REGULATORY AUDIT OF PACIFIC BELL
FOR THE YEARS 1997, 1998 AND 1999

Executive Summary

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PREPARED FOR
CALIFORNIA PUBLIC UTILITIES COMMISSION

BY

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Chapter 1 - Executive Summary

I. Introduction

In 1989 the California Public Utilities Commission (Commission or CPUC) adopted an incentive-based regulatory framework for Pacific Bell and Verizon California (at the time GTE California, Inc.). The New Regulatory Framework (NRF) incorporated financial incentives, streamlined regulation and safeguards for customers and shareholders. The Commission established a set of regulatory goals and linked the success of the NRF to its ability to obtain information of sufficient quality and depth to determine whether the goals were met. The Commission adopted a monitoring program intended to provide specific utility data and reports to assess progress in meeting its NRF regulatory goals.

This report documents the results of a regulatory audit of Pacific Bell performed by Overland Consulting. The audit was performed for the Commission under the supervision of the Telecommunications Division (TD). The audit covered calendar years 1997 through 1999 and included reviews of Pacific Bell's compliance with CPUC accounting requirements, procedures to allocate costs between regulated and non-regulated activities, policies and rules for pricing transactions between Pacific Bell and its affiliated companies and NRF monitoring reports. This audit report focuses on Commission-prescribed regulatory accounting and is not intended to express any opinion on 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.

II. Overview of Audit Findings and Conclusions

The audit of financial results identified 67 corrections to Pacific Bell's regulated 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 for 1999 would have totaled $457 million if the sharing rules had been effective. Following are additional key findings and conclusions from the audit.

Understatement of Regulated Earnings

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

- Because Pacific Bell did not comply with CPUC accounting requirements, regulated net operating income reported to the CPUC was substantially understated in each of the three audited years. As a result of understated regulated net operating income, earnings owed to customers under NRF sharing rules were not reported or refunded.

Issues Raised by Affiliate Relationships

- Pacific Bell's recent transfer of telephone company functions, assets and employees to corporate shared services affiliates controlled by SBC has the potential to significantly reduce the CPUC's control and authority in regulating telephone operations and accounting.

- Pacific Bell and its affiliates did not always comply with CPUC affiliate transactions rules. Internal control over certain affiliate transactions was inadequate.

- Pacific Bell and its affiliates were unable or unwilling to provide sufficient support for some affiliate transactions, including adequate cost support for affiliate transfer pricing and certain costs allocated by shared services affiliates. Pacific Bell did not answer questions regarding its policies for transferring telephone company customer information to affiliates.

The NRF Monitoring Program

- NRF monitoring program reports filed by Pacific Bell did not provide sufficient information to enable the CPUC to determine whether it was meeting its NRF goals.

A. Summary of Intrastate Financial Results

The table below summarizes intrastate financial results prepared for the CPUC and customer-refundable earnings as reported by Pacific Bell and as determined by the audit.

Table 1-1
Pacific Bell's CPUC-Basis Financial Results & NRF Customer Refunds Reported By Pacific Bell and Audit-Adjusted

Source: Pacific Bell Financial Reports and Audit workpapers

	Reported By Pacific Bell	Audit-Adjusted
1997		
Net Regulated Intrastate Operating Income	652,499,328	1,114,302,393
Return on Regulated Intrastate Rate Base	6.49%	11.72%
Customer Refunds Under NRF Sharing Provisions	0	17,638,716
1998		
Net Regulated Intrastate Operating Income	922,472,419	1,549,326,224
Return on Regulated Intrastate Rate Base	9.07%	15.86%
Customer Refunds Under NRF Sharing Provisions	0	331,184,800
1999		
Net Regulated Intrastate Operating Income	962,198,083	1,817,964,464
Return on Intrastate Regulated Rate Base	9.66%	18.22%
Customer Refunds Under NRF Sharing Provisions (1)	0	457,244,588
Audit Period Combined		
Net Regulated Operating Income	2,537,169,830	4,481,593,081

1. Audit-adjusted amount is pro forma. The CPUC suspended customer sharing effective in 1999.

Intrastate financial results prepared for the CPUC were the product of an overly complicated and poorly disclosed process involving the adjustment of FCC-basis financial data. The subsidiaries included in intrastate results Pacific Bell reported to the CPUC varied from year to year. Pro-forma financial information necessary to make the results comparable between years was not presented. There was insufficient disclosure of the amounts and basis for differences between FCC and CPUC financial results. CPUC-basis financial reporting adjustments and many ratemaking adjustments were bundled together on Pacific Bell's Intrastate Earnings Monitoring Reports (IEMRs) and were not separately identified or explained in materials filed with the CPUC.[1]

