
PUBLIC UTILITIES COMMISSION

505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298



December 6, 2005

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

Decision 05-12-014 is being mailed without the written concurrence and dissent of
Commissioner Susan P. Kennedy. The concurrence and dissent will be mailed separately.

Very truly yours,

/s/ ANGELA MINKIN

Angela Minkin, Chief
Administrative Law Judge

Attachment

Decision 05-12-014

December 1, 2005

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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

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

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

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

ORDER MODIFYING DECISION (D.) 04-02-063
AND DENYING REHEARING OF THE DECISION, AS MODIFIED

In this decision, we dispose of an application for rehearing filed jointly by the Office of Ratepayer Advocates and The Utility Reform Network ("Applicants") of Decision (D.) 04-02-063 ("Decision"). In D.04-02-063, we disposed of four of seventy-two findings resulting from an audit of SBC Pacific Bell Telephone Company ("Pacific") for the period of 1997 to 1999. The four issues were: (1) pensions, (2) post-retirement benefits other than pensions ("PBOPs"), (3) depreciation, and (4) income taxes associated with pensions, PBOPs, and the California High Cost Fund-B. At issue in this rehearing is our approval of Pacific's above-the-line write-off of the PBOP regulatory asset in 1998.

We have carefully considered each of the arguments raised by Applicants and are of the opinion that they have demonstrated error with respect to the write-off of pre-funded PBOP contributions embedded in the regulatory asset. We correct this error

by modifying D.04-02-063 to reduce the regulatory asset by \$41.6 million. We also modify the decision to clarify that the \$99.5 million rate reduction adopted by D.98-10-

026 was effective beginning in 1999, not 1998. Good cause does not warrant granting rehearing on all other issues raised by Applicants. Therefore, we deny rehearing of D.04-02-063, as modified.

I. FACTS

Pacific provides PBOPs to retired employees and their qualified beneficiaries. PBOPs consist primarily of medical, dental, and life insurance benefits for retirees. Pacific previously funded PBOPs as the benefits were paid to retirees. This method of funding was referred to as pay-as-you-go (“PAYGO”). PAYGO is a cash basis of accounting that only recognizes PBOP costs when they are paid and when a retiree receives benefits. Pacific’s rates were set in a way that provided Pacific with a reasonable opportunity to recover its PAYGO costs. In December 1990, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standard No. 106 (“SFAS 106”), *Employers’ Accounting for Post-retirement Benefits Other than Pensions*. Under SFAS 106, employers were required to account for the PBOP costs under the accrual method of accounting. Thus, PBOP costs would be recorded as an expense as they are earned over the working life of the employee. By the time an employee retired, all PBOP benefits owed to the employee would have already been recorded as an expense.

In December 1992, the Commission issued D.92-12-015, which ordered all energy, water and telecommunications utilities under the Commission’s jurisdiction to accrue their PBOP costs for both regulatory accounting and ratemaking purposes. (See *Re Post-retirement Benefits Other Than Pensions* [D.92-12-015] (1992) 46 Cal.P.U.C.2d 499.) Annual PBOP costs, determined in accordance with SFAS 106, consist of several elements. One element is the PBOP benefits earned during the year by employees. Another element is amortization of the liability for PBOP benefits that were earned by employees prior to the adoption of SFAS 106, but never booked as an expense. This “liability” is known as the Transition Benefit Obligation (“TBO”). D.92-12-015 required Pacific to amortize the TBO over 20 years.

D.92-12-015 limited the SFAS 106 costs that utilities could report for regulatory purposes to the amount of their tax-deductible contributions to PBOP trust funds.¹ Pacific was permitted to record as a regulatory asset any yearly differences between their SFAS 106 costs and their allowable tax-deductible contributions. (*Re Post-retirement Benefits Other Than Pensions* [D.92-12-015], *supra*, 46 Cal.P.U.C.2d at p. 523.) Pursuant to SFAS 71, *Accounting for the Effects of Certain Types of Regulation*, regulated utilities may record as a regulatory asset current expenses that will be recovered in future rates. The regulatory asset is amortized as an expense in the periods when the utility receives revenues through rates to recover the regulatory asset. (See generally, SFAS 71, ¶¶ 5 & 9.) SFAS 71 also provides that a regulatory asset must be written off to the extent that assurance of recovery in future rates is lost. (SFAS 71, ¶ 10.)

