should act on those problems. First, as Pacific's transactions with its parent and unregulated SBC affiliates grow in number and dollar value, problems we allow to persist may indeed rise to the level of financial "materiality" under any definition of the term. Second, there are important issues of regulatory compliance that are implicated by Overland's findings. Weak internal controls have adverse impacts that go beyond financial reporting.

Pacific explained SBC's process of passing its costs on to affiliates, which relies on FCC Part 64 guidelines to establish the hierarchy of cost allocation. The

¹⁸¹ 12 RT 1245:5-7 (Oetting).

¹⁸² Pacific Opening/Audit at 130, citing Exh. 2A:404 at 12-3 (Audit Report).

first principle of such assignment is that “costs shall be directly assigned to either regulated or nonregulated activities whenever possible.”¹⁸³ However, as noted above, Pacific took the position with regard to TRI allocations that it was up to TRI to make decisions about the allocations.

Moreover, as Overland pointed out, 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.

(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

¹⁸³ 47 C.F.R. § 64.901(b)(2).

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 ration of all expenses directly assigned or attributed to regulated and nonregulated activities.*¹⁸⁴

Pacific states that it follows the Part 64 methodology, but Overland's findings dispute this claim. As part of the completion of the affiliate transactions audit we order here, Pacific must provide the auditors full access to any materials that Pacific claims demonstrate that it analyzes costs using this hierarchy. SBC and Pacific shall supply all relevant data, and also shall fully explain how they apply the Part 64 rules to affiliates billing significant expense to Pacific. For example, if, as appears to be the case, TRI or other affiliates use a general allocator for much of their expense, SBC shall explain its analysis of the previous "steps" in the Part 64 hierarchy, and demonstrate that the process employed complies with the Part 64 cost allocation rules and principles.

ii. 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." It claims IEMR earnings were not impacted because the misallocations were appropriately designated as above- or below-the-line.¹⁸⁵ As part of its completion of the audit of Pacific's affiliate transactions, the auditors should review these

¹⁸⁴ *Id.* § 64.901 (emphasis added).

¹⁸⁵ Pacific Opening/Audit at 132.

“enhancements” and verify whether Pacific has remedied its acknowledged problems.

iii. 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.

However, because this area is but one of several areas showing deficiencies in affiliate transaction record-keeping, cost allocation and regulatory compliance, we are not satisfied that Pacific has remedied the problems the auditors found. The auditors’ completion of the affiliate transactions audit should, in addition to the other areas we identify in this decision, focus on the record-keeping and document retention efforts of the SBC shared service affiliates doing business with Pacific. The auditors should verify whether Pacific’s changes ensure better compliance and identify any deficiencies so that we may act on them.

iv. 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.¹⁸⁶ Once again, Pacific claims Overland had everything it needed and that it cannot understand why

¹⁸⁶ Exh. 2A:404 at 17-1 (Audit Report).

Overland could not determine if Pacific's affiliate billing system was functioning as intended. Pacific's key defense here is that Ernst & Young, its own auditors, reviewed its affiliate transactions without problems.

We find that Pacific did not provide Overland adequate information for Overland to reach an opinion on the reasonableness of the charges Pacific assessed on unregulated SBC affiliates. We therefore order that the completion of the affiliate transactions audit include a review of Pacific's charges to affiliates for service Pacific provides them. As Pacific never submitted any of the Ernst & Young material into the record of this proceeding, Pacific shall provide the auditors all available Ernst & Young material related to its affiliate transactions audit(s), including material in the possession of Ernst & Young.

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.¹⁸⁷ Overland also 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."¹⁸⁸ Pacific claims it does impose the 10% mark-up on its nonregulated affiliates.

Overland's findings on this matter raise concerns as to whether Pacific has adequate internal controls in place to ensure that its affiliates are properly billed for all of the costs related to marketing services performed by Pacific on behalf of

¹⁸⁷ Exh. 2A:404 at 20-37 – 20-38 (Audit Report).

its affiliates. We do not believe that we have a sufficient record on this matter. We therefore direct Overland to include as a part of the completion of the affiliate transactions audit further review of Pacific's systems and controls for billing affiliates for marketing services provided by Pacific.

In addition, we do not believe an FCC decision governs what Pacific must do in California. To the extent Pacific's claim that it is not required to impose the markup on transactions with other regulated affiliates represents an admission that it does not do so, Pacific may be violating our rules.

However, we do not have adequate briefing before us to determine the impact of D.86-01-026 on Pacific's conduct. That decision applies a 10% markup in one particular case,¹⁸⁹ but we need further analysis of that decision's applicability here. The parties should address this issue in Phase 3B. They may wish to discuss whether we should adopt a more comprehensive rule in view of the vast increase in the number of affiliates Pacific now has in comparison to the state of affairs in 1986 when we adopted D.86-01-026.

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 (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

¹⁸⁸ FCC *Order on Reconsideration*, FCC 87-305, ¶ 122.

¹⁸⁹ D.86-01-026, 1986 Cal. PUC LEXIS 890, finding of fact 11, at *326.

market value by requiring carriers to use methods that are routinely used by the general business community.”¹⁹⁰

However, whether the FMV figures are accurate is not the issue. Rather, Overland is attempting to validate the FDC figures, and it correctly questions Pacific’s surveys’ use in validating its FDC costs: “[B]ecause the [FMV] prices cannot be compared with SBC’s ‘FDC’ calculations, they neither prove nor disprove the reasonableness of the affiliate service transfer prices. . . . [I]t is not valid to conclude that a \$236 ‘FDC’ rate for . . . services is the ‘higher of market or fully distributed cost’ just because Pacific Bell determined it could purchase similar service from an outside service provider at an hourly rate of \$100.”¹⁹¹ We agree with Overland’s concern that these FMV surveys do nothing to prove that Pacific is adequately billing its affiliates for services it provides them.

Nor does it appear that Pacific adequately documented its FDC prices. According to the audit, both Pacific and SBC were unwilling or unable to provide cost support for transfer prices. Instead, they gave Overland only the most basic information about the rate – rather than cost – elements used to come up with the FDC cost figure. However, these rate elements do not establish whether the underlying costs justify the FDC amount.

We therefore find that Pacific did not provide Overland adequate information for it to assess the fairness of Pacific’s FDC rates. As part of the completion of the affiliate transactions audit, Pacific shall cooperate fully with the auditors’ efforts to determine the costs that Pacific uses to compute its FDC amounts.

¹⁹⁰ FCC *Accounting Standards Order*, CC 96-150, ¶ 154.

**v. Other Compliance with Affiliate
Transaction Rules Issues - 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.” In its follow-up audit, the auditors should verify that Pacific is now recording these transactions properly.

**d. Transfer or Use of Customer Information,
Trademarks and Other Intangible Assets**

i. Pacific’s Customer Database

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 SBC Operations “access” to the database, and denied that there was a “transfer” of customer records. We agree with TURN that this is a distinction without a difference: “In today’s information technology environment, the distinction between allowing the affiliate ‘access to’ the customer database and affecting a ‘transfer of’ that database is close to meaningless.”¹⁹²

TURN also asserts that the record actually supports the conclusion that there was a “transfer” of data. Pacific Bell’s witness described how the

¹⁹¹ Exh. 2A:404 at 17-12 – 17-14 (Audit Report).

¹⁹² TURN Reply/Audit at 30.

information from the Pacific Bell database that SBC Operations uses remains with Operations until it “rolls off the side of the earth.”¹⁹³ Pacific’s witness was not clear whether SBC Operations could continue to use the data it had obtained even after it had analyzed the data and returned the results of its analysis to the utility.

Thus, as TURN asserts, “If Pacific Bell allows SBC Operations to have unimpeded access to its customer database in order to assist the utility with a sales campaign, at the end of SBC Operations’ work for Pacific Bell it is possible and, as the utility’s witness seemed to acknowledge, even likely that at least some of the data would remain with SBC Operations. And this data would be valuable to any provider of telecommunications services, as it may include the customer’s calling patterns, as well as all of the regulated and unregulated services they receive.”¹⁹⁴

Pacific categorically denies that its affiliates make any use of Pacific’s customer information except to conduct marketing for Pacific’s own benefit. However, the witness’ lack of knowledge of what SBC Operations might do with the data after it had obtained and worked with it raises a concern. Moreover, Pacific concedes that there are “joint marketing” efforts using Pacific’s customer information: “Where joint marketing occurs, the access is still on Pacific’s initiative with appropriate fees paid when required.”¹⁹⁵ Pacific’s witness stated in this regard that “SBC Operations only accesses records for customers that are part of the joint marketing customer list provided by Pacific Bell, and all

¹⁹³ 16 RT 1891 (Henrichs). *See also* TURN Reply/Audit at 30.

¹⁹⁴ TURN Reply/Audit at 30-31.

¹⁹⁵ Pacific Opening/Audit at 144.

requirements for access of CPNI [Customer Proprietary Network Information] are followed.”¹⁹⁶

¹⁹⁶ *Id.* at 145, quoting 12 RT 1872-78 (Henrichs).

Overland states that time and scope constraints prevented it from assessing the potential for cross-subsidies relating to the transfer of intellectual property and proprietary information. It is also Overland's opinion that Pacific did not respond to requests concerning customer data sharing.¹⁹⁷

We believe further inquiry into this matter is warranted. As part of the follow-up audit that we order, Overland shall review Pacific's relationships and interactions with its affiliates regarding joint marketing activities, the use of customer data, and the transfer from Pacific of proprietary information and intellectual property. Pacific shall fully cooperate with the auditors and provide them with responsive answers to their questions.

Additionally, we have some specific questions to which we require answers. We hereby direct that within 60 days of the effective date of this decision, Pacific make a compliance filing addressing the following questions:

- Is it possible for SBC Operations (or other unregulated Pacific Bell or SBC affiliate) to retain data about Pacific Bell's customers after it works with such data for Pacific's benefit and returns the results of its analysis to Pacific Bell? In other words, even if it no longer has access to Pacific's database, does it retain data it has created using that database that contains customer-specific information about Pacific's customers?
- Has SBC Operations (or other unregulated Pacific Bell or SBC affiliate) ever used any Pacific Bell customer database information for purposes other than marketing services for Pacific Bell?
- Explain all uses SBC Operations (or other unregulated Pacific Bell or SBC affiliate) has ever made of Pacific Bell

¹⁹⁷ Exh. 2A:404 at 12-6 – 12-7 (Audit Report).

customer database information, giving the date(s) of use, the data obtained, and the use(s) made, during the period 1997-present.

Pacific shall file this information in this proceeding and serve it on the service list for this proceeding.

We reaffirm that SBC Operations (or any other unregulated Pacific Bell or SBC affiliate) is not to use any customer-specific information or data obtained from Pacific Bell to provide services to or otherwise benefit other members of the family of companies to which SBC Operations provides services without compensation to Pacific Bell. This compensation to Pacific Bell shall cover the value of customer data itself, rather than simply the cost of labor utilized when SBC Operations or other unregulated affiliates provide joint marketing services with or for Pacific Bell.¹⁹⁸ A determination of how to value such Pacific Bell data shall occur during Phase 3B of this proceeding.

Second, neither SBC Operations nor any other SBC affiliate is to have access to Pacific Bell's customer information or database once SBC Operations or the other affiliate has completed its work on Pacific Bell's behalf. It shall return all data and information it derives from that data to Pacific Bell at the conclusion of its work for Pacific Bell.

ii. Transfer of Pacific Bell Directory to Pacific Telesis Group

¹⁹⁸ Obviously, compensation for this customer data does not refer to amounts that Pacific Bell or other affiliates pay to SBC Operations for the latter entity's inter-company joint marketing services. Rather, such compensation refers to compensation that SBC Operations (or other affiliates) shall pay to Pacific Bell for use of Pacific Bell's customer data.

Overland suggests that Pacific Bell should have obtained the Commission's permission to transfer Pacific Bell Directory to its then-parent, Pacific Telesis Group. Pacific claims that it was not required to obtain Commission approval for the transfer pursuant to Pub. Util. Code § 851 *et seq.*, and states that it informed the Commission staff of its intention to make the transfer and of its interpretation that § 851 approval was not required. Pacific claims that because the Commission did not "intervene to prevent the transfer and never sought to reverse it," there was no problem with the transfer. We find that Pacific should have obtained Commission approval for the transfer, and in this decision order it to file an application seeking such approval.

Before reaching the merits of the transfer, it is important to put to rest any notion that it is sufficient for an applicant to inform the Commission or its staff that Commission approval is not required for a particular transaction to shift the burden to the Commission to act. Nor is Commission silence equal to acquiescence. If § 851 or any other approval was required, there was no waiver of the requirement if the utility told staff approval was not required and the Commission staff never contradicted the assertion. The law places affirmative obligations on those we regulate and does not excuse compliance simply because the Commission does not take enforcement action against a utility that is out of compliance.

Nor is it sufficient to rely on staff, as we informed Pacific in 2001: "Although utilities' discussion with staff prior to implementing a new service can be useful . . . the staff does not speak for the full Commission. Thus, the

[fact] that staff many not have objected to Pacific's implementation . . . [is] not [a defense] for Pacific in this action."¹⁹⁹

On the specific question of whether § 851 *et seq.* approval was required in these circumstances, we find that it was indeed required. Here, 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."²⁰⁰ Thus, the Commission found that it was appropriate for it to review the transaction.

Even after the Commission so stated, Pacific did nothing to seek the Commission's approval. While it is true that the Commission stated that it would open a proceeding to review the transaction if it felt it was necessary, it never granted Pacific authority to make the transfer without Commission approval.

Pacific should have known as far back as December 1985 that a transfer of Pacific Bell Directory would require Commission approval. In D.85-12-065,²⁰¹ the Commission granted Pacific approval to transfer its directory properties to a separate subsidiary of Pacific Bell, ostensibly to allow Pacific to respond to developing competition in the classified directory business and in other print

¹⁹⁹ D.01-08-067, *mimeo.*, at 31, 2001 Cal. PUC LEXIS 517.

²⁰⁰ Resolution T-16545, *Order Adopting Modifications to the Reporting Requirements Under NRF Monitoring Program*, dated August 23, 2001, at 15.

²⁰¹ 1985 Cal. PUC LEXIS 1063.

media businesses. However, in approving the transfer, provided that “Pacific Bell Directory shall be subject to all applicable sections of the Pub. Util. Code and of General Order 77-I, but not to the Uniform System of Accounts generally applicable to telephone utilities under Commission jurisdiction.”²⁰² Thus, the Commission did not exempt Directory from compliance with Sections 851 *et seq.* The Commission also required the consideration of the revenues and expenses of the Directory operation in setting Pacific Bell’s rates.

Article 6 of the Pub. Util. Code (Sections 851-56) addresses the transfer or encumbrance of utility property. For example, § 851 prohibits a public utility from selling, leasing, assigning, mortgaging, or otherwise disposing of or encumbering the whole or any part of its system or other property necessary or useful in the performance of its duties to the public. Section 851 applies to the transaction; since the revenues and costs associated with Directory operations were considered in setting Pacific’s rates, the operation is presumed to be necessary or useful in the performance of Pacific’s duties to the public.

Therefore, Pacific Bell shall file an application under the applicable sections of Article 6 of the Pub. Util. Code seeking Commission approval for the transfer no later than 60 days following the effective date of this decision. This filing shall also comply with all of the requirements of D.85-12-065.

e. 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, Advanced Services, Inc. (ASI). ASI is important because it is the entity in which

²⁰² Resolution T-16545, *supra*, ordering paragraph 6.

most of Pacific's DSL services are housed. 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.