B. <u>Affiliate Transactions</u>

Pacific Bell's regulated telephone company functions, employees and proprietary information are being transferred to corporate "shared services" affiliates. Several thousand Telco employees were transferred at the end of 1999 alone. The transfer of functions out of the telephone company has the potential to significantly reduce the control and authority the CPUC has traditionally exercised over regulated telephone operations. Evidence for this can be seen in Pacific Bell's resistance to auditing affiliate transactions, in the fact that the functions transferred to affiliates are no longer accounted for under FCC Part 32 accounting rules, in the lack of sufficient affiliate organizational documentation, and in the accounting complexities introduced by affiliate transactions that make them harder to track and evaluate than transactions incurred within Pacific Bell.

Internal accounting controls governing certain affiliate transactions processes were inadequate. Pacific Bell and SBC did not always comply with CPUC requirements governing affiliate transactions and could not adequately support certain affiliate transaction components, such as the cost basis for pricing transactions between Pacific Bell and its affiliates. The structure of SBC's affiliate organizations maintained for regulatory accounting purposes was undocumented and details about the activities and functions that constituted inter-company billing affiliates were sometimes poorly understood even by employees that Pacific Bell represented to be subject matter experts. Given the growing magnitude of affiliate transactions, unless control weaknesses and compliance problems are corrected they may materially affect the regulated operating income Pacific Bell reports to the CPUC in the years after the audit period. Audit corrections to affiliate transactions recorded in Pacific Bell's Intrastate Earnings Monitoring Reports increased regulated audit period intrastate net operating income by $97 million.

C. <u>Cost Allocations Between Regulated and Non-Regulated Activities</u>

A majority of the FCC procedures for allocating telephone company costs between regulated and non-regulated accounting categories were well controlled. However, we found certain allocation procedures were inconsistent with attributable cost principles adopted in FCC and CPUC rules and increasing levels of affiliate transactions has weakened Pacific Bell's compliance with Part 64 regulated / non-regulated cost allocation rules. Audit corrections to recorded Part 64 cost allocations increased audit period regulated intrastate net operating income by $44 million.

[1] The IEMR is a regulatory report intended to show regulated intrastate net operating income calculated in accordance with CPUC accounting and ratemaking rules. Its results are not subject to annual audit.

D. NRF Monitoring Program

The NRF monitoring program, last revised in 1992, does not provide sufficient information to enable the CPUC to determine whether it is meeting its NRF goals. Specific deficiencies include data to assess competition, service quality and customer satisfaction, technological advancement and intrastate regulated earnings.

E. Difficulties Encountered in Completing the Audit

The audit required approximately 18 months to complete, six months longer than originally scheduled. We met most, but not all, audit objectives. Impediments to successfully completing the audit within the time originally scheduled included restrictions 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.

We attempted to perform the audit in accordance with Generally Accepted Auditing Standards (GAAS) applicable to a regulatory audit. GAAS requires that auditors obtain sufficient competent evidential matter to provide a basis for findings and conclusions. The restrictions imposed on the audit prevented us from obtaining sufficient data to develop conclusions in some areas. To the extent that available time and Pacific Bell's responses to outstanding data requests permit us to complete our analysis and develop conclusions in these areas, we will supplement our report. Completing these areas will not affect our conclusion that regulated income was significantly understated during the audit period; however, it may result in a change in the calculated amount of NRF refunds owed to customers.

III. Discussion of Significant Audit Findings and Issues

A. Regulated Operating Revenue, Expense and Rate Base (Chapters 4 - 11)

Combined audit period corrections to amounts recorded directly in regulated accounts increased audit period (1997 to 1999) intrastate regulated operating income by $1.8 billion and decreased average intrastate regulated rate base by $314 million. Four corrections account for 75 percent of the change in intrastate operating income. These corrections address 1) depreciation reserve deficiency amortization; 2) pension costs; 3) other post-retirement benefits costs; and 4) income tax accounting policy.