D.92-12-015 authorized Pacific to recover some, but not all, of its SFAS 106 costs via the Z-factor.² Specifically, D.92-12-015 limited Z-factor recovery to the lesser of Pacific's (1) tax-deductible contributions to PBOP trust funds, or (2) SFAS 106 costs less PAYGO costs. D.92-12-015 also prohibited Z-factor recovery of contributions to PBOP trust funds made prior to the Decision. (See *Re Post-retirement Benefits Other Than Pensions* [D.92-12-015], *supra*, 46 Cal.P.U.C.2d at pp. 532 [Conclusion of Law No. 17] & 533 [Ordering Paragraph No. 6].) Following D.92-12-015, Pacific recovered \$107.5 million in SFAS 106 costs via the Z-factor in 1993 and \$99.5 million per year during 1994 through 1998, for a total of \$605 million.

¹ SFAS 106 recognizes the TBO as a legitimate PBOP cost. (SFAS 106, ¶ 46.f.) Therefore, pursuant to D.92-12-015, the amount amortized annually would be booked to the PBOP regulatory asset to the extent it exceeded contributions.

² The Z-Factor mechanism was a means to revise Pacific's customer bills under the New Regulatory Framework ("NRF") in response to specific changes to Pacific's costs and revenues. The Commission had to approve all Z-Factors, and each Z-Factor had to satisfy certain specified criteria. The Z-factor mechanism was an integral part of the NRF price cap form of regulation adapted in D.89-10-031. Z-factors represent recovery of, or refunds to customers, for costs over which the utility had no control (exogenous costs.) The Z-factor mechanism was intended to compensate the utilities for the extra PBOP costs that would be recorded on the utility's books as a result of the Commission adopting SFAS 106 (accrual basis.)

In October 1998, the Commission issued D.98-10-026, which eliminated Z-factor recovery for SFAS 106 costs effective January 1, 1999. (See *Re Third Triennial Review of the Regulatory Framework Adopted for GTE California Incorporated and Pacific Bell* (“*Third Triennial Review for GTE & PacBell*”) [D.98-10-026] 82 Cal.P.U.C.2d 335.) Following the issuance of D.98-10-026, Pacific wrote off its PBOP regulatory asset above-the-line. The pre-tax intrastate regulated amount of the write-off was \$400 million. (See D.04-02-063, p. 43.) Pacific justified the write-off on the grounds that it no longer had assurance that it would be able to recover the PBOP regulatory asset in future rates once the SFAS 106 Z-factor had been eliminated. Thus, Pacific believed that it was required to write off the regulatory asset pursuant to SFAS 71. (See D.04-02-063, p. 41.)

Between May 2000 and June 2001, an audit of Pacific was conducted by Overland Consulting (“Overland”) under the management of the Commission’s Telecommunications Division. The audit covered the three-year period of 1997 through 1999. In its audit report, Overland concluded that Pacific had improperly written off the entire \$400 million PBOP regulatory asset above-the-line. Therefore, it recommended that Pacific be ordered to record below-the-line the portion of the write-off that exceeded Pacific’s tax-deductible contributions to PBOP trusts in 1998. (D.04-02-063, p. 33.) Adoption of Overland’s recommendation would have resulted \$149.8 million of SFAS 106 costs recorded below-the-line in 1998.

In D.04-02-063, the Commission rejected Overland’s recommendation and determined that Pacific had properly written off the regulatory asset associated with PBOPs in 1998 and that it was appropriate that this write-off had been recorded above the line.³ (D.04-02-063, pp. 47 & 50-51.) The Office of Ratepayer Advocates (“ORA”) and The Utility Reform Network (“TURN”) jointly filed an application for rehearing of the

³ This refers to where revenue and expense items appear on a utility company’s income statement. Revenue and expense items recorded “above-the-line” relate to the provision of utility services. In contrast, revenue and expense items recorded “below-the-line” are unrelated to the provision of utility services and may not be recovered from customers.