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 conceded that this was an appropriate audit issue.²⁰³

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.

i. 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,²⁰⁴ 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 development costs. Therefore, we agree that it is appropriate to defer certain

²⁰³ 12 RT 1285:3-8 (Hayes).

²⁰⁴ Application 02-07-039.

issues to the § 851 proceeding. However, Pacific shall also furnish relevant information in this proceeding, as described below.

ii. 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.²⁰⁵ 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 1999.²⁰⁶ 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

²⁰⁵ Pacific Opening/Audit at 156-57.

²⁰⁶ 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.”²⁰⁷ The question is whether – and how – California ratepayers should be compensated for the risk they bore associated with the cost of DSL’s development.

We agree with Overland that, during the audit period, expenses and capital investment were charged to Pacific’s regulated operations, whereas a disproportionately small amount of revenues from the sale of DSL services was credited to regulated operations. In addition, as Overland notes, with the transfer of DSL services to ASI, revenues from the sale of DSL services have been collected by ASI, not Pacific.

However, 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

²⁰⁷ *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.

compensation issue.²⁰⁸ We also lack data about affiliate payments and other 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.

Although we expect the ratepayer compensation issue to be addressed in the ASI § 851 docket, in order to complete the record here, we direct Pacific to file a report in this docket within 60 days that shows, on an annual basis, all costs, investments and revenues related to the provision of DSL service in California for the period 2000 through 2003. The report shall identify for each year, the FCC Part 32 accounts that the revenues, expenses, and investments were charged to and describe the related jurisdictional treatment for these elements. The report should also separately list the same cost, investment and revenue data for ASI.

In addition to DSL service, we are concerned that Pacific may have developed other services above-the-line and transferred them to ASI. While we do not want to prejudge what regulatory treatment should be afforded these other services, if there are any, we will require Pacific to identify each service transferred from Pacific to ASI, track separately since the date of transfer the revenues, expenses, and investment for each service, and have this information available for review by Commission staff (including ORA) upon request. The

²⁰⁸ 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

next triennial audit of Pacific Bell should include a review of all services transferred from Pacific Bell to ASI.

f. 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.

**i. 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.

ii. Operating Expense Adjustments

(a) Executive Compensation

**1. Executive Compensation Allocated
From Parent and MSI-USA to Pacific**

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.

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

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.”²⁰⁹ Moreover, ORA points out, the Commission has made “ratemaking adjustments” even in the context of NRF. For example, in our NRF review of Roseville Telephone, we disallowed recovery from ratepayers for institutional or goodwill advertising.²¹⁰

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.²¹¹

The witness then suggested Pacific should renege on its voluntary reduction:

²⁰⁹ ORA Reply/Audit at 46.

²¹⁰ D.01-06-077, 2001 Cal. PUC LEXIS 604, at *44-45. *See* ORA Reply/Audit at 47 (listing other “ratemaking adjustments” the Commission made in D.01-06-077). ORA also cites the Phase 1 decision in this proceeding regarding Verizon as support for the proposition that we have also adopted “audit adjustments and order[ed] restatement of financial reports.” *Id.*

²¹¹ Exh. 2B:338 at 61:7-11 (Ellis Direct Testimony).

- Q. Are either the adjustment Pacific Bell made or the adjustments Overland proposes for executive compensation required?
- A. Based on the discontinuance of ratemaking adjustments as confirmed in Decision 91-07-056, Pacific is not required to adjust shareable earnings for executive compensation. Thus, intrastate regulated operating expense on the IEMR should be increased by \$20 million, \$8 million and \$7 million in 1997, 1998 and 1999, respectively.²¹²

Having voluntarily made the reduction, Pacific is not free to reverse it now. As TURN stated in another context, “[Pacific] cannot both set the rules and excuse itself for subsequent violation thereof.”²¹³ 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. Once again, such disparate treatment would encourage Pacific Bell to transfer executives to affiliates in order to record compensation costs that exceed the voluntary cap. 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.

Furthermore, to the extent that Pacific bears the cost of general “management fees” allocated from SBC to Pacific’s regulated operations, it would appear that Pacific’s regulated operations show double charges for management - once for excess executive salaries, and a second time for the cost of executives rolled into the management fee.

²¹² *Id.* at 61:12-19.

²¹³ TURN Reply/Audit at 27.

Finally, the Commission's affiliate transaction rules and Part 64 require that there be some benefit associated with an allocated cost. Pacific showed no such benefit for its excess executive compensation costs.

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 in 1999 for the excess executive compensation from MSI-USA as shown in Appendix A.

2. 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.²¹⁴ In turn, SBC allocated a portion of these payments to Pacific using a general allocator under Part 64. It is Overland's opinion that the payments were not attributable to Pacific Bell under cost causative principles. 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 the Parent Company.

3. Executive Compensation Allocated From Parent to Pacific Bell Directory

²¹⁴ See Exh. 2A:404 at 14-3 (Audit Report).

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.²¹⁵ 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 the Parent to Pacific Bell Directory is embedded in "Parent Impact of Adjustments on Billings to PBD" (Joint Exhibit #55 in Appendix B hereto).

4. Special Executive Compensation Allocated From Parent to Pacific Bell Directory

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."²¹⁶ 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 the Parent to Pacific Bell Directory is embedded in "Parent Impact of Adjustments on Billings to PBD" (Joint Exhibit #55 in Appendix B hereto).

5. Executive Compensation Allocated from SBC Operations

²¹⁵ Exh. 2A:404 at 14-3, 14-8 and 18-8 (Audit Report).

²¹⁶ Pacific Opening/Audit at 162.

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). Once again, we disallow any executive compensation in this area in excess of \$200,000, for the reasons set forth above. In addition, Pacific failed to show that it appropriately bore this expense from a cost causative 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.

6. Executive Compensation Allocated from SBC Services

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.

(b) Legal Expenses

1. Legal Expenses Allocated from Parent to Pacific

Overland finds that 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. We agree, and reduce Pacific's expense

by \$982,000 for 1998 and \$484,000 for 1999 on a Pacific Bell Total Company basis, as we discuss below.

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.”²¹⁷

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.

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. 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

²¹⁷ TURN Reply/Audit at 35.

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 in Appendix B hereto).

**(c) 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.” 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 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 conceded that it was not appropriate for Pacific's regulated books to show this type of expense by not disputing the auditor's non-affiliate-transaction adjustments in connection with similar items.²¹⁸ If Pacific's regulated operations should not bear the cost of image advertising, as

²¹⁸ 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 4th 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).

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.

To hold otherwise would give Pacific an improper incentive to move functions to unregulated affiliates, and charge to Pacific's regulated operations certain expenses that would not be allowable above-the-line if Pacific itself incurred them. As the Commission has previously determined in D.94-06-011, ratepayers should not support the costs of Pacific's image building efforts and public relations expense. We adopt Overland's recommendation in this regard. 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 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 in Appendix B hereto).

(d) Corporate Development

Pacific was charged in 1998 and 1999 when an unregulated affiliate, MSI, conducted market research and investigated potential acquisitions throughout the world. Pacific states that the costs were appropriately allocated from the parent to Pacific and Pacific Bell Directory, but does not substantiate this claim.

These expenses relate to international lines of business,²¹⁹ and we see no relationship between such investments and the regulated utility. We are not persuaded by Pacific's argument that these corporate acquisitions somehow benefit Pacific "by lowering Parent allocations to Pacific as the portfolio of SBC

²¹⁹ See Exh. 2A:414 at 14-34 (Audit Report) (listing corporate development projects around the world).

companies grow.”²²⁰ 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 the Parent Company 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 in Appendix B hereto).

(e) Strategic Planning

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 the plea that NRF countenances no ratemaking adjustments. Once again, Pacific misses the point. The issue here is whether Pacific and Pacific Bell Directory are cross-subsidizing the parent’s strategic 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 recommendations 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 in Appendix B hereto).

(f) Parent Out of Period Expense

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

²²⁰ Pacific Opening/Audit at 167, citing Exh. 2B:344 at 27 (Henrichs testimony).

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.

V. Regulated and Nonregulated Cost Allocations

A. Marketing Service – Affiliate Billings

A significant unanswered question 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. However, rather than provide ORA or the auditors with the correct revenue and expense figures, Pacific simply continued to insist they were focused on the wrong accounts. When asked for the correct accounts, Pacific's witness simply referred parties to "the affiliate billing group."²²¹

Once presented with the audit's conclusion that revenues and expenses did not match, Pacific was not free simply to sit back and dispute whether the auditors were matching up the correct two accounts. Rather, its obligation to cooperate with the audit also obligated it – if it intended to attempt to refute an audit claim such as this one – to provide the correct information. Indeed, even in its Reply Brief, Pacific continues to insist that the parties are attempting to link unrelated revenue and expense figures, rather than providing the correct

²²¹ 16 RT 1800:12-1802:16 (Ellis).

information.²²² Pacific's obligation goes deeper than this. It is not appropriate for Pacific simply to insist without documentation that the revenues and expenses match up.²²³ Indeed, Pacific's reticence bolsters our conclusion in the Section entitled "Whether Pacific Impeded the Audit," below, that it was less than fully cooperative with the audit.

Pacific also does not explain whether or not Pacific charged its unregulated affiliates not only the fully distributed cost (FDC) for its services, as the rules require, but an additional 10% mark-up.²²⁴ Overland conservatively assumed that the marketing services need only be billed at FDC, without the mark-up. ORA estimates that the difference between Overland's \$47.1 million audit adjustment increasing revenues to equal the FDC expenses for 1998 and 1999, and the amount including the 10% mark-up, is \$11.3 million.²²⁵

However, it appears Overland may need to adjust its figure to account for revenues Pacific furnished it after Overland issued the audit report. As previously discussed in the section of the decision addressing compliance with affiliate transaction requirements, we are concerned that Overland's audit findings suggest that Pacific is not fully billing its affiliates for services that Pacific provides to them. Overland shall include as part of its follow-up audit a

²²² Pacific quotes at length from the testimony of its witness, Mr. Ellis, in which he insists over and over again that the two accounts Overland compared were not comparable. Pacific Reply/Audit at 82-85. However, Pacific never gives the correct, comparable information.

²²³ See, e.g., Exh. 2B:338 at 35:4-15 (Witness Ellis' explanation that Overland was "compar[ing] the results of two separate and distinct processes," without ever furnishing the correct information for comparison).

²²⁴ D.86-01-026, finding of fact 11, 1986 Cal PUC LEXIS 890, at *326; D.87-12-067.

²²⁵ ORA Reply/Audit at 49-50.

further review of Pacific's billings to its affiliates for marketing services provided to the affiliates, and the systems and procedures Pacific uses to effect these billings.

Pacific shall furnish the auditors the correct amount of the revenues and expenses attributable to Pacific's marketing services billings to its unregulated affiliates. The auditors may then compute the difference, if any, between the revenues and expenses, while assuming that Pacific should have charged a 10% mark-up for any such marketing services. The intrastate after-tax amounts are \$3.2 million in 1998 and 13.7 million in 1999.

B. Other Regulated and Nonregulated Cost Allocation Issues

1. National-Local Strategy Implementation Costs

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" ²²⁶

Pacific would not have had to make this claim if, as it asserts, the regulated utility was not being billed for the National-Local 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 from its 1999 IEMR.

a. 1997 Corporate Sponsorship Costs – Pacific Bell Park

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

²²⁶ Exh. 2A:404 at 20-49 n.54 (Audit Report), citing Pacific Bell Data Response OC-1040 part 3.

that “[t]he Commission does not allow recovery from ratepayers of institutional or goodwill advertising.”²²⁷

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 above-the-line.

b. Depreciation Expense Allocation

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.

It is unclear what Pacific means when it says that the change Overland proposes would “violate the CAM Pacific has filed.” Nor does Pacific offer any evidence to show that the CAM requires any particular allocation. Indeed,

²²⁷ 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.

Overland also found that Pacific Bell's CPUC CAM was not appropriately updated.²²⁸ Further, Pacific offers no evidence that it "followed the existing Commission policy during the audit period"²²⁹ other than the assertion that it did so.

We therefore adopt the audit recommendation of \$1.7 million on an intrastate after-tax basis for the 1999 expense and 2.9 million for 1999 rate base adjustment.

c. Product Advertising Expense

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 only defense is that it "allocated product advertising expense according to the Cost Allocation Manual as discussed in Section VI."²³⁰ However, Pacific's brief makes no such argument, and we find no basis to Pacific's argument. We reject Pacific's position and adopt the audit recommendation of \$1.9 million in 1998 and \$1.8 million in 1999 on an intrastate after-tax basis on the same basis as we set forth in the previous section.

²²⁸ Exh. 2A:404 at 20-5 (Audit Report) ("Certain sections of Pacific Bell's California Cost Allocation Manual were not reflective of current procedures.")

²²⁹ Pacific Opening/Audit at 172.

²³⁰ *Id.*

d. External Relations

Overland states that the majority of the external relations costs in Pacific's account number 6722 were improperly assigned directly to regulated operations. 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.²³¹ 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.²³² 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.²³³ 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

²³¹ Exh. 2A:404 at 20-26 (Audit Report).

²³² 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.

²³³ 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.²³⁴

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 on an intrastate after-tax basis as shown in Appendix A.

e. Customer Service Expense

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.”²³⁵

Pacific highlights this conclusion and urges us to make no changes to its policy. It explains that “Overland oversimplifies the allocation process and presents skewed analytical results”²³⁶ Because we do not have an adequate record to determine whether Overland's adjustments to the allocations are

²³⁴ D.94-06-011, 153 PUR 4th 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).

²³⁵ Exh. 2A:404 at 20-27 (Audit Report).

²³⁶ Pacific Opening/Audit at 173.

sound, and because ultimately the regulated/nonregulated allocations are reasonable, we make no change to Pacific's current practice.

Overland notes that during the audit period, Pacific Bell tracked expenses it incurred in marketing telephone services in GTE's (now Verizon's) service territory in a way that indicated it planned to charge these expenses in whole or part to Pacific's regulated business. Overland suggests that we clarify now that Pacific will not be able to recover these costs from regulated services customers, "since [the costs] are not a cost of conducting business within Pacific Bell's franchised service territory . . ." ²³⁷ We agree that Pacific should not reflect these costs in its regulated operations, recover the costs from its regulated customers in Pacific's service territory, or reflect the costs in earnings of the regulated entity.

The intrastate regulatory after-tax amounts re \$1.0 million in 1997, \$3.4 million in 1998 and \$4.8 million in 1999.

f. 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.'" ²³⁸ It also accuses Overland of improperly trying to change policy.

On its face, Overland's suggestion makes sense. However, the portion of the audit devoted to this issue is one paragraph, and we lack information about

²³⁷ Exh. 2A:404 at 20-7 (Audit Report).

²³⁸ Pacific Opening/Audit at 174, quoting Exh. 2B:338 at 45 (Ellis Direct Testimony).

the nature of the expenses and how they were allocated. Therefore, we lack an adequate record to decide the issue at this time. The auditors should provide further detail about this matter as part of their completion of the affiliate transactions audit we order in this decision.

g. Fluctuation Analysis

This arcane 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 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.²³⁹ 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

²³⁹ See Exh. 2B:338 at 46-47 (Ellis Direct Testimony).

did not focus on specific explanations from operations that would explain what products or marketing initiatives were causing the resulting monthly fluctuations.”²⁴⁰

²⁴⁰ Exh. 2A:404 at 20-16 (Audit Report).

