

PUBLIC UTILITIES COMMISSION

505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3298



December 31, 2004

TO PARTIES OF RECORD IN RULEMAKING 01-09-001 AND  
INVESTIGATION 01-09-002

On March 3, 2004, Decision 04-02-063 was mailed to the parties without the dissent of Commissioner Loretta M. Lynch. The dissent is now available, and is enclosed herewith.

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

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Enclosure

COMMISSIONER LYNCH, dissenting:

This Phase 2A decision and the Phase 2B decision we leave for another day address the first comprehensive audit we have done of SBC since we adopted the NRF form of regulation in 1990. The audit covers the period 1997 through 1999. The key question in these decisions is the extent to which SBC underreported its regulated earnings during this period.

SBC had an incentive to make its regulated earnings appear as low as possible. In the mid-1990s, the Commission was deciding whether to relax its regulation of SBC's prices. SBC's reported, but unadited earnings, enabled it to argue that regulation was taking a toll on its profits and that it needed regulatory relief to be able to earn a fair level of profit. Aided by reported profits in 1997 and 1998 that fell below the 10% benchmark for healthy profits, SBC obtained the regulatory relief it was seeking in a 1998 decision, Decision (D.) 98-10-026. In addition, low regulated earnings enabled SBC to keep its profits from reaching the levels at which it was required to start sharing them with ratepayers.

The key dollar issue in today's 2A decision is a \$400 million write off of expenses that SBC recorded in 1998. SBC's 1998 earnings are important because 1998 was the last year when profit sharing was in place; part of the package of regulatory relief that SBC obtained in D.98-10-026 was the elimination of profit sharing beginning in 1999. SBC's reported earnings were closer to the sharing level in 1998 than in 1997, making it important to scrutinize any large accounting transactions that had a significant effect on reported earnings. The write off in question related to post retirement benefits other than pensions (or PBOPs), which refers to retiree health and life insurance benefits. By taking the large write-off of PBOP expenses in

just one year -- the last year of profit sharing -- SBC knocked its earnings down by hundreds of millions of dollars, keeping profits far away from the sharing range.

The auditors found that SBC's write off was excessive under the rules of the governing 1992 decision, D.92-12-015. The administrative law judge agreed, in a meticulous, thorough and well-reasoned proposed decision. The judge soundly rejected SBC's arguments that the Z factor cost recovery approved in the 1992 decision was meant to recover all of the PBOP costs under the newly adopted accrual method of accounting. The judge pointed out that the Z factor was only intended to recover a portion of those costs -- only the portion that exceeded pay as you go (or PAYGO) costs, which, under the New Regulatory Framework (NRF) adopted in D.89-10-031, were solely the responsibility of shareholders, not ratepayers.

The majority decision does not follow this analysis, however, and chooses to adopt the company's approach. Unfortunately, SBC's arguments are based on a highly selective reading of the 1992 decision that simply ignores the key passages of the decision that explain how PBOP cost recovery will work for NRF utilities.

The resolution of the PBOP issue in this case comes down to the proper interpretation of D.92-12-015. The judge's proposed decision shows that the majority decision directly conflicts with D.92-12-015.

D.92-12-015 was prompted by a change in accounting methodology for measuring the costs of PBOPs, the switch from cash (PAYGO) to accrual (or SSFAS 106) accounting. Accrual accounting created higher costs than PAYGO in the short term -- hence the issue of how this accounting change would affect rates. Ordering Paragraph 4 of that

decision directs utilities (all of them, including energy and water utilities governed by traditional cost of service regulation) to create a regulatory asset which they can recover until the asset reaches a zero balance. For cost of service utilities, there was nothing tricky about recovering this regulatory asset – they could simply include the total SFAS 106 amount in rates.

For the NRF utilities, the recovery of PBOP costs was complicated by the NRF incentive regulatory scheme, particularly the fact that NRF shifted the risk of increased operating costs away from customers (where it typically resides under cost of service ratemaking) and onto the utility shareholders. Accordingly, Ordering Paragraph 4 needs to be read in conjunction with Ordering Paragraph 8, which limits the rate recovery to a subset of the total SFAS 106 costs. Ordering Paragraph 8 provides in relevant part:

8. In addition to the requirements of Ordering Paragraph 2, NRF utilities shall recover through annual Z factor filings only the amount required to be accrued that year to cover future PBOP payments, *minus* their pay-as-you-go costs. Furthermore, the Z factor should only recover this amount to the extent it is actually put into a trust. (46 CPUC 2d 499, 533, emphasis in original).