Decision. In their application for rehearing, Applicants challenge the Commission's conclusions regarding Pacific's write-off of the PBOP regulatory asset. Their grounds for alleging legal error are essentially: (1) the Decision contradicts prior Commission policies concerning PBOP cost recovery; and (2) the inconsistencies in the Decision constitute retroactive ratemaking. Pacific filed a response opposing the application for rehearing.

II. DISCUSSION

A. **The Decision is modified to require Pacific to reduce the PBOP regulatory asset to the extent it contains VEBA 3 costs.**

In 1989, Pacific established the Voluntary Employee Benefit Association Trust No. 3 ("VEBA 3") to "pre-fund" future PBOP contributions. A total of \$208 million was recorded in this trust, reflecting contributions made by Pacific in 1989 and 1990. In D.92-12-015, the Commission determined that the pre-funded contributions in the VEBA 3 trust were not beyond the utility's control, and therefore, prohibited recovery of these contributions via the Z-factor. (*Re Post-retirement Benefits Other Than Pensions* [D.92-12-015], *supra*, 46 Cal.P.U.C.2d at p. 527.) In response, Pacific recalculated its TBO to reflect this higher obligation. (See D.04-02-063, p. 67.) In 1993, Pacific wrote off a portion of its TBO pursuant to SFAS 106 in connection with a reduction in workforce. Most of the write-off was booked into Pacific's PBOP regulatory asset. The portion of the TBO write-off that was booked into the PBOP regulatory asset included \$55.1 million of VEBA 3 contributions (\$22 million after-tax). (See D.04-02-063, pp. 67-68.)

In their rehearing application, Applicants' claim that the Decision contradicts D.92-12-015, Ordering Paragraph No. 6 by allowing Pacific to "lawfully

recover pre-funded pension contributions.”⁴ (Rhg. App., p. 8.) Ordering Paragraph No. 6 states:

“GTE California Incorporated (GTEC) and Pacific Bell shall not be authorized to recover their pre-funded PBOP costs through the Z factor adjustment provided for under the new regulatory framework.”

(*Re Post-retirement Benefits Other Than Pensions* [D.92-12-015], *supra*, 46 Cal.P.U.C.2d at p. 533 [Ordering Paragraph No. 6] (emphasis added).)

As an initial matter, we find Applicants’ basis for their argument somewhat confusing. Applicants cite to page 70 of the Decision for the proposition that we had misinterpreted Pacific’s position regarding retroactive ratemaking as the Commission’s holding. However, they do not explain how this is related to Z-factor recovery. Moreover, the portion of the Decision cited by Applicants relates to a discussion on whether it was proper for Pacific to have considered its contributions to the VEBA 3 trust as a prepaid PBOP asset (and thus amortized over 20 years) or whether Pacific should have expensed the contributions made in 1989 and 1990. Thus, the portion of the Decision relied on by Applicants as demonstrating legal error is inapplicable.

Nonetheless, we believe that Applicants’ underlying argument, that allowing Pacific to write-off the entire PBOP regulatory asset contradicts D.92-12-015, Ordering Paragraph No. 6, does have merit. As discussed above, a portion of the TBO write-off that was booked into the PBOP regulatory asset in 1993 included VEBA 3 contributions. Pursuant to D.92-12-015, the VEBA 3 contributions were not subject to

⁴ Applicants erroneously refer to “conclusion of law 6” in D.92-12-015 in their rehearing application. Conclusion of Law No. 6 does not relate to Z-factor recovery of pre-funded contributions, but states: “The utilities should amortize the TBO over 20 years.” We believe the proper reference should be to Conclusion of Law No. 17, which states “Utilities under NRF should not be allowed to recover their pre-funded PBOP contributions through Z-factor adjustment because they have not demonstrated that funding PBOP prior to the adoption of the Statement with modification was beyond their control.”

recovery via the Z-factor recovery.⁵ Additionally, the Commission determined in D.04-02-063 that the PBOP regulatory was allowed to contain only SFAS 106 costs that were recoverable via the Z-factor. (See D.04-02-063, pp. 46-47 & 162-163 [Finding of Fact Nos. 25 & 26].) Consequently, because the VEBA 3 costs were not recoverable via the Z-Factor, these costs should not have been booked to the regulatory asset. Thus, our decision to terminate the Z-factor in D.98-10-026 did not justify or support Pacific's decision to write off that portion of the PBOP regulatory asset that was not subject to recovery via the Z-factor (i.e., the portion of the regulatory asset representing the VEBA 3 contributions).