1. Reserve Deficiency Amortization Adjustment

Pacific Bell increased its intrastate regulated depreciation expense by $ **[Redacted]** in 1999 to reflect "reserve deficiency amortization." The increase reflects the amortization, over a six year period, of the intrastate portion of a plant write-down Pacific Bell recorded for external financial reporting purposes in

1995.[2] By 1999, the assumptions underlying the 1995 plant write-down had been proven to be highly inaccurate. In spite of this, Pacific Bell chose to amortize the reserve deficiency on the CPUC books, causing a significant reduction in the earnings reported the 1999 IEMR.[3] The reserve deficiency amortization was not implemented pursuant to accounting requirements; rather, it was implemented at management's discretion to achieve regulatory objectives. The six-year amortization period was arbitrary and also based on management's regulatory objectives, rather than accounting principles.

The reserve deficiency amortization is not an allowable cost for ratemaking purposes because it does not reflect a real increase in the cost of providing utility service. Pacific Bell did not request CPUC approval for the reserve deficiency amortization and has not made any showing that the reserve deficiency amortization would be allowed for ratemaking purposes. Therefore, we removed Pacific Bell's reserve deficiency amortization in calculating audit-adjusted regulated operating expense.

2. Pension Costs

Intrastate regulated pension expenses reported to the CPUC were overstated by $357 million during the audit period as a result of Pacific Bell's failure to correctly apply CPUC pension cost accounting requirements. As set forth in Decision 88-03-072, the CPUC requires the use of the Aggregate Cost Method (ACM) to determine pension costs. Essentially, ACM pension cost is the difference between the present value of pension benefit payments owed and funded pension assets attributable to the current year. The amount attributable to the current year is calculated by spreading the total difference over the average remaining employment period for active plan participants. Because Pacific Bell's pension plan is significantly overfunded (i.e. funded pension assets significantly exceed forecasted benefit payments), proper application of the ACM produces *negative* intrastate regulated pension expense of $357 million during the audit period. Pacific Bell did not use the ACM to determine its pension costs during the audit period. Instead, Pacific Bell arbitrarily set its intrastate pension costs equal to zero in all three years. This caused an overstatement of pension expense under CPUC accounting requirements.

Under Generally Accepted Accounting Principles (GAAP), pension costs are determined in accordance with Statement of Financial Accounting Standards (SFAS) 87. GAAP calculations of pension cost, which are different from the costs calculated for CPUC purposes, are used for Pacific Bell's FCC and SEC (external) financial reporting. Over time, pension costs calculated under GAAP have been lower than the pension costs Pacific Bell has been permitted to recover for CPUC purposes. Pacific Bell maintains a regulatory liability account to track the intrastate portion of the difference between its GAAP and CPUC pension costs. The December 31, 1999 balance of **$[Redacted]** in this account represents the cumulative amount by which the pension costs Pacific Bell recognized for CPUC purposes exceeded pension costs recognized under GAAP. Pacific Bell's decision to set pension costs equal to zero when the ACM produces negative expense has contributed to a large and growing disparity between GAAP and CPUC pension costs. The audit correction, designed to bring CPUC pension expense into compliance with CPUC accounting requirements, will slow the growth of the disparity.

3. Other Post-Retirement Benefit Costs

[2] A plant write down is the removal of plant from the books. Essentially, it is an acceleration of future years' depreciation expenses into the current period.

[3] Because it takes place over six years, the reserve deficiency amortization determined by Pacific Bell will continue to significantly reduce reported IEMR earnings through 2004.

Pacific Bell provides post-retirement benefits other than pensions (PBOPs) to retired employees. The PBOPs consist of post-retirement medical, dental and life insurance benefits and discounts on telephone service. Medical and dental benefits account for 85% of Pacific Bell's PBOP liability.

The CPUC's PBOP policy limits annual PBOP costs to the amount of tax-deductible contributions made to external trust funds established to pay PBOP benefits. Pacific Bell contributed **$[Redacted]** to its PBOP external trusts during the audit period, on an intrastate regulated operations basis. Therefore, under the CPUC's PBOP policy, Pacific Bell's maximum allowable PBOP expense was **$[Redacted]**. Pacific Bell claimed **$[Redacted]** in PBOP intrastate regulated expenses on its IEMR reports for the audit period. The PBOP operating expenses claimed by Pacific Bell exceeded the maximum amount permitted under the CPUC's PBOP policy by $528 million.