We order Pacific to make a compliance filing within 60 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 determine whether Pacific's method requires change.

h. 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 states, 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 statements with Overland's representation that Pacific staff informed it that the updates occurred in 1996 and identified areas needing updating. We find Overland's representation more credible given its specificity. Therefore, in its compliance filing due 60 days after the effective date of this decision, Pacific shall address each point raised in the audit, including those related to the information Overland obtained from staff. We will then address the issue in Phase 3B of this proceeding.

i. 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)²⁴¹ 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 books. It claims this is a significant internal control weakness within Pacific's financial reporting structure."²⁴²

Pacific points out that Overland found no errors in Pacific's translation data, and therefore 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."²⁴³

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 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

²⁴¹ 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.

²⁴² Exh. 2A:404 at 20-15 – 20-16 (Audit Report).

²⁴³ Exh. 2B:338 at 48:15-17 (Ellis Direct Testimony).

IEMR reports. Pacific shall also implement its proposed course of action, including any change(s) the Commission orders.

j. 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 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.”²⁴⁴

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. Whether Pacific Impeded the Audit

The record is replete with allegations that Pacific impeded the audit, although Overland states it did not actually use this term,²⁴⁵ choosing to state

²⁴⁴ Exh. 2A:404 at 20-45 – 20-46 (Audit Report).

²⁴⁵ 10 RT 1005:7-26.

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:

[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.

...

The restrictions imposed on the audit prevented us from obtaining sufficient data to develop conclusions in some areas.²⁴⁶

Mr. Welchlin testified that “[o]n average it took more than 70 days to obtain [Pacific’s] complete response to [discovery] requests.” 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,²⁴⁷ the document production was contained in approximately 48 boxes, 53 binders and a handful of small computer disk boxes that fit on one

²⁴⁶ Exh. 2A:404 at 1-4 (Audit Report).

²⁴⁷ 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.”).

set of bookshelves.²⁴⁸ According to Overland, “it took the company more than 18 months to provide this data.”²⁴⁹

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 Pyramids²⁵⁰ - or more than a mile high – was misleading when compared to the actual photograph Overland produced, which showed that all of the documents fit on one set of bookshelves in Overland’s offices.²⁵¹

Moreover, 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

²⁴⁸ Exh. 2B:410, Attachment RW-4 (Welchlin Reply Testimony).

²⁴⁹ *Id.* at 20:26-29.

²⁵⁰ See <http://www.tapyramid.com>.

²⁵¹ 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)).

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.

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.”²⁵² Had Pacific simply responded to the requests as § 314 and the Commission’s own decision required – or at least sought recourse to the Commission’s Law and Motion procedure to obtain 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.

Indeed, 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”²⁵³ 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

²⁵² D.01-08-062, 2001 Cal PUC LEXIS 513, at *3, citing D.01-02-047, *mimeo.*, at 5-6.

²⁵³ D.01-08-062, 2001 Cal PUC LEXIS 513, at *6.

participate in the audit.”²⁵⁴ 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 sample.”²⁵⁵ 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 was 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.”²⁵⁶

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

²⁵⁴ *Id.*

²⁵⁵ Exh. 2B:346 at 8:20-21 (Hogue Direct Testimony).

²⁵⁶ Exh. 2B:410 at 18:29-19:1 (Welchlin Reply Testimony).

10 days, claiming that it only said that for “readily available information,” Pacific would “endeavor to provide it within 10 days.”²⁵⁷

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 70 days means that in many instances, Pacific took longer than 70 days to respond. 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, 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.”²⁵⁸ This claim directly contradicts the point Pacific’s witness made in testimony that “Pacific objected to . . . requests for information outside the audit time period”²⁵⁹ Either Pacific provided information “back to the early 1990s,” or it “objected to requests for information outside the audit

²⁵⁷ Pacific Opening/Audit at 196.

²⁵⁸ Exh. 2B:421 at 2 (Letter from Pacific’s Hogue to Commission’s Leutza).

²⁵⁹ Exh. 2B:346 at 7:19 & 21 (Hogue Direct Testimony).

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.

Third, even if Pacific’s claim regarding the extraordinary amount of data it produced rang 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),”²⁶⁰ “Pacific’s objections totaled less than 5%, or only 65 of the more than 1,300 data requests issued prior to the Report”²⁶¹; “Pacific produced nearly 172,000 pages of paper documents and the equivalent of approximately 19 million pages of documents provided on electronic media”²⁶²

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.²⁶³ 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

²⁶⁰ *Id.* at 7:9-11 (emphasis in original).

²⁶¹ *Id.* at 8:1-2.

²⁶² *Id.* at 14:7-9.

²⁶³ *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.²⁶⁴

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 sought by the Telecommunications Division in carrying out the audit we have

²⁶⁴ Exh. 2B:412 at 7:33-8:4 (Harpster Reply Testimony).

directed, is not inappropriate; indeed it is consistent with ORA's statutory independence to pursue discovery as ORA deems fit."²⁶⁵

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.²⁶⁶

We discuss remedies in more detail in the following section, but as one remedy order completion of the 1997-99 audit with regard to affiliate transactions. The completed audit will also address the concerns we raise in this decision about the adequacy of Pacific's internal controls on affiliate transactions issues.

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.

²⁶⁵ D.01-08-062, 2001 Cal PUC LEXIS 513, at *8.

²⁶⁶ 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.

- 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.

We order this remedy as to 1998. When one totals the adopted audit adjustments from both Phases 2A and 2B, earnings did not exceed the sharing threshold in 1997.

- 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 impose a 10 percent interest rate as a surcredit.

- 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 order this remedy.

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

We commence the next triennial audit under NRF in this decision and in so doing, see to it that audits of years 2000 and beyond will occur in the normal course of our regulatory process.

- 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, but set up a self-executing process of penalties if Pacific does not meet pre-defined discovery deadlines or make a good faith case in support of a protective order shielding it from the discovery.

- 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. 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. We agree that even where the changes do not cause Pacific to share earnings, the integrity of its books and records, and the regulatory process, must be preserved. Therefore, we order Pacific to make each of the changes we discuss in this decision. Pacific shall update its reports no later than 60 days following the effective date of this decision, file and serve the updated reports as a compliance filing in this proceeding, and also file them in the manner it files its other IEMR reports as they come due.

C. 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. It is unclear whether Pacific opposes this request.²⁶⁷ We grant this remedy.

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 be required to change its IEMRs for 2000 forward and continuing until otherwise specified by the Commission.

Pacific shall therefore correct its IEMRs for years subsequent to 1999 consistent with this decision. Pacific should file the correct reports no later than 60 days following the effective date of this decision in the manner it files its other IEMR reports as they come due, and also file and serve the updated IEMRs as a compliance filing in this proceeding.

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 the changes we order 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. Therefore, we will require Pacific to amend its IEMRs and other processes to demonstrate that it is not continuing the practices that we find objectionable or improper in this decision.

²⁶⁷ Pacific's Opening Brief contains an entry in the table of contents stating "ORA's proposal that Pacific submit revised IEMR annual reports for years 2000 and 2001 should be rejected," but the body of its briefs contain no such discussion.

Pacific shall make a compliance filing within 60 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 under oath that it is no longer engaged in disallowed practices, and demonstrating that its practices for 2001 forward comply with this decision.

D. Sharing in 1997 and 1998

ORA contends Pacific should share earnings for 1997 and 1998 if its earnings exceed the sharing threshold. Implicit in this proposal is the recommendation that Pacific change its IEMRs retroactively in the affected years, rather than making “catch-up” adjustments now.

We agree that Pacific should recalculate earnings for 1997 and 1998 based on the audit corrections we order it to make here. If we simply reverse the incorrect expense and revenue assumptions the audit reveals in the current year, the ratepayers will not be made whole. Rather, we find that GAAP does not preclude us from making changes to the IEMR in the affected years, as we discuss fully in the Section entitled “Pacific’s Books and Generally Accepted Accounting Principles,” above.

E. 18 Percent Interest on 1997-98 Shareable Earnings

1. Consideration of 18 Percent Figure

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. It is true that Pacific uses the 18 percent rate for

late payments, and what we have before us is indeed a late payment (in the form of sharing) to ratepayers. There is a certain symmetry to ORA's claim.

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.

There is support for the 18 percent rate ORA advocates. We agree with ORA that the issue was uncontested in the Roseville case, so we did not consider other possible rates. Moreover, we recently stated in another decision that it would be appropriate to use Pacific's late payment rate of 18 percent in similar circumstances:

Recognizing a basic economic principle, that a monetary amount received in the future has less value to the recipient as the same amount received in the present, we will require that the payment account accrue interest. . . . Consequently, we will require the ILECs [Pacific and Verizon] to make monthly payments into an interest-bearing memorandum account *with an interest rate equal to the tariffed rate the respective ILECs charge their customers for late payment*. . . compounded monthly . . .

. "268

²⁶⁸ D.02-03-023, *mimeo.*, at 68-69 (emphasis added).

In that decision, we reasoned that it was important for the ILECs to have “incentives” to perform promptly and properly.²⁶⁹

Nonetheless, for reasons described below, we decline to impose the 18 percent interest rate requested by ORA. We also believe that the 90-day commercial paper rate is inappropriately low for a large sum of money that Pacific has retained for a significant period of time. Interest at a short-term commercial paper rate would allow Pacific to benefit from failing to make timely sharing refunds to ratepayers.

We believe that a 10 percent interest rate is proper in this proceeding. The shareable earnings that should have been returned to ratepayers were tantamount to a substantial infusion of cash into Pacific. If Pacific had obtained these funds from the capital markets, it is reasonable to assume that the cost of the funds would have approximated the 10 percent market-based rate of return (MBROR) established in D.94-06-011. For these reasons, we believe that ratepayers should be compensated at the 10 percent MBROR rate of return.

We note that Pacific’s actual rates of return beginning in 1997 and continuing through 1999 exceed the 10 percent MBROR, showing that Pacific was able to compensate its investors at levels even higher than 10 percent during this period.²⁷⁰ Given that there is authority supporting an 18 percent rate, as noted above, the 10 percent rate is very conservative.

²⁶⁹ *Id.* at 67.

²⁷⁰ As set forth in our Phase 2A decision, Pacific’s RORs in 1997, 1998 and 1999 were 10.22%, 15.38% and 14.19% respectively. The unaudited RORs that Pacific reported on its IEMRs for 2000 and 2001 were 12.83% and 12.55%, respectively. Exh. 2A:411, Attachment MLB-2 (Phase 2A, Brosch Opening Testimony); Pacific’s Advice

Footnote continued on next page

The Commission has used Pacific's rate of return (ROR) as a basis for calculating interest in the past. In D.93-05-062, the Commission used a 12 percent interest rate, based on Pacific's authorized ROR, to assess interest on reparations for overcharges. We stated the following:

We have found that interest shall be paid where the utility has had the use of complainant's money, consistent with PU Code Section 734 which provides that reparations shall be paid with interest (*Wright's Stationers v. Pacific Bell* (1990) 37 CPUC 2d 464). A logical estimate of the value of the funds held by Pacific is its rate of return. Pacific's rate of return is well below its customers' short-term cost of money which is best measured by the interest rate on their credit card purchases. *To simplify the calculation, and calculations of refunds to individual customers, we will use 12% as a reasonable proxy for Pacific's actual rate of return in each year.*²⁷¹

Pacific shall record the refund of sharable earnings and the interest thereon that it is required to pay as a result of this decision and the Phase 2A decision below-the-line. Such treatment is consistent with the Commission's treatment of shareable earnings in D.89-10-031. In that decision, the Commission stated that a "ratemaking adjustment may be required in a year in which a prior year's excess earnings are returned to ratepayers through the sharing mechanism, to prevent the return of earnings from depressing current year earnings in the sharing calculation."²⁷² Thus, it was clearly the Commission's intent that shareable earnings in a prior year should not distort reported earnings in a subsequent

Letter 22800A, of which we take official notice (2001 reported ROR revised from 12.48% to 12.55%).

²⁷¹ 1993 Cal. PUC LEXIS 394, at *41-42, 49 CPUC 2d 299, 314 (1993) (emphasis added).

²⁷² D.89-10-031, 33 CPUC 2d 43, 186 (1989).

year. Likewise, the interest that Pacific owes on shareable earnings should not distort reported earnings.

2. 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. 33.²⁷³ That Rule lists Pacific's billing surcharges, and seems to be an appropriate place to list the surcredit we order here. 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."²⁷⁴ 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 shared earnings will be returned to ratepayers through a surcredit on bills for basic end user monopoly services."²⁷⁵

We agree with ORA's suggestion, and will require that Pacific reflect the surcredit in Rule 33 of its tariffs. This refund mechanism is consistent with the procedure adopted in D.89-10-031²⁷⁶ for returning shareable earnings to end-users. In that decision, the Commission required that shareable earnings

²⁷³ 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, at sheet 135 *et seq.*

²⁷⁴ ORA Opening/Audit at 81.

²⁷⁵ D.89-10-031, 1989 Cal. PUC LEXIS 576, at *6.

²⁷⁶ 1989 Cal. PUC LEXIS 576.

should be made through a bill and keep surcredit to all Category I basic monopoly services, excluding switched and low speed special access and other services normally excluded from surcredits. This process returns any shared revenues to end-users in a practical, fair, and equitable manner. While there have been substantial recategorization of services from Category I since the Commission rendered its decision in D.89-10-031, the rationale of flowing shareable earnings and applicable interest to end users is the same today as it was previously. Consequently, regardless of the category that the above services reside in, Pacific shall follow the procedure adopted in D.89-10-031 to return to ratepayers the shareable earnings adopted in this decision and the Phase 2A decision.

Only end-user customers – and not purchasers of intermediary services such as access services and UNEs – shall receive the benefits of the surcredit. In D.98-09-039, we chose a three month surcredit in connection with a refund of approximately \$400 million by balancing the interests of “1) customers of the large LECs who would not fully benefit from a surcredit of longer duration because they would not remain customers of the large LECs for more than three months, and (2) customers who would not fully benefit from a surcredit of shorter duration because they happen to have an unusually small amount of usage or charges during the period the surcredit would be in effect.”²⁷⁷

We believe that balancing the interest of the same two classes of customers is appropriate, but in view of the size of the surcredit in this case, we find it is most prudent to extend the credit over a 12-month period, commencing no later

²⁷⁷ D.98-09-039, 1998 Cal. PUC LEXIS 971.

than 120 days from the effective date of this decision. In this way, we avoid the “rate shock” that may occur after a short surcredit period in which customers receive significantly discounted bills. With a 12-month period, the credit each ratepayer receives each month will still be significant, but the transition back to regular rates will not be as drastic.

F. Suspension of Sharing in 1999

ORA and TURN claim 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.

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.²⁷⁸

This does not mean that we will not make 1999 audit adjustments that we find supported by the evidence. We will require Pacific to make these adjustments to the 1999 IEMR report. 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 60 days after the effective date of this

²⁷⁸ 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.

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.

G. 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 reimpose sharing 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*²⁷⁹ for the proposition that we may fashion an appropriate remedy where a utility has obtained a rate by fraud.²⁸⁰ 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, with the exception of those earnings that exceed the sharing threshold.

By the same token, we are concerned that because the Commission no longer requires sharing, if we only impose interest on the shareable earnings, Pacific will have little added incentive to report its earnings accurately in the future. This is because if it underreports earnings, its only future obligation will be to correct its reporting if we find it to be in error. If Pacific only is required to pay the amount it would have paid had it not made the error, it will have little incentive to ensure the correctness of its future IEMRs. ORA explains that “the Commission needs to find effective ways to deter Pacific from engaging in this

²⁷⁹ 77 Cal. App. 4th 287 (1999).