Based on this, and the evidentiary record, we modify D.04-02-063 to require Pacific to reduce the PBOP regulatory asset to the extent it contains VEBA 3 costs. This would include not only the \$22 million (after-tax) that was booked into the regulatory asset as a result of the write-off of a portion of the TBO in 1993, but also the amount of VEBA 3 contributions included in Pacific's TBO that was not written-off but amortized annually. This amount was \$3.1 million (after-tax) annually for a total of \$18.9 million between 1994 and 1999. Thus, the total reduction of the regulatory asset will be \$41.6 million (after-tax). This reduction will reduce Pacific's write-off by \$41.6 million and result in a corresponding increase in Pacific's 1998 earnings. This increase in earnings, however, is not sufficient to increase Pacific's overall earnings above the shareable earnings threshold of 11.5%.

Further, Pacific shall submit a compliance filing that revises its 1998 Intrastate Earnings Monitoring Report ("IEMR") to reduce the write-off of the regulatory asset by \$41.6 million. The IEMR compliance filing shall show: (1) the \$41.6 million adjustment to the write-off, and (2) the effect of the adjustment to the write-off on each row of the IEMR (i.e., each USOA line item). The effect of the adjustment should also

⁵ Conclusion of Law No. 39 of the Decision notes "Decision 92-12-015, OP 6, prohibited Pacific from recovering via the Z-factor any of the contributions to Pacific's VEBA 3 in 1989 and 1990." (D.04-02-063, p. 180.)

be reflected in the final intrastate regulated rate of return shown on the IEMR. Finally, this decision revises the appendices and tables in D.04-02-063 to reflect the \$41.6 million dollar reduction.

B. The Decision is consistent with D.98-10-026.

Applicants raise numerous arguments that the Decision is inconsistent with D.98-10-028. First, they contend that the Decision incorrectly concluded that D.98-10-028 had provided ratepayers with a \$99.5 million rate reduction in 1998. (Rhg. App., p. 3.) Applicants note that D.04-02-063 states: “The principal effect of D.98-10-026 was to guarantee to ratepayers an immediate \$99.5 million rate reduction in rates for that year and every year going forward.” (Rhg. App., p. 4, citing D.04-02-063, p.48 (emphasis added).)

Applicants’ argument has some merit. When D.98-10-026 was adopted in October 1998, the \$99.5 million PBOP Z-factor for 1998 had already been approved in December 1997. (See Resolution T-16102, dated December 16, 1997.) Thus, the PBOP Z-factor could not have been eliminated in the 1998 price cap filing because the filing had already been approved, and Pacific was already recovering this amount in rates as of January 1998. Applicants are correct that the Decision suggests that rates were reduced by \$99.5 million beginning in 1998, rather than 1999. The rate reduction, however, was implemented in 1999, not 1998 as indicated in the Decision. As Pacific points out in its response to the application for rehearing, the error can be corrected by deleting the words “that year and” found on page 48 of the Decision. Accordingly, we shall make this modification.

Applicants next allege that the Decision errs because D.98-10-026 was silent with respect to the effect of terminating the Z-factor on the PBOP regulatory asset. Specifically, Applicants contend that there was no evidence that the Commission knew that termination of the Z-factor mechanism would result in Pacific’s writing off the PBOP regulatory asset. (Rhg. App., p. 4.) We have already considered this argument

and found it unpersuasive. (See D.04-02-063, pp. 48-49.) The Decision specifically states:

“The treatment of the regulatory asset did not require explicit discussion in 1998 because the standard treatment - a write-off of an above-the-line asset by an above-the line adjustment - was simple, consistent with the decision and uncontroverted by any discussion in D.92-12-015, which determined the treatment for this regulated asset on requested accounts. Moreover, the failure to discuss the alternative of below-the-line treatment of the regulatory asset in D.98-10-026 suggests that this alternative does not (and did not) merit serious discussion.”

(D.04-02-063, pp. 48-49.) Applicants have presented no new arguments to support their allegation and thus, there is no basis for granting rehearing.