Thus, rate recovery through the Z factor was limited to the difference between SFAS 106 costs and PAYGO costs for each year (with an additional cap on recovery based on tax deductible contributions to a PBOP trust). As D.92-12-015 explains, the Commission imposed this limitation because, under NRF, the escalations in PAYGO costs were the

responsibility of SBC's shareholders and not to be included in increased rates:

We note that pay-as-you-go costs are projected to increase over time. Furthermore, if we retained pay-as-you-go accounting, any increase in pay-as-you-go costs would not be entitled to Z factor treatment. Therefore, the NRF utilities' additional recovery for PBOP costs through the Z factor should be limited to the difference between what is required by accrual accounting and what their pay-as-you-go costs otherwise would have been. (46 CPUC 2d at 528).

Harmonizing Ordering Paragraphs 4 and 8, it is clear that the Commission anticipated recovery of the NRF utilities' PBOP costs through two sources: 1) the Z factor, which allowed additional rate recovery for the increment between total accrual costs and PAYGO costs (*i.e.* accrual minus PAYGO) and 2) the deemed recovery in rates of the remaining portion of PBOP costs, the PAYGO costs. As noted, this deemed recovery included any increases in PAYGO costs over time, as this was the responsibility of shareholders, not ratepayers. Together, these two sources add up to the total SFAS 106 (or accrual) costs.

When the Commission eliminated the Z factor – notably at SBC's behest -- in D.98-10-026, SBC no longer had the opportunity to recover any more PBOP costs through the Z factor. This elimination of the Z factor was the sole triggering event for SBC's write off, a point over which there is no dispute. Here is where the majority decision goes awry: in assessing the impact of the elimination of the Z factor, the sole issue should be what, if any, Z factor rate recovery was lost when SBC's own proposal to eliminate the Z factor was adopted. Put more precisely, what is the present value of

the stream of additional revenue that was lost when the Commission eliminated the Z factor? As will be explained below, this is not necessarily a positive number.

Contrary to D.92-12-015, the majority decision incorrectly assumes that the entirety of the regulatory asset was “impaired” by the elimination of the Z factor. In so doing, the majority ignores the clear teaching of D.92-12-015 that SBC’s PBOP costs were to be recovered through the combination of Z factor recovery *and the ever-increasing PAYGO costs*. The only portion of the regulatory asset that was impaired was the portion (if any) attributable to expected future Z factor recovery.

Despite the auditors’ challenge to the appropriateness of SBC’s large write off under the rules in D.92-12-015, SBC chose not to present any evidence about the expected present value of future Z factor recovery. This was SBC’s burden as the proponent of the extraordinary write-off, because the auditors had made a prima facie case that SBC’s write off was improper, and because SBC was the primary party in possession of the data necessary to calculate future PAYGO costs. SBC failed to meet this burden and thereby failed to justify any of its write-off of PBOP expenses.

There is good reason to believe that future Z factor rate decreases would exceed Z factor rate increases. D. 92-12-015 explains that the Z factor recovery was expected to diminish over time and could reach the point where, because PAYGO costs would start to exceed accrual costs, the Z factor would turn negative, meaning rate decreases. (46 CPUC 2d at 528). (Under NRF, negative Z factors were permitted and, in fact, not unusual.) The ALJ’s proposed decision cites evidence that the gap between accrual and PAYGO was indeed shrinking over time and that it

appears that SBC had recovered too much from the Z factor in 1997 and 1998. The judge conservatively estimates the overpayment at \$50M, but states that the real number is probably higher.<sup>1</sup> The probability that SBC would some day find that the PBOP Z factor adjustment would significantly *reduce* revenues may be why SBC supported elimination of prospective Z factor adjustments in our 1998 NRF docket.

In sum, the majority decision blatantly errs in finding that the elimination of the Z factor impaired the entirety of the regulatory asset. Only the expected future stream of PBOP-related Z factor revenues was impaired. SBC made no attempt to meet its burden of quantifying this future stream of revenue and therefore failed to substantiate any of its write off. Accordingly, SBC's write-off should not have been allowed to affect regulated earnings.