²⁸⁰ ORA Reply/Audit at 55.

type of conduct if the Commission is to obtain the accurate financial information it need[s].”²⁸¹

We agree with ORA that Pacific should be incented to take better care with its expense and earnings reporting. If we were simply to require Pacific to change its financial statements Pacific would have no financial incentive to ensure the correctness of its financial statements. Because any error would result only in the requirement that Pacific go back and do what it should have done in the first place, there would be no disincentive to sloppy reporting. While it may be argued that every utility has such a disincentive simply in its desire to obey the law, experience has shown that financial incentives are a far more powerful means of ensuring compliance.

Over the years, we have adopted financial penalties as an incentive to ensure compliance with our rules, including those related to financial reporting. For example, in our recent decision on Pacific’s application pursuant to § 271 of the federal Telecommunications Act of 1996,²⁸² 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.²⁸³

²⁸¹ ORA Opening/Audit at 89.

²⁸² 42 U.S.C. § 271.

²⁸³ 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).

We do not have an adequate record on the types of incentives we might impose in this context. We invite parties to propose mechanisms in Phase 3B that will create the proper incentives for Pacific to report its results accurately.

H. Reinstating 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 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. Indeed, we have included this precise issue in the scoping memo for that phase.

I. Completion of 1997-99 Audit – Affiliate Transactions

Overland recommends that it be allowed to complete its 1997-99 audit of Pacific's affiliate transactions, and we concur with that recommendation. As Overland's Mr. Welchlin testified: "Affiliate transactions when we began the audit was a significant area of focus. It was later in the audit that a determination was made based on preliminary review to shift some of the work effort toward regulated transactions that did not involve affiliates. . . . [One of the] issue[s] is we were running into difficulties in having the company coordinate [sic] with responding to data requests."²⁸⁴ In issuing a supplemental

²⁸⁴ 10 RT 1003:12-16, 1005:2-4 (Welchlin). Overland also concluded that it "did not conclude that internal control weaknesses affecting affiliate service transactions had a material impact on Pacific Bell's CPUC-basis financial results during the years 1997 through 1999." Exh. 2A:404 at 12-3 (Audit Report). We discuss the concept of materiality in the Section entitled "Materiality," above, and reject the concept that the

Footnote continued on next page

audit report, Overland reported that it had not been able to include the supplemental discussion “because relevant data responses were not received in time to be incorporated into the report.”²⁸⁵

We find at least two reasons to complete the affiliate transactions audit for 1997-99. First, as we note above, Overland was unable to complete the audit it undertook. Thus, we order completion of the affiliate transactions audit for the 1997-99 audit period in order to ensure a complete record. Second, we find in analyzing the affiliate transactions issues for this decision that several issues require additional work, as we point out in the substantive discussion above. We attach hereto as Appendix E a list of the areas requiring further audit.

We will leave this specific audit responsibility with TD. When we assigned the audit to TD, we did so on the ground that the Commission has authority to assign its personnel as it sees fit. While we believe ORA should be in charge of future audits on this same ground, it makes practical sense for TD to finish the coordination of the affiliate transactions audit since it has overseen the audit for so long.

The auditors shall complete the affiliate transactions portion of the audit and their associated audit report no later than 6 months following the effective date of this decision, or such other date as the Assigned Commissioner may determine. After the audit is complete, we suggest the following procedure: Once the affiliate transactions audit is finished, TD shall file and serve a notice of availability of the supplemental audit report on the service list for this

affiliate transaction weaknesses Overland found were not “material” enough to require the changes in Pacific’s reporting that we order in this decision.

²⁸⁵ Exh. 2B:415 at S12-1 (Supplemental Audit Report).

proceeding. TD shall also provide a copy of the supplemental audit report to the assigned Commissioner, the assigned ALJ, and Pacific. Pacific shall file a response to the audit report no later than 45 days after TD serves notice that the audit report is available. TD shall provide a copy of its audit report to any party that requests a copy. Pacific shall likewise provide a copy of its response to any party that requests a copy. Any party requesting a copy of the audit report and/or response should sign a non-disclosure agreement, as appropriate.²⁸⁶ The Assigned Commissioner may determine what steps, if any, are necessary in response to TD's audit report and Pacific's response. For example, the Commissioner may schedule evidentiary hearings or require briefing.

The auditors need not provide Pacific with a copy of the draft audit before it is issued, but the foregoing process ensures that Pacific will have adequate opportunity to comment on the final follow-up audit report.

J. Audit of Pacific's 2000-02 Reporting, Including Affiliate Transactions

We hereby order commencement of the next triennial review under NRF of Pacific's performance covering the years 2000 forward, including affiliate transactions.²⁸⁷ Therefore, we do not order a separate audit for the years 2000 and beyond as part of Phase 2B of this current review. Rather, the next audit –

²⁸⁶ These rules are identical to what we provided in the OIR, R.01-09-001/I.01-09-002, Appendix A. *See also* D.96-05-036, 66 CPUC 2d 274, 278 (1996), ordering paragraphs 3 and 4.

²⁸⁷ We note the auditors' conclusion here that the magnitude of the affiliate transactions really did not grow until 2000, the year after the audit period ended. If we are truly to ensure that the problems the audit began to unearth are not continuing – and to verify Pacific's claims to have improved its own internal controls – we believe an audit of the

Footnote continued on next page

including an examination of Pacific's affiliate transactions for the period 2000-02 – will occur as part of the normal NRF triennial review process. We reiterate what we said in our Phase 1 decision regarding Verizon. The same process shall apply to Pacific:

Audits are an essential part of NRF. They 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.

...

[E]ven if no problems had been found, it is prudent for the Commission to maintain continuous, comprehensive, and vigilant oversight of large utilities like Verizon [and Pacific] that provide essential services to millions of Californians.²⁸⁸

For the preceding reasons, we will direct ORA to conduct a thorough audit of Pacific covering the period of time of 2000 through 2002. A primary purpose of the audit should be to determine if the information that Pacific reported in its NRF monitoring reports for the years 2000-02 was accurate and reflected Commission regulatory requirements. This will necessarily entail a detailed examination of the information that Pacific provided in its monitoring reports pertaining to its revenues, expenses, assets, liabilities, cash flows, service quality, affiliate transactions, and such other matters as the Commission may designate. ORA's audit of information regarding service quality should extend to any reports that Pacific submitted to the FCC that contain information pertaining to

post-audit period years is necessary. We therefore order that the next triennial review include an affiliate transactions audit.

²⁸⁸ D.02-10-020, *mimeo.*, at 54.

service quality in California. In addition, ORA's audit of information regarding affiliate transactions should include an examination of affiliates' books and records.

We expect Pacific to cooperate fully with the audit. For example, Pacific shall (1) comply in a timely manner with ORA's requests for information and documents, and (2) provide ORA with access to any and all documents, whether or not they are monitoring reports filed with the Commission, that are necessary or useful to ORA in conducting its audit. We place Pacific on notice that any failure to cooperate will be subject to monetary penalties and other sanctions.

The Commission is required by Pub. Util. Code § 314.5 to audit Pacific at least every three years. Because Overland's audit report on Pacific that is before us in this proceeding was issued on February 21, 2002 (with the supplemental report issued on June 20, 2002), we conclude that ORA should commence the next audit of Pacific as soon as possible in order to meet the statutory requirement of triennial audits.

ORA should submit its audit report in the next triennial NRF review. After the audit report is submitted, Pacific and other parties will have an opportunity to respond to the report. The exact dates for the submittal of ORA's audit report and responses will be determined in the next NRF review.

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).²⁸⁹

It will be the responsibility of ORA and the Commission to ensure that any CPAs or other technical experts that ORA hires possess the requisite competence, objectivity, and independence. Nothing in this decision authorizes parties outside the Commission to participate in or challenge the selection or oversight of any auditors or technical experts that ORA hires. If any party outside the Commission wishes to challenge the competence, objectivity, or independence of any CPAs or other technical experts that ORA retains, they will have an opportunity to do so only after the audit is complete and only in a docketed proceeding in which the audit findings are considered by the Commission.

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.²⁹⁰ The audit-related costs included in the advice letter should not exceed the amount billed to Pacific by the Commission 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.

²⁸⁹ 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.

²⁹⁰ 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."

K. Incentive Payment of \$20 Million

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. However, Pacific shall be on notice that we consider its participation in the completed portions of the audit to have been less than satisfactory. We will not hesitate to fine Pacific or impose other sanctions if the auditors, TD or ORA experience problems in conducting the future audits we discuss here.

In addition, Pacific shall provide written responses within 10 days of receipt²⁹¹ of data requests issued in connection with the continued 1997-99 affiliate transactions audit or the 2000-02 audit we order in this decision. These written responses shall contain, at a minimum, all of Pacific's objections to the request, and a statement of what Pacific intends to produce in response to the request. Where information responsive to the request is readily available, Pacific shall also produce such material with its 10-day response. At the outside limit, Pacific shall produce all documents and provide full substantive responses to the data requests within 30 days of receipt of a data request.

²⁹¹ We will deem a request to have been received on the date it is hand delivered, emailed or faxed before 5:00 p.m. Pacific time; to have been received on the business day after it is delivered by express mail for next day delivery; and to have been received within 3 business days of mailing for requests sent via regular U.S. mail.

If Pacific requires additional time to respond, and only after a good faith attempt to meet and confer with the propounding party, Pacific may file a motion for protective order. In the motion, Pacific must establish a good faith basis for further delay. If Pacific neither responds fully to a data request, nor files a motion for protective order within the 30-day period, we will impose a penalty on Pacific of \$500 per day per data request in keeping with the authority granted us in Pub. Util. Code § 2107.

L. 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.

It is premature to decide whether a penalty phase is warranted on Pacific's affiliate transactions compliance until the auditors complete the affiliate transactions review for 1997-99. ORA may renew its request after that audit is completed.

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.²⁹² The only evidence in the record is that Pacific shares information about its customers with SBC Operations, a subsidiary

²⁹² California Public Utilities Code § 2891(d) contains ten exceptions to this requirement, none of which are applicable here.

of Pacific's parent, SBC, which in turn uses the information to conduct marketing and research on Pacific's behalf.

In D.01-09-058, we declined to reach a claim that Pacific violated § 2891 by this same conduct due again to the absence of an adequate record on the issue. Pacific claimed that there was an "agency" exception that allowed it to disclose customer information to SBC Operations and third parties conducting marketing on Pacific's behalf. We found that we could not rule on the claim because there was insufficient evidence in the record. We initially stated that "Based on the plain language of the statute, this release of residential subscribers' personal information [to SBC Operations] appears to constitute a violation of § 2891." Nonetheless, we concluded that "we cannot determine whether Pacific Bell's treatment of confidential subscriber information violated § 2891. As the burden of demonstrating that a violation was committed lies with complainants, we decline to find Pacific Bell in violation of § 2891 in this proceeding."²⁹³

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.

M. 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.

²⁹³ D.01-09-058, 2001 Cal. PUC LEXIS 914, at *109-110.

VIII. Recovery of Audit Costs

Pacific claims it should recover the full cost of the audit from its customers, an amount it estimates at just over \$2 million.²⁹⁴ However, as the Commission noted in D.96-05-036, one decision addressing Pacific's effort to transfer audit responsibility away from DRA, ORA's predecessor, "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.*"²⁹⁵ At the same time, however, the Commission provided that Pacific could later seek exogenous cost treatment for the audit.²⁹⁶

Exogenous cost recovery allows a company to recover extraordinary costs in a process separate from the NRF price indexing mechanism itself. The company must satisfy nine criteria in order to qualify for such recovery.²⁹⁷ The nine criteria are: (1) is the event creating the cost at issue exogenous?; (2) did the event causing the cost occur after the NRF was adopted in late 1989?; (3) is the cost clearly beyond management's control?; (4) is the cost a normal cost of doing business, even if it is increased by an exogenous event?; (5) does the event have a disproportionate impact on local exchange carriers?; (6) is the cost caused by the event reflected in the economy-wide inflation factor (GDPPI) used in the annual NRF price cap proceeding?; (7) does the event have a major impact on the

²⁹⁴ Pacific Opening/Audit at 214.

²⁹⁵ D.96-05-036, 66 CPUC 2d 274 (1996), 1996 Cal. PUC LEXIS 657, at *9.

²⁹⁶ *Id.*

²⁹⁷ The Commission originally adopted these nine criteria, collectively known as Z-factors, in D.94-06-011, 55 CPUC 2d 1 (1994). In D.98-10-026, the Commission allowed Limited Exogenous (LE) Factor treatment as a replacement for the Z-factor.

utility's overall cost?; (8) can actual costs be used to measure the financial impact of the event, or can the costs be determined with reasonable certainty and minimal controversy?; and (9) are the proposed costs reasonable?²⁹⁸

Pacific claims it meets all nine criteria. ORA asserts it fails to meet four of the criteria. TURN claims that audits are simply part of Pacific's regulatory compliance costs, are a normal cost of doing business, are not extraordinary and therefore do not warrant exogenous recovery under the fourth criterion.

Because all criteria must be satisfied, and we find that several are not, we only discuss here the criteria Pacific's claim does not satisfy. ORA contends that the claim for audit costs does not meet the third requirement that the cost clearly be beyond management's control. A finding against Pacific on this criterion might still allow Pacific some cost recovery, because at least some of the cost of the audit clearly was beyond such control.

ORA claims that much of the effort expended on the audit was due to Pacific's alleged recalcitrance in responding to data requests and its general resistance to furnishing the auditors requested information. We discuss this general allegation in more detail in the Section entitled "Whether Pacific Impeded the Audit," above, and find there that in at least some instances, Pacific's own conduct delayed and unduly increased the work associated with the audit. Thus, under this criterion, some of the audit costs were within the control of Pacific's management, and are not recoverable. However, because we find that Pacific fails to meet other LE criteria allowing it any audit cost recovery,

²⁹⁸ D.94-06-011, 55 CPUC 2d 1, 36-41 (1994); D.98-10-026, 82 CPUC 2d 335, 1998 Cal. PUC LEXIS 669, § 7.2.3, n.23.

we need not decide which costs were and were not within management's control.

ORA also claims the costs do not meet criterion 7: "does the event have a major impact on the utility's overall cost?" ORA claims that given Pacific's strict view of what is "material" in other parts of its case (a view we reject elsewhere in this decision), Pacific ought to have to live by that view in calculating whether \$2 million has a major impact on Pacific's overall cost. We do not view the issue this way, and find that \$2 million does have a major impact.

ORA also questions whether actual costs can be used to measure the financial impact of the event, or whether the costs can be determined with reasonable certainty and minimal controversy (criterion 8). Because, ORA contends, the audit is not even finished as to affiliate transactions due to Pacific's own resistance, it is impossible at this time to determine the actual costs. We agree, but suspect that at some point the total audit costs will be ascertainable with reasonable certainty and minimal controversy. By the same token, since we find that management could have controlled some of the costs under criterion 3, a determination of which costs Pacific should and should not recover will probably never be uncontroversial. For this reason, we find Pacific cannot satisfy criterion 8.

Finally, ORA questions whether the costs proposed for exogenous factor treatment are reasonable (criterion 9). Once again, ORA states that due to Pacific's unreasonable behavior, costs escalated far above what they would have been had Pacific been more cooperative. We have agreed with this view, at least in part, in discussing whether Pacific impeded the audit. Any costs that were entirely within the control of management would not be reasonably recovered

from ratepayers. At least as to those costs, therefore, we find once again that Pacific has failed to prove entitlement to exogenous cost recovery.

The question then becomes whether we should disallow some or all of the audit costs. We find that such a determination is premature. We order completion of the affiliate transactions audit of Pacific, in part because of its failure to cooperate with the original audit. Many of the exogenous cost factors we discuss above deal with whether the company seeking exogenous treatment has acted reasonably, unnecessarily increased the relevant costs, or contributed to a delay in the work generating the expense.