Finally, Applicants make an unspecified and vague claim that the Decision errs in allowing Pacific to write off the PBOP regulatory asset in 1998 because even if the elimination of the PBOP Z-factor and associated rate reduction embodied some sort of “regulatory bargain,” that bargain did not become effective until 1999. (See Rhg. App., p. 4.) Based on the lack of specificity in Applicant’s argument, we deny rehearing on this issue pursuant to section 1732 and Rule 86.1. As the party seeking rehearing, Applicants have the burden to demonstrate the specific grounds upon which they consider the Decision to be unlawful, and vague assertions to the record or the law, without citation, may be afforded little weight. (See Pub. Util. Code, § 1732; see also Cal. Code. Regs., Tit. 20, § 86.1.) Accordingly, rehearing on this claim is denied.

C. The Decision’s treatment of the PBOP regulatory asset is not dictated by the treatment of annual depreciation costs adopted in D.89-10-031.

Applicants argue that the Commission is clear that ratepayers’ interests must be guarded under a sharing mechanism. They contend that this policy is demonstrated by the Commission’s treatment of NRF companies’ depreciation expenses while sharing was in place. (See Rhg. App., p. 9.) Applicants claim that because the Commission did not eliminate depreciation review until after sharing was suspended by

D.98-10-026, the Commission must not authorize Pacific to write off the PBOP regulatory asset above-the-line in 1998, since it would retroactively deprive ratepayers of shareable earnings. (See Rhg. App. p. 9.)

In support of their claim, Applicants quote D.98-10-026, which states:

“ ‘Because depreciation accruals will directly affect shareable earnings, we believe that depreciation rates should be examined annually to ensure their continued reasonableness.’ (33 CPUC2d 43, 138.) That is we needed to carefully examine depreciation rates because excessive depreciation charges could keep a utility’s return below the benchmark or ceiling (and thereby avoid a rate reduction) or put a utility’s return below the floor.”

(Rhg. App., p. 9, citing *Third Triennial Review for GTE & PacBell* [D.98-10-026], *supra*, 82 Cal P.U.C.2d at pp. 360-361.)

Applicants appear to be arguing that Commission’s treatment of annual depreciation costs somehow dictates how the PBOP regulatory asset should be written off. This argument is without merit. We did not eliminate regulatory control of depreciation rates until sharing was eliminated because depreciation rates were under the control of the utility, and thus could be changed to the utility’s benefit. (See generally, *Re Alternative Regulatory Frameworks for Local Exchange Carriers* [D.89-10-031] 33 Cal.P.U.C.2d 43, 138; *Third Triennial Review for GTE & PacBell* [D.98-10-026], *supra*, 82 Cal P.U.C.2d at pp. 360-361.) In contrast, as discussed below in Part II.E., we have authority to determine whether write-off of the PBOP regulatory asset should be recorded above- or below-the-line. This determination was based on the policy considerations supported by the evidentiary record.⁶ Accordingly, we find no grounds for granting rehearing.

⁶ Indeed, D.98-10-026’s statements regarding depreciation review are not dispositive of whether the write-off of the PBOP regulatory asset should be recorded above- or below-the-line.

D. Applicants' assertion that the Decision is internally inconsistent is without merit.

Applicants next contend that the Decision is internally inconsistent. First, Applicants maintain that the Decision ignores the criteria established in D.92-12-015 concerning PBOP cost recovery through the Z-factor mechanism, as the Decision allows Pacific to write off the entire \$400 million regulatory asset instead of just the amount that was placed in a tax-deductible trust fund. (Rhg. App., p. 5.) As support for this argument, Applicants rely on Ordering Paragraph 8 of D.92-12-015, which states, in relevant part:

“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 put into a trust.”

(*Re Post-retirement Benefits Other Than Pensions* [D.92-12-015], *supra*, 46 Cal.P.U.C.2d at p. 533 [Ordering Paragraph No. 8] (emphasis added).) Applicants' reliance is misplaced. D.04-02-063 concerns write-off of the PBOP regulatory asset pursuant to the criteria contained in SFAS 71, not recovery of the PBOP by the Z-factor. Thus, Ordering Paragraph 8 is not applicable.