The ALJ's proposed decision adopts a reasonable approach to prevent the unjustified write-off from affecting sharable earnings; it requires that the write-off be recorded below the line. By placing it below the line, the write-off does not reduce earnings and thus does not improperly distort the profit sharing calculation.

The majority decision relies on SBC's argument that PBOP expenses are a legitimate cost of doing business and should not be recorded below the line. This argument is beside the point. No one disputes that PBOP expenses are legitimate costs of business. The issue here is how much of those expenses were expected to be recovered through the Z factor, as opposed to the deemed recovery of PAYGO costs built into NRF rates.

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<sup>1</sup> PD (as amended for 2/26/04 Commission meeting) at 63-64 and fn 131 (referencing computations in Appendix G).

SBC has not shown that the future stream of Z factors, as they were explicitly defined and limited in D.92-12-015, would recover any additional PBOP costs. Consequently, SBC failed to show that Z factor elimination undermined its ability to recover any PBOP expenses.

SBC's write-off conflicts with D.92-12-015 in another respect. Ordering Paragraph 8, quoted above, and Finding of Fact 52<sup>2</sup> limit the reasonable amount of PBOP expense that can be recorded in any year to the tax deductible contributions to the PBOP trusts. Consequently, under D.92-12-015, only costs below the tax deductible limit could be recorded as a reasonable, above-the-line expense. SBC's write-off exceeded by \$150 million its 1998 tax deductible contributions and thus were not eligible for above-the-line recovery in 1998. The ALJ's proposed decision invokes this requirement of D.92-12-015 as an additional reason for disallowing SBC's write-off.<sup>3</sup> The majority decision errs by failing to adhere to hold SBC to this clear requirement in our governing 1992 decision.

Three additional points underscore the injustice of the majority decision with respect to the PBOP issue. First, as noted above, the record shows that SBC has already overcharged ratepayers for PBOP costs by at least \$50 million, and potentially much more.<sup>4</sup> The majority decision accentuates this injustice by preventing ratepayers from recouping any of those overcharges through profit sharing refunds. Second, as Section III.B of the majority decision acknowledges, SBC improperly withdrew \$99 million from a PBOP trust, money that it had collected from ratepayers to

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<sup>2</sup> Finding of Fact 52 states in relevant part: "Reasonable PBOP costs are defined to be those PBOP costs applicable to regulated services that meet the [SSFAS 106] criteria as modified by this order and *are invested in tax-deductible plans . . .*" (46 CPUC 2d at 530-531, emphasis added).

<sup>3</sup> PD at 58-60.

<sup>4</sup> PD at 63-64 and fn 131 (referencing computations in Appendix G).

pay for PBOP costs. Under the majority decision, SBC suffers no ill effects from this violation, and (because of retroactive ratemaking concerns) ratepayers do not get back any of their money that SBC misappropriated.<sup>5</sup> Third, the sad irony of the majority decision is that, while it is billed as a pro-labor decision (*mimeo* at p.50), the PBOP write off that SBC used to prevent profit sharing was primarily the by-product of massive employee layoffs in 1993. Those layoffs added considerably to SBC's PBOP costs, which it then wrote off in 1998. Effectively, SBC slashed union jobs, and thereby increased its profits in 1993 and later years, but then managed to use those job cuts to inflate its expenses and prevent profit sharing in 1998. So, under today's decision, we reward SBC for slashing its workforce, we do nothing about the company's misappropriation of ratepayer money that was supposed to be used for PBOP costs, we do nothing about the company's overcharges for PBOP costs, and we deny ratepayers the profit sharing they are due.

Because of the serious errors in the majority decision, I dissent.

Dated February 26, 2004 at San Francisco, California

/s/ Loretta M. Lynch

Loretta M. Lynch  
Commissioner

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<sup>5</sup> The original version alternate decision that was approved by the majority would have refunded these misappropriated funds to ratepayers.

CERTIFICATE OF SERVICE

I certify that I have by mail, and by electronic mail to the parties of which an electronic mail address has been provided; this day served a true copy of the original attached Dissent of Commissioner Lynch on all parties of record for proceedings R.01-09-001 and I.01-09-002 or their attorneys of record.

Dated December 31, 2004, at San Francisco, California.

/s/ Ernesto Melendez  
Ernesto Melendez

N O T I C E

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