We will closely examine Pacific's level of cooperation with the remaining portion of the audit in considering its exogenous cost recovery request. We expect Pacific's full cooperation with the audit, and will consider a renewed request for exogenous treatment of the full amount of audit costs once we deem the audit complete. Therefore, we defer ruling on Pacific's request until the affiliate transactions portion of the audit is complete.

IX. Comments on Proposed Decision

The proposed decision of the Administrative Law Judge was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on _____, and reply comments were filed on _____.

X. Assignment of Proceeding

Susan Kennedy is the Assigned Commissioner and Sarah R. Thomas is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. Many of the audit findings are justified and in many instances Pacific over-reported expenses with significant consequences for ratepayers.

2. In 1997 and 1998, Pacific was under an obligation to share earnings above a certain threshold with ratepayers. However, its excessive reported expenses caused Pacific's reported earnings to be improperly depressed. In combination with the audit decision resulting from Phase 2A of this proceeding, the adjusted earnings rose to a level that requires Pacific to share earnings in 1998.

3. In 1999, Pacific also over-reported expenses, but was under no obligation in that year to share earnings with ratepayers.

4. Neither Overland nor the TD is a party to this proceeding.

5. 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.

6. Pacific maintained its FR books during the audit period solely for the purpose of creating the IEMR. 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.

7. An adjustment to Pacific's IEMR in the current period – when sharing is no longer Pacific's obligation – is insufficient to make ratepayers whole.

8. NRF alters the direct link between a utility's costs and its prices.

9. During a period when revenue sharing is in effect, a reduction in the amount of net revenues shared with ratepayers constitutes a form of economic harm to those ratepayers. The higher Pacific's costs as reported in the IEMR, the lower its revenues and ultimately its potentially shareable earnings.

10. 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.

11. It is essential to the regulatory process that we have accurate information regarding the earnings of companies we regulate.

12. Materiality in the context of the audit is to be determined by ORA and/or the Commission. The Commission imposed a low threshold of materiality in this context in order to insure “full compliance with its rules and regulations.”

13. Even if a single item of adjustment is immaterial, it may be material viewed in context with the other adjustments we order. Where, as here, the Commission’s review is likely to result in a cumulative adjustment in an amount that meets anyone’s definition of material, then every issue should be deemed material.

14. The one area in which Overland was unable to meet GAAS was where Pacific failed to give it adequate information to allow the auditors to perform their auditing function and form a professional opinion based on verifiable data.

15. There is no evidence that Overland is biased against Pacific.

16. Overland’s statement that it would meet NARUC requirements in carrying out its audit was a typographical error. The Commission required that Overland follow GAAS, and Overland did so.

17. Pacific had adequate opportunity to respond to the audit report.

18. Overland did not engage in lengthy policy discussions in its audit report. Rather, 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.”

19. Any errors Overland made in its audit are inconsequential in an audit of this size.

20. Pacific conceded 20 out of 72 audit adjustments, at least to the extent of agreeing that the accounting treatment it used for purposes of its IEMR was incorrect.

21. The Commission has adequate means of protecting confidential information.

22. In 1996, Pacific implemented the new RCRMS automated bill collection system.

23. Pacific was aware of problems with RCRMS in 1996.

24. Other than in the period in 1996 at issue, Pacific's bad debt did not fluctuate drastically as it did during the period at issue. The fluctuation put Pacific on notice of a serious problem in 1996.

25. In 1996, Pacific changed how it accounted for revenues and expenses related to published directories. Prior to then, it accounted for them over the life of the directory. In 1996, it began recognizing revenue and expense when the directory is issued.

26. 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.

27. 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 no impact on earnings, the difference between an expense and a regulatory asset is significant to Pacific's IEMR.

28. 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.

29. In December 1999, Pacific amended its existing contract with Lucent for software right-to-use fees, replacing Pacific's obligation to make quarterly payments for the contract period with a one-time payment of \$56 million. All other terms and conditions of the existing contract remained in effect.

30. 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.

31. 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.

32. In 1997, Pacific recorded a \$12.6 million entry related to pre-1976 employee 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 \$10 million in that year to the possible detriment of ratepayers.

33. 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.

34. 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.

35. 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."

36. The purpose of an audit is to test management's judgments, and to ensure that all accounting transactions that raise questions are verified.

37. It is not correct in all cases that when subsequent events indicate that a previously recorded liability has been reduced or eliminated, a reversal is appropriate in the current period.

38. 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.

39. 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, rather than reflecting a change in 1998 and 1999, the affected years.

40. 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.

41. 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, show that Pacific had a serious internal control problem in maintaining accurate property records during the audit period.

42. 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.

43. During the audit period, Pacific reported financial results of property it did not have, had property in inventory that it did not report, and generally lacked control over its property records and inventory.

44. 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.

45. Pacific incorrectly assumed for plant it located in the central offices for which it had no record that it had never recorded that plant in its accounts. It is more plausible that Pacific either charged the equipment to expense when it acquired it or originally lumped it in with other continuing property record items.

46. Allowing Pacific to depreciate the unrecorded central office plant anew would double depreciation expense and depress earnings.

47. 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.

48. Pacific's defense to Overland's finding that Pacific's intrastate net plant is overstated – that Overland's calculations are wrong because they do not account for more recent activity – is a non sequitur, because Overland was not focused on recent activity, but rather on the period 1997-99. Pacific cites no other reason to change Overland's conclusion. Pacific concedes an error of \$4.4 million for each year.

49. Pacific acknowledges that to the extent we adopt any of Overland's adjustments to depreciation expense, we should also adjust accumulated reserve for depreciation.

50. 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.

51. Pacific did not provide any Commission ruling or order authorizing the methodology Pacific employs to implement the Resolution RF-4 AFUDC calculations.

52. 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.

53. Pacific has not updated any of its lead-lag studies, used to determine its cash working capital needs, since 1988.

54. Because Pacific has not updated its lead-lag studies since 1988, Pacific cannot support its lead-lag assumptions.

55. In its supplemental audit report, Overland found that Pacific's intrastate cash working capital averaged \$3 million per year during the audit period.

56. Setting 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.

57. The volume of relevant transactions subject to Pacific's lead-lag studies was substantially higher in 1997-99 than in 1988, when Pacific last updated the approximately 20 relevant lead-lag calculations.

58. In its cash working capital calculation, Pacific assumed lengthy periods for payments to it by its affiliates, from 669 days in 1997 to 115 days in 1999.

59. Pacific overstated Directory's cash working capital requirements due to a 1996 change in the way Pacific accounted for the costs of publishing directories, from amortizing the publishing costs over the directory billing period and recognizing revenues as they were billed, to charging all publishing costs to expense when the directory was issued and accruing all of the revenues for the directory on the issue date. The revenue recognized on the issue date exceeds the publishing costs by a significant margin because publishing costs represent only approximately 20 percent of Directory's total revenues.

60. Because Pacific does not always know when the directory is published how long the directory will be in use, it is not correct to realize all revenues from that directory at the time the directory is issued, since those revenues will vary based on the life of the directory.

61. There are problems in including "non-cash" items such as depreciation in cash working capital, since these expenses do not actually require Pacific to make a cash outlay. Excluding non-cash items from cash working capital requirements actually brings that requirement to a negative (below zero) figure.

62. For the audit period and subsequent years, the evidence establishes that Pacific's actual cash working capital requirement was close to zero.

63. The record is not sufficiently specific on what was in Pacific's start-up rate base.

64. Overland could not determine there was an impact on revenues and expenses when Pacific began charging its prepaid directory publishing costs when the directory is published, rather than including prepaid publishing costs in rate base and amortizing them over the 12-month life of the published directory.

65. The Phase 2A decision deals with audit corrections related to prepaid pension assets.

66. Pacific recorded its FAS 112 liability in Account 4310.

67. Rate base consists of investments made by utility shareholders on which they are entitled to earn a reasonable return.

68. Pacific's FAS 112 liability is a zero-cost source of funds, rather than a shareholder investment.

69. Vacation pay liability represents cost-free capital to Pacific.

70. Pacific's FAS 106 liability represents cost-free capital to the company.

71. The absolute value of reported income statement transactions between SBC Pacific and affiliates doubled between 1999 to 2000, from \$1.3 billion to \$2.5 billion.

72. Transactions between Pacific Bell and affiliates grew seven-fold between 1996 and 2000.

73. Pacific did not fully cooperate with the audit in the area of affiliate transactions.

74. Pacific agreed with 13 of Overland's affiliate transaction-related adjustments.

75. Pacific acknowledges that it should improve some existing internal controls, related to classification of costs among its FCC Part 32 accounts; retain

certain data to support allocations to Pacific; and revise certain portions of the SBC Operations cost apportionment methodology.

76. Affiliate transactions are one of the more difficult areas of regulatory accounting to understand. Pacific's witnesses did not fully explain the transactions when dealing with the auditors, but rather assumed a great deal of knowledge that the auditors may not have had. This is not the fault of the auditors; the onus is on Pacific to act cooperatively with the auditors to break through these barriers in "translation."

77. Pacific required employees of SBC Operations and SBC Services to comply with the affiliate transactions time reporting requirement set forth in the 1997 FCC Consent Decree.

78. Overland initially reviewed only samples of the FCC Consent Decree affiliate transaction time records provided. During the hearing, it reviewed more complete documents. The later review produced higher rates of compliance.

79. Even if one omits Consent Decree compliance as an issue relevant to how well SBC ensures that Pacific's regulated operations do not subsidize the unregulated affiliates, Pacific still has many internal control problems.

80. 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."

81. Pacific draft report of the 1998 internal review of affiliate transactions was more credible than the final, since it examined actual results rather than relying on what would happen in a future year end true-up.

82. The evidence did not establish 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.

83. Pacific did not furnish Overland enough information about the process it uses for tracking legal matters for Overland to determine whether that process is adequate to ensure that the regulated utility is only paying appropriate legal bills.

84. There was no documented dispute between Pacific and the entities charging Pacific management fees.

85. The management fees SBC Services passed on to Pacific rose from \$30 million in 1999 to \$1.1 billion in 2000.

86. Pacific's management had little control over SBC decisions on the type and amount of management fees to assess on the regulated utility.

87. 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.

88. TRI followed a general allocation process for attributing costs to Pacific, rather than attempting to bill Pacific based on a determination of whether its R&D expenses actually benefited the utility.

89. R&D costs allocated on the basis of size-based allocators such as historical investment and customer count are not designed to match costs with the affiliates receiving the benefit of such endeavors.

90. Pacific was not part of SBC during the period of the FCC's joint audit of TRI's expenses.

91. 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.

92. Pacific classified certain expenses to the incorrect Part 32 accounts.

93. SBC Operations lost certain documentation supporting the SBC Operations allocation factors for assignment of costs to Pacific Bell.

94. 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. Pacific did not provide Overland adequate information for Overland to reach an opinion on the reasonableness of the charges Pacific assessed on unregulated SBC affiliates.

95. Pacific did not charge regulated affiliates a 10% mark-up for services Pacific performed on behalf of those affiliates.

96. Pacific's FMV studies do not justify the FDC rates it charges its affiliates.

97. Pacific did not adequately document its FDC prices. It gave Overland only the most basic information about the rate – rather than cost – elements used to come up with the FDC cost figure. However, these rate elements do not establish whether the underlying costs justify the FDC amount.

98. Pacific's act of giving the SBC Shared Services organization "access" to its customer database was equivalent to effecting a "transfer" of customer records.

99. The evidence did not establish whether SBC Operations retains any data or other work product related to its analysis of Pacific's customer records or marketing to Pacific's customers after returning the analysis to Pacific.

100. The Pacific customer data SBC Operations uses to perform analysis and marketing for Pacific would be valuable to any provider of telecommunications services, as it may include the customer's calling patterns, as well as all of the regulated and unregulated services they receive.

101. SBC uses Pacific's customer information to conduct "joint marketing" efforts on Pacific's behalf.

102. Pacific did not obtain the Commission's approval to transfer Pacific Bell Directory to Pacific Telesis Group.

103. Pacific should have known as far back as December 1985 that a transfer of Pacific Bell Directory would require Commission approval.

104. Pacific's affiliate ASI is important because it is the entity in which most of Pacific's DSL services are housed.

105. 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.

106. Pacific conceded that it is appropriate for the Commission to 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.

107. 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.

108. The current record lacks information that is necessary for us to rule on the issue of ratepayer compensation for DSL development costs. Therefore, we agree that it is appropriate to defer certain issues to the § 851 proceeding. However, Pacific shall also furnish relevant information in this proceeding.

109. During the audit period, DSL/ASI expenses and capital investment were charged to Pacific's regulated operations, whereas a disproportionately small amount of revenues from the sale of DSL services was credited to regulated operations.

110. With the transfer of DSL services to ASI, revenues from the sale of DSL services have been collected by ASI, not Pacific.

111. We lack information about Pacific's "separation" of DSL costs and revenues between the interstate and intrastate jurisdictions, which may be a relevant consideration in deciding the ratepayer compensation issue.

112. We lack data about affiliate payments and other revenues that Pacific may receive from furnishing DSL-related services to ASI.

113. It would be helpful to the Commission to have DSL/ASI expense, investment, and revenue information for the years 2000 and beyond, information we also lack here, to determine whether to compensate Pacific's regulated operations for DSL development costs.

114. Pacific may have developed non-DSL services above-the-line and transferred them to ASI.

115. Pacific agreed voluntarily to limit its regulated operations' exposure for Pacific Bell executive compensation to \$200,000 per year per executive.

116. 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.

117. Pacific's witness suggested Pacific should renege on its voluntary cap on executive compensation that it reports for regulatory purposes.

118. 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.

119. During the audit period, the SBC parent organization allocated certain executive compensation to Pacific Bell Directory that exceeded the \$200,000 cap.

120. 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.

121. Pacific also bore the expense of the AMDOCS acquisition/Ameritech merger executive compensation allocated to it by SBC Operations (and not just the parent).

122. Pacific bore executive compensation related to the AMDOCS acquisition/Ameritech merger - this time allocated to it by SBC Services.

123. 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.

124. SBC allocated legal expenses to Pacific Bell Directory.

125. As shown in Appendix D hereto, Pacific did not dispute the auditor's non-affiliate-transaction adjustments in connection with items similar to those Pacific disputes related to parent expenses for public relations and corporate sponsorship allocated to Pacific Bell and Pacific Bell Directory.

126. 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.

127. During the audit period, Pacific and Pacific Bell Directory bore expense related to the SBC parent's strategic planning activities.

128. The SBC parent company billed Pacific \$7.4 million in 1998 for services rendered in 1997.

129. The record does not show whether Pacific charged its unregulated affiliates FDC for its services, as the rules require, or an additional 10% mark-up.

130. 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."

131. In 1997, Pacific recorded a portion of the payment it made for the naming rights to Pacific Bell Park above-the-line.

132. Pacific corrected depreciation expense allocation in December 1999 according to incorrect rates of depreciation, understating its California nonregulated depreciation expense.

133. Pacific concedes that audit adjustments for political and legislative influence and regulatory affairs are appropriate when the regulated utility carries out the activities.

134. We do not have an adequate record to determine whether Pacific misallocates Customer Service expense between regulated and nonregulated cost categories.

135. During the audit period, Pacific Bell tracked expenses it incurred in marketing telephone services in GTE's (now Verizon's) service territory in a way that indicated it planned to charge these expenses in whole or part to Pacific's regulated business.

136. We lack an adequate record to consider Overland's recommendation 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."

137. 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.

138. 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.

139. 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.

140. 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.