As previously discussed, D.92-12-015 ordered utilities under NRF (such as Pacific) to establish a regulatory asset pursuant to SFAS 71. The amount to be recorded in the regulatory asset, however, was limited to any yearly differences between Pacific's SFAS 106 costs and its allowable tax-deductible contributions. (D.92-12-015, *supra*, 46 Cal.P.U.C.2d at p. 523.) D.92-12-015 also provided for recovery of the regulatory asset through the Z-factor. Ordering Paragraph 8 limited the amount that Pacific could recover via the Z-factor *annually*, not overall.

D.04-02-063 concluded that because the SFAS 106 Z-factor provided the revenue stream that supported the regulatory asset, when the Z-factor was eliminated, SFAS 71 required Pacific to write off the entire regulatory asset. No aspect of D.92-12-

015 countermanded this aspect of SFAS 71. (D.04-02-063, p. 46.) Indeed, Ordering Paragraph 4 notes, in relevant part: “The recovery of such regulatory asset in future rates shall begin during the year when tax-deductible limits exceed PBOP costs and shall continue until the regulatory asset has reached a zero balance.” (*Re Post-retirement Benefits Other Than Pensions* [D.92-12-015], *supra*, 46 Cal.P.U.C.2d at p. 533 [Ordering Paragraph No. 4] (emphasis added).) Thus, D.92-12-015 clearly contemplated that the entire regulatory asset could eventually be recovered. Moreover, if Applicants’ assertion that only a portion of the PBOP regulatory asset would be recovered via the Z-factor were true, then D.92-12-015 would have created a regulatory asset that was only partly recoverable. This would clearly be contrary to the requirement of SFAS 71 that before a regulatory asset is recorded, there is reasonable assurance that the regulator intends to permit recovery of that asset. (See, SFAS 71, ¶ 9.a.)

D.98-10-026 eliminated Z-factor recovery, and we did not authorize Z-factor recovery of the write-off in D.04-02-063. Thus, the limitations in Ordering Paragraph 8 “that Z-factor should only recover this amount to the extent it is put into a trust” are inapplicable. Accordingly, there is no basis for finding legal error on this ground.

Applicants further claim that the Decision is inconsistent because allowing Pacific to write-off the PBOP regulatory asset above-the-line actually rewards Pacific for employee layoffs, and contradicts the Decision’s stated criteria to create a regulatory structure that supports continued employment.⁷ (See Rhg. App., p. 7.) This argument is unfounded.

In the Decision, we considered the nature of PBOP expenses and the policies that affect these benefits. As discussed below, we have clearly explained our basis for concluding that an above-the-line write-off of the regulatory asset was

⁷ In 1993, as a result of a substantial reduction in its workforce, Pacific wrote off 26.5% of its TBO. Most of the write-off was booked to Pacific’s TBO in accordance with D.92-12-015. Thus, the PBOP regulatory asset included costs associated the reduction in workforce.

appropriate accounting practice. Moreover, we explained why we believed that permitting Pacific to write off the regulatory asset above-the-line was appropriate policy. As the Decision notes, “post-retirement benefits, remain subject to the control of the utility providing them and are not subject to the principal federal regulations concerning pensions.” (D.04-02-063, p. 50.) Consequently,

“[e]stablishing a regulatory policy that now regulates recovery of these costs to the non-regulated side of the utility introduces uncertainty concerning the ultimate costs of these benefits and ultimately increases the cost of providing this benefit. This adverse regulatory treatment of this employment benefit produces a powerful incentive for a utility to discontinue such benefits.”

(D.04-02-063, p. 50.) Applicants have not established any legal or factual basis justifying a departure from this reasoning, and thus, have failed to demonstrate grounds for finding legal error.

Finally, Applicants contend that the Decision erred in permitting write-off of the portion of the regulatory asset associated with Pacific’s 1993 workforce reduction. They assert that since lay-off costs are “totally under management control and discretion,” the costs are not eligible for Z-factor recovery. (See Rhg. App., p. 7.)

