



# California Public Utilities Commission

505 Van Ness Avenue, San Francisco, CA 94102

## NEWS RELEASE

---

February 21, 2002

PUC: 18

Media Contact: PUC Press Office – 415.703.1366 – news@cpuc.ca.gov PUC

### **INDEPENDENT AUDIT FINDS PACIFIC BELL OWES RATEPAYERS ALMOST \$350 MILLION**

The California Public Utilities Commission (PUC) today released the results of a comprehensive independent audit of Pacific Bell that recommends customer refunds of almost \$350 million.

The audit, which spans the period 1997 through 1999, concluded that Pacific Bell had failed to comply with various PUC accounting and regulatory requirements, and identified 67 specific adjustments to Pacific Bell's regulated operating revenues, expenses, and rate base. According to the audit, these adjustments would increase Pacific Bell's net operating income for the three-year audit period by almost \$2 billion, which translates into recommended customer refunds of almost \$350 million for the years 1997 and 1998.

The audit, performed by Kansas-based Overland Consulting for the PUC's Telecommunications Division, focuses solely on PUC regulatory accounting. The audit addresses only how Pacific Bell accounts for its California regulated operations for PUC reporting purposes, and does not address corporate accounting practices for external reporting purposes. Auditors did not review financial statements that Pacific Bell or its parent, SBC Communications, Inc. (SBC), filed with the Securities and Exchange Commission (SEC) or in annual shareholder reports.

The audit was completed as part of the PUC's triennial review of an incentive-based regulatory program called the New Regulatory Framework (NRF). In 1989, the PUC adopted NRF for the two largest local telephone companies in California: Pacific Bell and Verizon California (then known as GTE California, Inc.).

Key findings and allegations of the audit include:

- Pacific Bell did not comply with PUC accounting requirements in reporting regulated financial results to the PUC. Most significantly, Pacific Bell did not account for pension expenses, other post retirement benefits expenses, depreciation expenses, or income tax expenses in compliance with PUC regulatory requirements.

- Because Pacific Bell did not comply with PUC accounting requirements, the amount of regulated net operating income reported to the PUC was substantially understated in each of the three audit years. The understatement of regulated net operating income means that earnings owed to customers under the NRF sharing rules were neither reported nor refunded to Pacific Bell's customers.
- Pacific Bell has transferred telephone company functions, assets, and employees to affiliates not regulated by the PUC, potentially reducing the PUC's authority to regulate telephone operations and accounting in California.
- Pacific Bell and its affiliates did not always comply with PUC rules governing utility financial relationships with affiliates, called "affiliate transaction rules."
- Pacific Bell and its affiliates were unable or unwilling to provide sufficient support for costs its affiliates assigned to Pacific Bell, and vice versa.
- NRF monitoring program reports that Pacific Bell filed with the PUC did not provide sufficient information for the PUC to determine if Pacific Bell was meeting NRF goals.

NRF was designed to streamline regulation and contained financial incentives to encourage companies to attain greater productivity, as well as appropriate safeguards for ratepayers. One of the safeguards was a mechanism requiring the companies to share high levels of earnings with ratepayers. This component, known as the sharing mechanism, was in effect during the years 1997 and 1998 of the audit period. As additional safeguards, the PUC established a monitoring program that relies on specific types of data and reports that the utilities must submit regularly, and directed companies to provide increased utility cooperation with PUC investigations and audits.

Because the NRF sharing mechanism requires that excess earnings be shared with ratepayers, the audit proposes that a portion of the excess earnings be returned to ratepayers in the form of a refund, consistent with the NRF sharing mechanism. Since the PUC suspended NRF sharing beginning in 1999, the audit does not propose a refund for that year.

The PUC will review the audit report and results in the context of a formal proceeding in which it also will review and evaluate the present status of NRF. Pacific Bell and other parties to the formal proceeding will have the opportunity to respond to the audit report and to make recommendations to implement changes to NRF based on the audit report and other evidence put forward in the proceeding.

Only a redacted copy of the executive summary of the audit is available today in order to allow Pacific Bell adequate time to determine what portion of the complete audit, if any, it believes contains confidential business information. The complete redacted version of the audit is expected to be available Tuesday, March 5, 2002. A redacted version of the executive summary of the audit report is on the PUC

website at [www.cpuc.ca.gov](http://www.cpuc.ca.gov).

###