141. PBIS and PBNI have a significant financial impact on Pacific's business.

142. Pacific uses its ESTRS system as a statistically valid sampling process to determine the allocation of marketing hours between regulated and nonregulated work activities.

143. On average it took more than 70 days for Overland to obtain Pacific's complete response to Overland's discovery requests.

144. A photograph of the entire universe of documents Pacific produced to Overland related to the audit shows that 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. It took Pacific more than 18 months to provide this data.

145. For an audit covering the operations of a company the size of Pacific Bell – which included focus on many of Pacific's affiliates – the universe of documents described in the preceding Finding of Fact is not an inordinate number of documents.

146. Pacific's witness' claim that the documents it produced would stack as high as more than seven Transamerica Pyramids - or more than a mile high – was misleading when compared to the actual photograph Overland produced, which showed that all of the documents fit on one set of bookshelves in Overland's offices.

147. If Pacific felt the auditors sought information that was not relevant or that was burdensome, it did not respond.

148. 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.”

149. Pacific effectively conceded that Pub. Util. Code § 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” 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.”

150. 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.

151. 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. The fact that the average was 70 days means that in many instances, Pacific took longer than 70 days to respond. Had Pacific only needed slightly more time than 10 days to respond, the average would have been far lower than 70 days.

152. 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.

153. Pacific had a motivation to slow down the audit process, since it was clear Overland was focusing on potential errors in Pacific’s accounting methods.

154. 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.” This claim contradicts the point Pacific’s witness made in testimony that “Pacific objected to . . . requests for information outside the audit time period” 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.

155. Sheer volume in data request responses does not necessarily mean quality.

156. One of the examples Pacific’s witness gave in response to the question “Please provide some examples of Overland’s data requests that contributed to the delays in the response time,” related to contingent liabilities. The request was narrower than how the witness characterized it.

157. It took Pacific 384 days – more than a full year – to respond to a 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.

158. The pleadings Pacific produced in response to the foregoing request were voluminous and in many cases highly repetitive. The documents they did produce did not provide enough information for an auditor to estimate the contingent liability that should be recorded for the cases.

159. Pacific’s resistance to discovery was not 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.

160. While there are small differences among the various ORA remedy 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.

161. Many of the changes we order to the 1997-99 IEMR reports also apply to subsequent years.

162. 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.

163. Pacific charges customers making late payments on their telephone bills a late charge amounting to 18 percent of the bill.

164. Pacific earned at least a 10 percent rate of return during the audit years.

165. The 90-day commercial paper rate currently stands in the 2 percent range.

166. Pacific's actual rates of return beginning in 1997 and continuing through 1999 exceed the 10% MBROR, showing that Pacific was able to compensate its investors at levels even higher than 10% during this period.

167. Pacific's RORs in 1997, 1998 and 1999 were 10.22%, 15.38% and 14.19%, respectively. The unaudited RORs that Pacific reported on its IEMRs for 2000 and 2001 were 12.83% and 12.55%, respectively.

168. Overland was unable to complete the affiliate transactions portion of the audit because of Pacific's failure to produce requested data.

169. We find in analyzing the affiliate transactions issues for this decision that several issues require additional work, as we point out in the substantive

findings of fact above. We attach hereto as Appendix E a list of the areas requiring further audit.

170. 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.

171. Pacific estimates the costs of the audit at just over \$2 million.

172. In at least some instances, Pacific's own conduct delayed and unduly increased the work associated with the audit.

Conclusions of Law

1. It does not violate GAAP to require Pacific to make changes to its IEMR, which is a ratemaking tool, for the year in which we find Pacific made an error in its reporting, rather than in the year the error was discovered.

2. 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.

3. In combination, the audit corrections Overland identified were sufficiently "material" to require the changes in Pacific's reporting that we order in this decision.

4. Overland's staff was qualified to perform the audit.

5. Overland conducted the audit in accordance with GAAS.
6. We should disallow as unauditable Pacific's contingent liability accruals, and required Pacific to account for its contingent liabilities on an as-paid basis.
7. Contingent liabilities are cost-free sources of funds.
8. Determinations of how Pacific allocated its contingent liabilities among above-the-line and below-the-line accounts and between the intra- (state) and interstate (federal) jurisdictions were not privileged.
9. In the context of its contingent liability claims, Pacific put the reasonableness of its lawyers' advice at issue in this proceeding, thereby waiving the privilege and requiring production of the relevant advice for the sake of fairness.
10. Where a party claims its regulatory position is reasonable based on the advice of counsel, but seeks to preclude discovery about that advice, waiver of the attorney-client privilege may be implied.
11. It is far from clear that disclosure of allegedly privileged information to independent auditors waives the privilege as to the rest of the world.
12. It is standard practice in the accounting industry to obtain privileged information about contingent liability accruals when auditing a company's claimed accruals.
13. Pacific's conduct in failing to turn over adequate information regarding its contingent liability accruals made it impossible for Overland to carry out the audit in accordance with GAAS.
14. Pacific's contingent liability accruals were improper 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.

15. The FCC only allows utilities to account for contingent liability claims on an as-paid basis.

16. Pacific should have posted accruals in 1996 for estimated bad debts resulting from its RCRMS system.

17. 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.

18. Pacific should have deferred LNP costs as a regulatory asset on its IEMR books as of April 1996. The Commission's INP decision, D.96-04-052, gave Pacific adequate certainty of future cost recovery to trigger an obligation to defer LNP expenses as a regulatory asset at that time.

19. It was not necessary under FAS 71 that every single dollar of local number portability cost, and every single cost category, be probable of recovery. Rather, the more sensible interpretation of FAS 71, and the related pronouncements in FAS 90 and FAS 5, is that once it became probable that Pacific would be able to recover a category of LNP costs, it should have deferred those costs as a regulatory asset. Pacific's approach – that it should assume it would recover zero costs and record no asset as long as it was not guaranteed recovery of 100% of the costs – is unreasonable.

20. 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.

21. 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.

22. As of the issuance of D.96-03-020 in 1996, it was probable that Pacific Bell would recover some amount of local competition implementation costs greater than zero. Under SFAS 71, Pacific should have established a regulatory asset at that time.

23. D.96-03-020, D.97-04-083 and D.98-11-066 each provided Pacific adequate assurance of cost recovery for local competition implementation costs that each case should have caused Pacific to accrue a regulatory asset for such costs.

24. FAS 71 does not require that until Pacific was guaranteed complete recovery of all of its local competition costs, it should have expensed those costs rather than deferring them as a regulatory asset. To so conclude would render FAS 71 a nullity and would cause a utility to expense every possible regulatory liability until it was guaranteed recovery of every cent it spent on the project at issue. FAS 71 is broader than that; it does not require certainty and anticipates that a utility should project future events in appropriate cases.

25. Pacific should restate its 1997 and 1998 IEMRs to remove local competition implementation costs.

26. Pacific properly accounted for its SBC-Pacific merger savings, with the exception of \$4.2 million in conceded adjustments for both 1998 and 1999.

27. Pacific's 1999 change to the Lucent software right-to-use contract 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.

28. We should adopt Overland's recommended adjustment for the year 1999 related to Pacific's software right-to-use contract with Lucent, and direct Pacific to restate the 1999 Commission regulatory books of account to reflect the proper accounting for this transaction.

29. Because GAAP does not preclude retroactive changes to the IEMR books, Pacific's incentive pay cost accruals should be changed to reflect actual payout amounts.

30. We should adopt no change based on the audit report in how Pacific accounted for \$30 million in what Overland called a "royalty fee."

31. Pacific should not have made a \$12.6 million entry related to pre-1976 employee 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.

32. Pacific should be required to provide stand-alone actuarial reports for the Pacific Bell component of SBC benefit plans.

33. Regardless of whether or not Pacific had "depreciation freedom" until the Commission decided D.98-10-026, Pacific was not prohibited before then from coming to the Commission, revealing its error in amortization of its intrabuilding network cable investment, and seeking permission to restate prior years' IEMRs in order to reflect depreciation expense accurately in the affected years.

34. Pacific overstated expenses in 1997 as a result of its catch-up accrual for amortization of its intrabuilding network cable investment. Pacific should adjust and refile its IEMRs for 1994-97.

35. Pacific's accumulated deferred income taxes (ADIT) should be given flow-through tax treatment in accordance with our decision in Phase 2A.

36. Pacific should have reversed out its sales and use tax accruals in the period in which it originally recorded them, rather than in later periods.

37. Pacific should have corrected its error of failing to generate accruals for the employer's portion of payroll taxes, made when it processed certain manual

paychecks, in 1998 and prior periods, rather than making a catch-up accrual in 1999. To do so would not have violated GAAP.

38. Pacific should have adjusted 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 than correcting the error in 2000.

39. Pacific should account for the Ameritech severance accrual and the associated income tax effects on a consistent basis, below-the-line. Pacific should restate its 1999 Commission books to remove the current period and deferred income tax effects associated from the severance accrual from its above-the-line accounts.

40. Pacific's "reverse retirement" procedure has no basis in the FCC Uniform System of Accounts (USOA).

41. We reject Pacific's claim that its "reverse retirement" procedure is lawful because it is "systematic and rational," if such phrase simply means that Pacific "didn't just pick a number at random," and that the reversal was "tied to the value of the asset [and] . . . to the appropriate depreciation rates that were in effect at that time."

42. It was inappropriate for Pacific to record depreciation expense on the "reverse-retired" assets when Pacific could not show that it incurred any costs for those assets.

43. Pacific should not take it upon itself to create an accounting adjustment based on its own subjective assessment that the adjustment is appropriate.

44. We should adopt all audit recommendations with regard to Pacific's property records.

45. Pacific demonstrates problems with plant internal controls.

46. We should adopt Overland's audit findings with regard to Pacific's intrastate net plant.

47. 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.

48. Pacific's calculation of its AFUDC does not logically implement the method adopted for Pacific in Resolution RF-4, because 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. Pacific's implementation of Resolution RF-4 AFUDC calculation methodology does not comply with the Resolution, has led to unreasonable AFUDC rates, and has overstated Pacific's intrastate telephone plant in service.

49. Pacific should adjust its average intrastate rate base downward by \$8 million and depreciation expense downward by \$1.7 million. Pacific should restate its Commission financial statements for the affected periods to reflect the adopted adjustments. Pacific should also use the Resolution RF-4 AFUDC methodology, as clarified in this decision, for the years 2000-02. We should adopt Pacific's recommendation to use the FCC's AFUDC rate beginning with the year 2003.

50. Pacific should have expensed PBOP pre-funding contributions made prior to the adoption of FAS 106 in accordance with Overland's audit recommendation and our decision in Phase 2A decision of this proceeding.

51. The procedures set forth in Standard Practice U-16 serve only as a guide. The Commission may find that "special circumstances" exist to deviate from Standard Practice U-16.

52. Setting Pacific's working capital figure at zero is reasonable given the considerable doubt that the record creates as to the accuracy or reasonableness of the utility's cash working capital calculations.

53. Pacific's cash working capital requirement should remain at zero in the years after the audit period (commencing in 2000) until Pacific can demonstrate that it has updated each of its lead-lag studies.

54. D.89-12-048 does not specify what elements comprise rate base.

55. Rate base must be dynamic in order to accord consistent regulatory treatment to broad categories of rate base, recognizing that the innumerable components of each broad category of rate base (*e.g.*, plant in service, materials and supplies) change over time.

56. We should include Pacific's prepaid directory expense in rate base.

57. The FCC requires amounts in account 4310 to be removed from interstate rate base.

58. Although FCC accounting methodology is not controlling for our purposes, the Commission often looks to the FCC for guidance.

59. Since there is no controlling precedent of this Commission on the treatment of FAS 112 liabilities, we should follow the FCC's guidance and exclude the liabilities from rate base.

60. Pacific's FAS 112 liability is inappropriate for inclusion in rate base because it is a zero-cost source of funds, rather than a shareholder investment.

61. Accrued vacation pay liability should not form part of the rate base that is used to determine Pacific's ROR and shareable earnings.

62. Pacific's FAS 106 liability should be excluded from rate base because D.92-12-015 required utilities to exclude their FAS 106 regulatory assets from rate base. The related liabilities should be excluded for the same reason.

63. Our Phase 2A decision requires Pacific to record below-the-line much of its 1998 FAS 106 costs. To be consistent, an amount of the FAS 106 liability should be removed from rate base in an amount equal to the FAS 106 costs recorded below-the-line.

64. Our Phase 2A decision finds that ratepayers were not liable in 1999 and subsequent years for FAS 106 costs that Pacific chose not to fund. These unfunded accruals should be removed from rate base. These accruals should not be included in rate base that is used to determine Pacific's ROR and shareable earnings.

65. Because we disallow as unauditible Pacific's contingent liability accruals, there is nothing to add to rate base. These accruals should not be included in rate base that is used to determine Pacific's ROR and shareable earnings.

66. The work Pacific has done thus far to enhance its internal controls is inadequate to ensure compliance with our rules.

67. The FCC 1997's Consent Decree required employees of certain SBC parent organizations to keep time records for affiliate transactions. The Consent Decree applied to SBC Communications (referred to in the audit as MSI), SBC Operations and SBC Services.

68. If Pacific agreed to do the FCC Consent Decree affiliate transactions time reporting "voluntarily," it was not free to break the rules related to such reporting. Pacific cannot both set the rules and excuse itself for subsequent violation thereof.

69. Pacific's own internal documents help bolster Overland's conclusion that Pacific lacked adequate internal controls.

70. Pacific's "Image Maker" program does not provide evidence of inadequate internal controls at Pacific.

71. Overland should further audit legal expenses allocated from SBC to Pacific during its completion of the affiliate transactions audit we order herein.

72. Allocating most of TRI's expense to the regulated utility makes no sense because TRI's forward-looking research and development efforts primarily benefit nonregulated lines of Pacific's business.

73. 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.

74. Even if the internal control problems Overland found hypothetically did not materially affect Pacific's financial statements, we should still act on those problems.

75. As Pacific's transactions with its parent and unregulated SBC affiliates grow in number and dollar value, problems we allow to persist may indeed rise to the level of financial "materiality" under anyone's definition of the term.

76. There are important issues of regulatory compliance that are implicated by Overland's findings. Weak internal controls have adverse impacts that go beyond financial reporting.

77. 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.

78. As part of its completion of the audit of Pacific's affiliate transactions, the auditors should review the enhancements Pacific has implemented to ensure appropriate Part 32 classification of costs.

79. The auditors' completion of the affiliate transactions audit should, in addition to the other areas we identify in this decision, focus on the record-keeping and document retention efforts of the SBC shared service affiliates doing business with Pacific. The auditors should verify whether Pacific's changes ensure better compliance and identify any deficiencies so that we may act on them.

80. The completion of the affiliate transactions audit should include a review of Pacific's charges to affiliates for services Pacific provides them. As Pacific never submitted any of the Ernst & Young material into the record of this proceeding, Pacific should provide the auditors all available Ernst & Young material related to its affiliate transactions audit(s), including material in the possession of Ernst & Young.

81. FCC decisions do not necessarily govern how Pacific charges its affiliates for services it renders to them.

82. D.86-01-026 applies a 10% markup for services rendered by Pacific to an affiliate in one particular case, but we need further analysis of that decision's applicability here. The parties should address this issue in Phase 3B. They may wish to discuss whether we should adopt a more comprehensive rule in view of the vast increase in the number of affiliates Pacific now has in comparison to the state of affairs in 1986 when we adopted D.86-01-026.

83. 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.

84. Pacific Bell should have obtained the Commission's permission pursuant to Cal. Pub. Util. Code § 851 *et seq.* to transfer Pacific Bell Directory to its then-parent, Pacific Telesis Group.