Applicants are correct to the extent that a utility is not entitled to Z-factor recovery of the force reduction related costs because these costs are within management control. (See *Re Post-retirement Benefits Other Than Pensions* [D.97-04-043] (1997) 71 Cal.P.U.C.2d 653, 663 [noting that utilities were able to control staffing levels and/or terms of benefits packages].) However, Applicants are mistaken that the TBO costs associated with the lay-off were not eligible for Z-factor recovery. Pursuant to SFAS 106, the TBO represented PBOP benefits that were earned by employees prior to the adoption of January 1, 1993, but never booked as an expense. Pursuant to D.92-12-015, “costs associated with the change from cash to accrual accounting for PBOP not recovered through the GNPPI should be recovered through a Z factor adjustment.” (*Re Post-retirement Benefits Other Than Pensions* [D.92-12-015], *supra*, 46 Cal.P.U.C.2d at

p. 527.) Since the TBO was a result of implementing SFAS 106, it was eligible for Z-factor recovery, subject to the limitations stated in D.92-12-015. The fact that Pacific had written off a portion of the TBO as a result of layoffs does not now render these costs “unrecoverable.”⁸ Additionally, the write-off of TBO costs was done in accordance with SFAS 106. (D.04-02-063, p. 67.) Thus, those costs were properly part of the regulatory asset and were properly included as part of the write-off of the regulatory asset.⁹

For the reasons discussed above, Applicants have failed to demonstrate that the Decision is internally inconsistent. Accordingly, there is no basis for granting rehearing.

E. Pacific’s above-the-line write-off of the PBOP regulatory asset is consistent with standard accounting practice.

Applicants contend that the Decision’s conclusion that allowing Pacific to write off the PBOP regulatory asset above-the-line was consistent with standard accounting practice is not supported by record evidence. (See Rhg. App., p. 9.) They maintain that the write-off of the PBOP regulatory asset should be considered an “extraordinary loss” and, thus, must be charged below-the-line. (See Rhg. App., p. 9.) Applicants rely on the FCC’s Uniform System of Accounts’ (“USOA”) Account 7620 to support their claim. Account 7620 states:

“This account shall be debited with non-typical, non-customary and infrequently recurring losses which would significantly distort the current year’s income computed before such extraordinary items, if reported other than as extraordinary items.”

⁸ Pacific witness David W. Toti also stated “the write-off of a regulatory asset does not change the underlying nature of the cost.” (Exh. 308: Reply Testimony (Toti/Pacific), p. 32.)

⁹ The discussion in this paragraph only applies to the TBO associated with PBOP benefits that were earned by employees prior to the adoption of January 1, 1993 but not yet expensed. As discussed previously, the pre-funded PBOP contributions in the VEBA 3 trust that were transferred into the TBO were ineligible for Z-factor recovery and should not have been booked in the regulatory asset.

Applicants' reliance is misplaced.

As Applicants are well aware, GAAP requirements for financial reporting are not binding on the Commission. SFAS 71 specifically notes:

“This Statement [SFAS 71] neither limits a regulator's actions nor endorses them. Regulators' actions are based on many considerations. Accounting addresses the effects of those actions. This Statement merely specifies how the effects of different types of rate actions are reported in general-purpose financial statements.”

(SFAS 71, ¶ 55.) Further, the evidentiary record demonstrated that Pacific had recognized below-the-line extraordinary losses in 1997 and 1999 related of SFAS 106 that were not recognized as extraordinary losses for Commission accounting purposes. (D.04-02-063, p. 37.) Thus, we could allow Pacific to write-off the regulatory asset above-the-line if there was a reasonable basis to do so based on the evidence.

In this instance, Pacific's witness Toti testified that standard regulatory accounting dictates above-the-line treatment of costs found to meet the cost of service criterion. (See Exh. 308: Reply Testimony (Toti/Pacific), p. 32.) There was also record evidence that the SFAS 106 costs met the cost of service criterion. (See, e.g., RT Vol. 6, p. 497:10-26 (Carver/ORR).) Based on its consideration of the evidence, we concluded:

“these PBOP expenses arise from the benefits granted to employees who provided regulated telecommunications services. These other labor cost (sic) receive 'above-the-line' accounting treatment. As a consequence, writing these PBOPs costs off 'above-the-line' is consistent with the origin of these costs and the accounting treatment of similar costs.”

(D.04-02-063, p. 50.) Moreover, we explained policy reasons why we believed an above-the-line write-off was appropriate. (D.04-02-063, p. 50.) Thus, based on these reasonable policy considerations, which are support by the evidentiary record, we properly permitted Pacific to record the write-off above the line.