85. It is not sufficient for an applicant to inform the Commission or its staff that Commission approval is not required for a particular transaction to shift the burden to the Commission to act.

86. Commission silence after receiving information from a utility is not equal to consent to the utility's proposed action.

87. There was no waiver of the requirement that Pacific obtain the Commission's permission pursuant to Cal. Pub. Util. Code § 851 *et seq.* to transfer Pacific Bell Directory to its then-parent, Pacific Telesis Group, simply because the utility told staff approval was not required and the Commission staff never contradicted the assertion.

88. The law places affirmative obligations on those we regulate and does not excuse compliance simply because the Commission does not take enforcement action against a utility that is out of compliance.

89. It is not sufficient for a utility to rely on staff's interpretation of whether the law requires Commission approval. Although utilities' discussion with staff prior to implementing a new service can be useful, the staff does not speak for the full Commission. The fact that staff many not have objected to Pacific's proposal implementation is not a defense for Pacific.

90. The Commission has already found that it was appropriate for it to review the transaction involving the transfer of Pacific Bell Directory to Pacific Telesis Group.

91. Article 6 of the Pub. Util. Code (Sections 851-56) addresses the transfer or encumbrance of utility property. For example, § 851 prohibits a public utility from selling, leasing, assigning, mortgaging, or otherwise disposing of or encumbering the whole or any part of its system or other property necessary or useful in the performance of its duties to the public.

92. Section 851 applies to the transfer of Pacific Bell Directory to Pacific Telesis Group. Since the revenues and costs associated with Directory operations were considered in setting Pacific's rates, the operation is presumed to be necessary or useful in the performance of Pacific's duties to the public.

93. The ASI asset transfer proceeding would be a better docket in which to determine whether ratepayers are entitled to compensation for DSL development costs.

94. 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.

95. The Commission has made "ratemaking adjustments" in the context of NRF. In our NRF review of Roseville Telephone, we disallowed recovery from ratepayers for institutional or goodwill advertising.

96. Having voluntarily made a reduction in Pacific executives' compensation Pacific is not free to reverse it now.

97. 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. Such disparate treatment would encourage Pacific Bell to transfer executives to affiliates in order to record compensation costs that exceed the voluntary cap.

98. To the extent that Pacific bears the cost of general "management fees" allocated from SBC to Pacific's regulated operations, those operations show double charges for management-once for excess executive salaries, and a second time for the cost of executives rolled into the management fee.

99. 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.

100. For the audit period, 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.

101. 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 had no direct or obvious benefit for Pacific's regulated operations.

102. The SBC parent organization should not have allocated any executive compensation to Pacific Bell Directory that exceeded the \$200,000 cap. Such compensation had no direct or obvious benefit for Pacific's regulated operations.

103. Pacific Bell Directory should not have borne any "special executive compensation" expense for key executives overseeing the operations of SBC in excess of the \$200,000 cap.

104. 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.

105. 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.

106. 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.

107. Pacific did not demonstrate how the legal expenses the parent operation billed to Pacific Bell Directory benefited Directory, and we should disallow those expenses.

108. Cross-subsidies flowing from the regulated utility to the unregulated parent and affiliates are 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.

109. If Pacific's regulated operations should not bear the cost of image advertising, as Pacific concedes by not disputing audit adjustments related for public relations and corporate sponsorship, 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.

110. 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.

111. Ratepayers should not even indirectly support the costs of Pacific's image building efforts and public relations expense.

112. The Commission has disallowed having regulated operations bear the cost of image advertising under NRF.

113. 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.

114. 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.

115. Because GAAP does not govern the IEMR, it did not preclude the SBC parent company from billing Pacific \$7.4 million in 1997 for services rendered in that year, rather than in 1998.

116. With regard to whether Pacific's affiliates fully compensate the regulated business when Pacific performs marketing functions for them, once presented with the audit's conclusion that revenues and expenses did not match, Pacific was not free simply to sit back and dispute whether the auditors were matching up the correct two accounts. Rather, its obligation to cooperate with the audit also obligated it – if it intended to attempt to refute an audit claim such as this one – to provide the correct information.

117. 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.

118. Pacific's regulated operations should not have borne any expense related to Pacific's National-Local affiliate.

119. In D.01-06-077, we stated that “[t]he Commission does not allow recovery from ratepayers of institutional or goodwill advertising.

120. Pacific should not have recorded expense related to its sponsorship of Pacific Bell Park, a baseball stadium, above-the-line.

121. Pacific made an erroneous correction to the December 1999 allocation of depreciation expense, resulting in an understatement of nonregulated depreciation expense.

122. Pacific did not establish that correcting an error in how it made its depreciation expense allocation violated its CAM.

123. Certain sections of Pacific Bell's California CAM were not reflective of current procedures.

124. Pacific did not allocate its Product Advertising Expense between regulated and non-regulated activities in accordance with cost causation principles.

125. The majority of the external relations costs in Pacific's account number 6722 were improperly assigned directly to regulated operations.

126. In D.94-06-011, the Commission found that Pacific should continue to record dues, donations and political advocacy expenses below-the-line.

127. Pacific's regulated operations should not be charged differently depending upon which entity engages in the legislative and regulatory activities.

128. California regulated operations should not bear the expense of political and legislative influence activities and other external relations expenses.

129. Pacific should not reflect costs related to marketing telephone services in GTE's (now Verizon's) service territory in its regulated operations, recover the costs from its regulated customers in Pacific's service territory, or reflect the costs in the earnings of the regulated entity.

130. 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.

131. 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 should decline to take any action on the audit recommendation in this regard.

132. 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.

133. It was not within Pacific's discretion to decide whether Overland's data requests were relevant or within the scope of the audit decision.

134. Pacific's obligation was to respond to the auditors' data requests as § 314 and the Commission's own decision required – or at least to seek recourse to the Commission's Law and Motion procedure to obtain a protective order shielding it from some of the data requests. 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.

135. 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.

136. 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.

137. Pacific's earnings exceeded the sharing threshold in 1998, in accordance with the findings of this decision combined with our findings in the Phase 2A decision.

138. Even where the changes we order in this decision do not cause Pacific to share earnings, the integrity of its books and records, and the regulatory process, must be preserved. Therefore, we should order Pacific to make each of the changes we discuss in this decision.

139. Pacific should be required to change its IEMRs for 2000 forward and continuing until otherwise specified by the Commission. 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.

140. To the extent the changes we order 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. We should require Pacific to amend its IEMRs and other processes to demonstrate that it is not continuing the practices that we find objectionable or improper in this decision.

141. Pacific should recalculate earnings for 1997, 1998 and 1999 based on the audit corrections we order it to make here. If we simply reverse the incorrect

expense and revenue assumptions the audit reveals in the current year, ratepayers will not be made whole.

142. In D.01-06-077, 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.

143. The issue of the interest rate was not contested in the Roseville Telephone Company proceeding leading up to D.01-06-077 and does not preclude us from ordering a different interest rate.

144. In D.02-03-023, we stated that it would be appropriate to apply Pacific's late payment rate of 18 percent reciprocally:

Recognizing a basic economic principle, that a monetary amount received in the future has less value to the recipient as the same amount received in the present, we will require that the payment account accrue interest. . . . Consequently, we will require the ILECs [Pacific and Verizon] to make monthly payments into an interest-bearing memorandum account with an interest rate equal to the tariffed rate the respective ILECs charge their customers for late payment . . . compounded monthly

145. Were we simply to require Pacific to pay the 90-day commercial paper rate, Pacific would remain better off if it continued to understate earnings than if it stated them correctly in the first place. Pacific earned at least a 10 percent rate of return during the audit years.

146. The Commission has the discretion to order Pacific to pay 10 percent interest on the underreported sharing amount regardless of whether Pacific "agreed" to the payment in advance.

147. The Commission has authority under Pub. Util. Code § 701 to do all things, whether specifically designated in the Public Utilities Code or in addition

thereto, which are necessary and convenient in the supervision and regulation of California public utilities.

148. We decline to impose the 18 percent interest rate requested by ORA. However, we also believe that the 90-day commercial paper rate is inappropriately low for a large sum of money that Pacific has retained for a significant period of time. Interest at a short-term commercial paper rate would allow Pacific to benefit from failing to make timely sharing refunds to ratepayers.

149. The shareable earnings that should have been returned to ratepayers was tantamount to a substantial infusion of cash into Pacific. If Pacific had obtained these funds from the capital markets, it is reasonable to assume that the cost of the funds would have approximated the 10% market-based rate of return (MBROR) established in D.94-06-011.

150. Ratepayers should be compensated at Pacific to pay 10% MBROR rate of return.

151. The Commission has used Pacific's ROR as a basis for calculating interest in the past. In D.93-05-062, the Commission used a 12% interest rate, based on Pacific's authorized ROR, to assess interest on reparations for overcharges. We stated the following:

We have found that interest shall be paid where the utility has had the use of complainant's money, consistent with PU Code Section 734 which provides that reparations shall be paid with interest (*Wright's Stationers v. Pacific Bell* (1990) 37 CPUC 2d 464). A logical estimate of the value of the funds held by Pacific is its rate of return. Pacific's rate of return is well below its customers' short-term cost of money which is best measured by the interest rate on their credit card purchases. To simplify the calculation, and calculations of refunds to individual customers, we will use 12% as a reasonable proxy for Pacific's actual rate of return in each year.

152. Requiring Pacific to record the refund of shareable earnings and the associated interest below-the-line is consistent with the Commission's treatment of shareable earnings in D.89-10-031, in which the Commission stated that a "ratemaking adjustment may be required in a year in which a prior year's excess earnings are returned to ratepayers through the sharing mechanism, to prevent the return of earnings from depressing current year earnings in the sharing calculation." Shareable earnings in a prior year should not distort reported earnings in a subsequent year.

153. Requiring Pacific to reflect the shareable earnings surcredit in Rule 33 of its tariffs is consistent with the procedure adopted in D.89-10-031 for returning shareable earnings to end-users. In that decision, the Commission required that shareable earnings should be made through a bill and keep surcredit to all Category I basic monopoly services, excluding switched and low speed special access and other services normally excluded from surcredits.

154. The surcredit process we adopt in this decision will return any shareable earnings to end-users in a practical, fair, and equitable manner.

155. While there have been substantial recategorization of services from Category I since the Commission rendered its decision in D.89-10-031, the rationale of flowing shareable earnings and applicable interest to end users is the same today as it was previously.

156. In view of the large size of the shareable earnings surcredit in this case, it is most prudent to extend the credit over a 12-month period. In this way, we avoid the "rate shock" that may occur after a short surcredit period in which customers receive significantly discounted bills. With a 12-month period, the surcredit each ratepayer receives each month will still be significant, but the transition back to regular rates will not be as drastic.

157. Only end-user customers – and not purchasers of intermediary services such as access services and UNEs – should receive the benefits of the surcredit.

158. In D.98-09-039, we chose a three month surcredit in connection with a refund of approximately \$400 million by balancing the interests of “1) customers of the large LECs who would not fully benefit from a surcredit of longer duration because they would not remain customers of the large LECs for more than three months, and (2) customers who would not fully benefit from a surcredit of shorter duration because they happen to have an unusually small amount of usage or charges during the period the surcredit would be in effect.”

159. We do not 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.

160. 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.

161. Under the sharing mechanism, ratepayers share only in earnings above a certain threshold. Ratepayers by definition receive no amount of earnings below the threshold.

162. 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.

163. We do not have an adequate basis in the record currently before us to conclude that Pacific committed fraud in underreporting its earnings or convincing the Commission to suspend sharing in 1999.

164. 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.

165. If we only impose interest on the shareable earnings, Pacific will have little added incentive to report its earnings accurately in the future. This is because if it underreports earnings, its only future obligation will be to correct its reporting if we find it to be in error. If Pacific only is required to pay the amount it would have paid had it not made the error, it will have little incentive to ensure the correctness of its future IEMRs.

166. The Commission needs to find effective ways to deter Pacific from underreporting earnings and overreporting expenses if the Commission is to obtain the accurate financial information it needs.

167. Financial incentives are a powerful means of ensuring regulatory compliance.

168. The Commission has adopted financial penalties as an incentive to ensure compliance with our rules, including those related to financial reporting. For example, in our recent decision on Pacific's application pursuant to § 271 of the federal Telecommunications Act of 1996, 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.

169. We do not have an adequate record on the types of incentives we might impose in this context. We should invite parties to propose mechanisms in Phase 3B that will create the proper incentives for Pacific to report its results accurately.

170. We do not have an adequate record to determine whether the Commission should reinstitute ratepayer sharing. This decision does not mean that we cannot consider the reimposition of sharing in Phase 3B.

171. Audits are an essential part of NRF. They 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.

172. 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.

173. 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. It is premature to decide whether a penalty phase is warranted on Pacific's affiliate transactions compliance until the auditors complete the affiliate transactions review for 1997-99. ORA should be able to renew its request after that audit is completed.

174. We also lack adequate evidence and briefing on whether a penalty phase pursuant to Pub. Util. Code § 2891 is warranted. That section 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.

175. In D.01-09-058, we declined to reach a claim that Pacific violated § 2891 by this same conduct due again to the absence of an adequate record on the issue. Pacific claimed that there was an “agency” exception that allowed it to disclose customer information to SBC Operations and third parties conducting marketing on Pacific’s behalf. We found that we could not rule on the claim because there was insufficient evidence in the record. We initially stated that, “Based on the plain language of the statute, this release of residential subscribers' personal information [to SBC Operations] appears to constitute a violation of § 2891.” Nonetheless, we concluded that, “we cannot determine whether Pacific Bell's treatment of confidential subscriber information violated § 2891.”

176. 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.”

177. Exogenous cost recovery allows a company to recover extraordinary costs in a process separate from the NRF price indexing mechanism itself. The company must satisfy nine criteria (LE criteria) in order to qualify for such recovery. The nine criteria are: (1) is the event creating the cost at issue exogenous?; (2) did the event causing the cost occur after the NRF was adopted in late 1989?; (3) is the cost clearly beyond management's control?; (4) is the cost a normal cost of doing business, even if it is increased by an exogenous event?; (5) does the event have a disproportionate impact on local exchange carriers?;

(6) is the cost caused by the event reflected in the economy-wide inflation factor (GDPPI) used in the annual NRF price cap proceeding?; (7) does the event have a major impact on the utility's overall cost?; (8) can actual costs be used to measure the financial impact of the event, or can the costs be determined with reasonable certainty and minimal controversy?; and (9) are the proposed costs reasonable?

178. Under criterion 3, some of the audit costs were within the control of Pacific's management, and are not recoverable.

179. Pacific meets exogenous cost criterion 7 with regard to audit costs: "does the event have a major impact on the utility's overall cost?" We find that \$2 million has a major impact on Pacific's overall cost.

180. At some point the total audit costs will be ascertainable with reasonable certainty and minimal controversy. By the same token, since we find that management could have controlled some of the costs under criterion 3, a determination of which costs Pacific should and should not recover will probably never be uncontroversial. For this reason, we find Pacific cannot satisfy LE criterion 8 with regard to audit costs.

181. Due to Pacific's behavior, audit costs escalated above what they would have been had Pacific been more cooperative. Pacific should not recover from ratepayers any costs that were entirely within the control of management. As to these costs, Pacific has failed to prove entitlement to exogenous cost recovery.

182. It is premature to determine whether we should disallow some or all of the audit costs.

O R D E R

IT IS ORDERED that:

1. Pacific Bell, now known as SBC (Pacific), shall prepare schedules that identify each of this decision's adopted adjustments and demonstrate that Pacific

has properly reflected the ordered adjustments in its financial reporting. Pacific shall file and serve the schedules, along with supporting documentation, as a compliance Advice Letter filing due no later than 60 days after the effective date of this decision.

2. Pacific shall correct its Intrastate Earnings Monitoring Reports (IEMRs) for 1997-1999 to reflect all of the audit adjustments adopted in Phases 2A and 2B no later than 60 days following the effective date of this decision, file and serve the updated reports as a compliance filing in this proceeding, and also file them in the manner it files its other IEMR reports as they come due.

3. Pacific shall correct its IEMRs for years subsequent to 1999 consistent with the adjustments we require for the 1997–1999 reports. Pacific shall file the correct reports no later than 60 days following the effective date of this decision in the manner it files its other IEMR reports as they come due, and also submit the updated IEMRs as a compliance filing in this proceeding.

4. Pacific shall implement a surcredit to refund the shareable earnings in 1998 that result from the Commission’s decision issued in Phases 2A and 2B of this proceeding. The amount of shareable earnings is set forth the Phase 2A decision.

5. Pacific shall implement the surcredit we order herein for a 12-month period and apply the surcredit uniformly across local exchange services and residential intraLATA toll services, in accordance with Pacific tariff Rule 33. The surcredit shall commence no later than 120 days from the effective date of this decision. The surcredit shall not apply to intermediary services such as access services and unbundled network elements.

6. Regardless of the category that the above services reside in, Pacific shall follow the procedure adopted in D.89-10-031 to return to ratepayers the shareable earnings adopted in this decision and the Phase 2A decision.

7. Pacific shall make a compliance filing within 60 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 under oath that it is no longer engaged in disallowed practices, and demonstrating that its practices for 2001 forward comply with this decision.

8. Overland shall complete the affiliate transactions audit on the ground that Pacific did not allow the auditors access to the documentation they needed to finish their work. Pacific shall cooperate fully with Overland during the remainder of the audit. The audit shall cover the issues identified in Appendix E to this decision, as more fully described in the body of this decision.

9. We will closely examine Pacific's level of cooperation with the remaining portion of the affiliate transactions audit in considering its exogenous cost recovery request. We expect Pacific's full cooperation with the audit, and will consider a renewed request for exogenous treatment of the full amount of audit costs once we deem the audit complete. We defer ruling on Pacific's request for exogenous cost recovery of the audit costs until the affiliate transactions portion of the audit is complete.

10. We will leave specific responsibility for the completion of the affiliate transactions audit with the Commission's Telecommunications Division (TD). When we assigned the audit to TD, we did so on the ground that the Commission has authority to assign its personnel as it sees fit. While we believe ORA should be in charge of future audits on this same ground, it makes practical sense for TD to finish the coordination of the affiliate transactions audit since it has overseen the audit for so long.

11. The auditors shall complete the affiliate transactions portion of the audit and their associated audit report no later than 6 months from the effective date of this decision, or such other date as the Assigned Commissioner may order.

12. After the affiliate transactions audit is complete, we suggest the following procedure: Once the affiliate transactions audit is finished, TD shall file and serve a notice of availability of the supplemental audit report on the service list for this proceeding. TD shall also provide a copy of the supplemental audit report to the assigned Commissioner, the assigned ALJ, and Pacific. Pacific shall file and serve a response to the audit report no later than 45 days after TD serves notice that the audit report is available. TD shall provide a copy of its audit report to any party that requests a copy. Pacific shall likewise provide a copy of its response to any party that requests a copy. Any party requesting a copy of the audit report and/or response should sign a non-disclosure agreement, as appropriate. The Assigned Commissioner may held evidentiary hearings and take such other steps the Commissioner deems necessary in response to TD's audit report and Pacific's response to the report.

13. The auditors need not provide Pacific with a copy of the draft audit before it is issued, but the foregoing process ensures that Pacific will have adequate opportunity to comment on the final follow-up audit report.

14. Overland shall further audit legal expenses allocated from SBC to Pacific during its completion of the affiliate transactions audit we order herein. Pacific shall provide the auditors full access to SBC's and Pacific's existing process, records and personnel. If the continued audit uncovers problems, we will consider remedies, if appropriate, once we consider the supplemental audit in its entirety.

15. We invite proposals in Phase 3B of this proceeding addressing how we can oversee and control how SBC's unregulated businesses charge the regulated utility for their "management" contributions.

16. As part of the completion of the affiliate transactions audit we order here, Pacific must provide the auditors full access to any materials that Pacific claims demonstrate that it analyzes costs using the FCC Part 64 hierarchy. SBC and Pacific shall not simply dump data in the auditors' lap, but also shall fully explain how they apply the Part 64 rules to affiliates billing significant expense to Pacific. If affiliates use a general allocator for much of their expense, SBC shall explain its analysis of the previous "steps" in the Part 64 hierarchy, and demonstrate that the process employed complies with the Part 64 cost allocation rules and principles.

17. The auditors' completion of the affiliate transactions audit shall, in addition to the other areas we identify in this decision, focus on the record-keeping and document retention efforts of the SBC shared service affiliates doing business with Pacific. The auditors shall verify whether Pacific's changes ensure better compliance and identify any deficiencies so that we may act on them.

18. Because we do not have a sufficient record on how Pacific charges its regulated and unregulated affiliates for services it renders to them, we direct Overland to include as a part of the completion of the affiliate transactions audit further review of Pacific's systems and controls for billing affiliates for marketing services provided by Pacific.

19. The parties may address in Phase 3B of this proceeding whether the Commission should require Pacific to assess a 10% mark-up for services it renders to regulated and unregulated affiliates.

20. As part of the completion of the affiliate transactions audit, Pacific shall cooperate fully with the auditors' efforts to determine the costs that Pacific uses to compute its fully distributed cost (FDC) amounts.

21. In its follow-up audit, the auditors shall determine if Pacific is now recording its purchases from AMDOCS – an SBC software subsidiary – at the lower of FDC or fair market value (FMV).

22. As part of the follow-up audit that we order, Overland shall review Pacific's relationships and interactions with its affiliates regarding joint marketing activities, the use of customer data, and the transfer from Pacific of proprietary information and intellectual property. Pacific shall fully cooperate with the auditors and provide them with timely and responsive answers to their questions.

23. Within 60 days of the effective date of this decision, Pacific shall make a compliance filing addressing the following questions:

- Is it possible for SBC Operations (or other unregulated Pacific Bell or SBC affiliate) to retain data about Pacific Bell's customers after it works with such data for Pacific's benefit and returns the results of its analysis to Pacific Bell? In other words, even if it no longer has access to Pacific's database, does it retain data it has created using that database that contains customer-specific information about Pacific's customers?
- Has SBC Operations (or other unregulated Pacific Bell or SBC affiliate) ever used any Pacific Bell customer database information for purposes other than marketing services for Pacific Bell?
- Explain all uses SBC Operations (or other unregulated Pacific Bell or SBC affiliate) has ever made of Pacific Bell customer database information, giving the date(s) of use, the data obtained, and the use(s) made, during the period 1997-present.

24. Pacific shall file the above information in this proceeding and serve it on the service list for this proceeding.

25. SBC Operations (or any other unregulated Pacific Bell or SBC affiliate) shall not use any customer-specific information or data obtained from Pacific Bell to provide services to or otherwise benefit other members of the family of companies to which SBC Operations provides services without compensation to Pacific Bell. This compensation to Pacific Bell shall cover the value of customer data itself, rather than simply the cost of labor utilized when SBC Operations or other unregulated affiliates provide joint marketing services with or for Pacific Bell. A determination of how to value such Pacific Bell data shall occur during Phase 3B of this proceeding.

26. Neither SBC Operations nor any other SBC affiliate is to have access to Pacific Bell's customer information or database once SBC Operations or the other affiliate has completed its work on Pacific Bell's behalf. It shall return all data and information it derives from that data to Pacific Bell at the conclusion of its work for Pacific Bell.

27. Pacific Bell shall file an application under the applicable sections of Article 6 of the Pub. Util. Code seeking Commission approval for the transfer of Pacific Bell Directory to Pacific Telesis Group no later than 60 days following the effective date of this decision. This filing shall also comply with all of the requirements of D.85-12-065.

28. We defer to the ASI transfer proceeding, Application 02-07-039, the determination of whether ratepayers are entitled to compensation for DSL development costs.

29. Pacific shall file a report in this docket within 60 days that shows, on an annual basis, all costs, investments and revenues related to the provision of DSL

service in California for the period 2000 through 2003. The report shall identify for each year, the FCC Part 32 accounts that the revenues, expenses, and investments were charged to and describe the related jurisdictional treatment for these elements. The report should also separately list the same cost, investment and revenue data for ASI.

30. Pacific shall identify each service transferred from Pacific to ASI, track separately since the date of transfer the revenues, expenses, and investment for each service, and have this information available for review by Commission staff (including ORA) upon request. The next triennial audit of Pacific Bell shall include a review of all services transferred from Pacific Bell to ASI.

31. Overland shall include as part of its follow-up affiliate transactions audit a further review of Pacific's billings to its affiliates for marketing services provided to the affiliates, and the systems and procedures Pacific uses to effect these billings. Pacific shall furnish the auditors the correct amount of the revenues and expenses attributable to Pacific's marketing services billings to its unregulated affiliates. The auditors may then compute the difference, if any, between the revenues and expenses, while assuming that Pacific should have charged a 10% mark-up for any such marketing services.

32. With regard to the amount SBC National-Local charged to Pacific's regulated California operating expense, Pacific shall work with Overland to clarify the affected amount and reflect it in the compliance filing we require within 60 days of the effective date of this decision.

33. The auditors should provide further detail about whether costs associated with Pacific's application for interLATA service should be charged to regulated operating income or be charged to SBC's interLATA long distance subsidiary as

part of their completion of the affiliate transactions audit we order in this decision.

34. Pacific shall make a compliance filing within 60 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. We will determine in Phase 3B of this proceeding whether Pacific's method requires change.

35. In its compliance filing due 60 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.

36. Pacific shall 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. Pacific shall also implement its proposed course of action, with any change(s) the Commission orders. We will then address the issue in Phase 3B of this proceeding.

37. As one remedy for Pacific's conduct in delaying the audit, we order completion of the 1997-99 audit with regard to affiliate transactions.

38. Pacific shall pay 10 percent interest on top of the amount it shares in earnings in accordance with this decision, in the form of a surcredit.

39. Pacific shall record the shareable earnings refund and associated interest it is required to pay as a result of this decision and the Phase 2A decision below-the-line.

40. 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.

41. 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 60 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.

42. 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.

43. We invite input in Phase 3B on the how the Commission can deter under-reporting and create incentives for accurate reporting in the future.

44. The parties shall address in Phase 3B how to remedy problems we find in this decision with Pacific's plant internal controls.

45. We deny ORA's request to lift the suspension of sharing and establish a memorandum account to track excess earnings subject to refund.

46. We order commencement of the next triennial review under NRF of Pacific's performance covering the years 2000 forward, including affiliate transactions.

47. ORA shall conduct the triennial review audit, which shall cover the period of time from 2000 through 2002.

48. A primary purpose of the next triennial review audit should be to determine if the information that Pacific reported in its NRF monitoring reports for the years 2000-02 was accurate and reflected Commission regulatory requirements. This will necessarily entail a detailed examination of the information that Pacific provided in its monitoring reports pertaining to its revenues, expenses, assets, liabilities, cash flows, service quality, affiliate transactions, and such other matters as the Commission may designate. ORA's audit of information regarding service quality should extend to any reports that Pacific submitted to the FCC that contain information pertaining to service quality in California. In addition, ORA's audit of information regarding affiliate transactions should include an examination of affiliates' books and records.

49. Pacific shall cooperate fully with the next triennial audit. For example, Pacific shall (1) comply in a timely manner with ORA's requests for information and documents, and (2) provide ORA with access to any and all documents, whether or not they are monitoring reports filed with the Commission, that are necessary or useful to ORA in conducting its audit. We place Pacific on notice that any failure to cooperate will be subject to monetary penalties and other sanctions.

50. The Commission is required by Pub. Util. Code § 314.5 to audit Pacific at least every three years. Because Overland's audit report on Pacific that is before us in this proceeding was issued on February 21, 2002 (with the supplemental report issued on June 20, 2002), we conclude that ORA should commence the next audit of Pacific as soon as possible in order to meet the statutory requirement of triennial audits.

51. ORA should submit its audit report in the next triennial NRF review. After the audit report is submitted, Pacific and other parties will have an opportunity to respond to the report. The exact dates for the submittal of ORA's audit report and responses will be determined in the next NRF review.

52. 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).

53. It will be the responsibility of ORA and the Commission to ensure that any CPAs or other technical experts that ORA hires possess the requisite competence, objectivity, and independence.

54. Nothing in this decision authorizes parties outside the Commission to participate in or challenge the selection or oversight of any auditors or technical experts that ORA hires. If any party outside the Commission wishes to challenge the competence, objectivity, or independence of any CPAs or other technical experts that ORA retains, they will have an opportunity to do so only after the audit is complete and only in a docketed proceeding in which the audit findings are considered by the Commission.

55. 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. The audit-related costs included in the advice letter shall not exceed the amount billed to Pacific by the Commission 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.

56. We decline 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.

57. For the completion of the 1997-1999 affiliate transactions audit and the 2000-2002 triennial audit we will impose a self-executing process of penalties if Pacific does not meet pre-defined discovery deadlines or make a good faith case in support of a protective order shielding it from the discovery.

58. Pacific shall be on notice that we consider its participation in the completed portions of the audit to have been less than satisfactory. We will not hesitate to fine Pacific or impose other sanctions if the auditors, TD or ORA experience problems in conducting the future audits we order here.

59. Pacific shall provide written responses within 10 days of receipt of data requests issued in connection with the continued 1997-99 affiliate transactions audit or the 2000-02 audit we order in this decision. We will deem a request to have been received on the date it is hand delivered, emailed or faxed before 5:00 p.m. Pacific time; to have been received on the business day after it is delivered by express mail for next day delivery; and to have been received within 3 business days of mailing for requests sent via regular U.S. mail. These written responses shall contain, at a minimum, all of Pacific's objections to the request, and a statement of what Pacific intends to produce in response to the request. Where information responsive to the request is readily available, Pacific shall also produce such material with its 10-day response. At the outside limit, Pacific shall produce all documents and provide full substantive responses to the data requests within 30 days of receipt of a data request.

60. If Pacific requires additional time to respond, and only after a good faith attempt to meet and confer with the propounding party, Pacific may file a motion for protective order. In the motion, Pacific must establish a good faith basis for further delay. If Pacific neither responds fully to a data request, nor files a motion for protective order within the 30-day period, we will impose a penalty on Pacific of \$500 per day per data request in keeping with the authority granted us in Pub. Util. Code § 2107.

61. We decline 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.

62. It is premature to decide whether a penalty phase is warranted on Pacific's affiliate transactions compliance until the auditors complete the affiliate transactions review for 1997-99. ORA may renew its request after that audit is completed.

63. We defer to Phase 3B ORA's request to revise the Commission's NRF monitoring report program.

64. We take official notice pursuant to Rule 73 of Pacific's Advice Letter 22800A.

This order is effective today.

Dated _____, at San Francisco, California.

CERTIFICATE OF SERVICE

I certify that I have this day served a true copy of the original attached Notice of Availability of Draft Decisions and Alternate Draft Decisions Regarding Phase 2A and Phase 2B Audit Issues on all parties of record in this proceeding or their attorneys of record.

Dated August 29, 2003, at San Francisco, California.

/s/ KRIS KELLER

Kris Keller