F. The Decision is consistent with the NRF goal of fairness.

Applicants argue that allowing above-the-line treatment for the write-off of the regulatory asset violates the spirit of NRF and D.98-10-026. Specifically, Applicants maintain that booking the write-off of the asset above-the-line violates the fairness concept because it reduces ratepayers' share of profits. Applicants further claim that the "regulatory bargain" D.98-10-026 adopted was to shift risks to shareholders, not ratepayers, and above-the-line treatment accomplishes the opposite. (Rhg. App., p. 10.) These allegations lack merit.

The concept of fairness has been described as the following: "whether the regulatory changes are balanced and do not unreasonably disadvantage one or more stakeholders (the local exchange carriers, shareholders, various customer groups or competitors) to the advantage of other stakeholders." (*Re Alternative Regulatory Frameworks for Local Exchange Carriers* [D.89-10-031], *supra*, 33 Cal.P.U.C.2d at p. 114.) Thus, the goal of fairness balances the interests of *all* NRF stakeholders. However, Applicants are in effect asserting that as a result of D.98-10-026, "fairness" would dictate that only shareholders assume all risks. We disagree. In this instance, we considered all arguments concerning whether Pacific had properly written off its PBOP regulatory asset above-the-line and determined that policy considerations that are supported by the evidentiary record warranted approval of Pacific's action.

G. Applicants have failed to demonstrate grounds for finding retroactive ratemaking.

Applicants assert that as a result of the alleged inconsistencies, the Decision eliminated the revenue sharing benefits ordered in D.92-12-015, D.95-12-052 and D.98-10-026. Thus, they contend that the Decision changed rates retroactively. (See Rhg. App., pp. 2-3.) This assertion is without merit. As discussed in this order, Applicants have failed to demonstrate any grounds for concluding that the Decision improperly allowed Pacific to write-off the PBOP regulatory asset above-the-line in 1998. Absent such a showing, there is no basis for concluding that ratepayers were entitled to revenue

sharing in 1998. To the extent Applicants demonstrated error with respect to the write-off of non-recoverable costs, the adjustment ordered would not result in shareable earnings.¹⁰ Therefore, Applicants have failed to demonstrate grounds for finding retroactive ratemaking. Accordingly, there is no basis for granting rehearing on this issue.

Therefore, **IT IS ORDERED** that:

1. D.04-02-063 is modified to reduce Pacific's regulatory asset by \$41.6 million. This amount represents the pre-funded VEBA 3 contributions that were part of Pacific's TBO. Pacific shall reduce its 1998 write-off of the PBOP regulatory asset by \$41.6 million.
2. Within 30 days of this decision, Pacific shall submit a compliance filing that revises its 1998 Intrastate Earnings Monitoring Report ("IEMR") to reduce the write-off of the regulatory asset by \$41.6 million. The IEMR compliance filing shall show: (1) the \$41.6 million adjustment to the write-off, and (2) the effect of the adjustment to the write-off on each row of the IEMR (i.e., each USOA line item). The effect of the adjustment should also be reflected in the final intrastate regulated rate of return shown on the IEMR.
3. Appendices A through K of D.04-02-063 are deleted and replaced with Appendices A through L in Attachment A of this order.
4. On page 48 of D.04-02-063, the third sentence in the first paragraph is deleted and replaced with the following: "The principal effect of D.98-10-026 was to guarantee to ratepayers an immediate \$99.5 million reduction in rates for every year going forward."
5. Rehearing of all other issues raised by Applicants is denied.
6. Rehearing of D.04-02-063, as modified, is denied.

¹⁰ Further, the adjustment does not constitute retroactive ratemaking. (See *Southern Cal. Edison Co. v. Public Utilities Com.* (1978) 20 Cal.3d 813, 818-819 & 829-830.)

This order is effective today.

Dated December 1, 2005, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
SUSAN P. KENNEDY
DIAN M. GRUENEICH
JOHN A. BOHN
Commissioners

I will file a concurrence in part

/s/ SUSAN P. KENNEDY
Commissioner

I will file a dissent in part.

/s/ SUSAN P. KENNEDY
Commissioner