The $528 million of PBOP expense improperly claimed by Pacific Bell largely reflects the accelerated recognition of costs for employees terminated in a 1993 force reduction program. Pacific Bell recognized the accelerated costs in 1993 when it announced the force reduction program and deferred the costs as a regulatory asset. Pacific Bell increased the PBOP costs claimed on its 1998 IEMR by **$[Redacted]** to reflect the immediate write-off of that regulatory asset. The CPUC's PBOP accounting policies do not permit accelerated recognition of PBOP costs for terminated employees. Under the CPUC's policy, PBOP costs associated with terminated employees are recognized when the contributions needed to pay their PBOP benefits are actually made to the PBOP external trusts. Limiting Pacific Bell's PBOP costs to the amount permitted by the CPUC's PBOP policy (i.e. the amount actually funded during the audit period) will not deny Pacific Bell an opportunity to fully recognize its reasonable PBOP costs over the appropriate funding period.

Pacific Bell withdrew **$[Redacted]** from its management pension plan trust fund in December 1999. In the same month, Pacific Bell withdrew **$[Redacted]** from its PBOP life insurance trust. The withdrawals violated the CPUC's policies concerning the use of pension and PBOP trust fund assets. The pension and PBOP trust fund withdrawals potentially impact the amount of PBOP costs reportable under CPUC accounting requirements in 1999. The proper accounting and ratemaking treatment for those transactions will be determined after Pacific Bell responds to outstanding data requests.

4. CPUC Regulated Income Tax Expense

The CPUC has a long-standing policy of requiring flow-through accounting treatment for temporary differences between book and taxable income to the extent permitted by federal income tax regulations.[4] Under the flow-through accounting method, income tax expense reported for regulatory financial results reflects the actual taxes paid to the government for the current year. Pacific Bell provided flow-through accounting treatment to some temporary differences during the audit period. However, Pacific Bell provided tax normalization treatment to many temporary differences that should have been accounted for on a flow-through basis. After considering the impact of other audit corrections on temporary difference amounts, the proper application of the CPUC's flow-through policy reduces audit period intrastate regulated deferred income taxes by $438 million compared to the level produced by

[4] Temporary differences reflect differences in the timing of the recognition of revenues and expenses for financial reporting and income tax return purposes. Temporary differences are caused by differences between financial reporting accounting policies and the tax requirements for determining taxable income. Because the same expenses and revenues are ultimately recognized on the financial statements and the tax returns over time, the differences eventually reverse and are therefore called temporary differences.

Pacific Bell's income tax normalization policy. Temporary differences attributable to pension expense and the California universal service fund account for 86 percent of that amount. Therefore, from the standpoint of audit period regulated operating income, the key income tax accounting issue is whether the pension and universal service fund temporary differences should be accounted for on a flow-through or a normalization basis.
The proper application of the aggregate cost method to determine CPUC pension expenses results in negative intrastate regulated pension expense of $357 million during the audit period. Negative pension expense increases book income but does not increase taxable income. Under the normalization method, book income tax expense is set as if the negative pension expense was taxable income. The flow-through method results in lower tax expense than the normalization method in years in which pension expense is negative because negative pension expense does not increase the amount of taxes owed to the government for the current tax year. Under the CPUC's flow-through policy, the pension temporary difference should be accounted for on a flow-through basis.

The universal service fund temporary difference is a new temporary difference resulting from the implementation of the California High Cost Fund-B. For income tax purposes, the payments received from the fund are treated as a reduction of construction costs because the payments are made to subsidize the provision of service requiring plant investment in high cost (rural) areas. As a result, the fund payments are taxed over the lives of associated assets (as smaller depreciation expense deductions due to the reduction of plant costs), rather than in the year of receipt. For financial reporting to the CPUC, Pacific Bell included the money it received from the fund as operating revenue and normalized the temporary difference in revenue recognition on its CPUC-basis books. Under the CPUC's income tax expense accounting policy the universal service fund temporary difference should be accounted for on a flow-through basis. Income tax expense for IEMR purposes should be based on the tax law, which recognizes the high-cost fund revenue over the life of the assets it subsidizes.

5. <u>Operating Revenues and Expenses</u>

Our review resulted in four audit corrections to Pacific Bell's 1997 regulated operating revenues and other operating income. These include 1) eliminating unsupported and unauditable accruals for regulatory contingent liabilities; 2) correcting a posting error related to Bellcore dividends; 3) removing uncollectible revenues recorded in 1997 but attributable to 1996 operations; and 4) increasing other operating income to reflect the ratepayer's portion of the pre-tax gain on the sale of Bellcore. We did not identify any corrections to Pacific Bell's 1998 and 1999 revenues. The four corrections increased Pacific Bell's 1997 intrastate regulated revenues by $116 million.

We identified and calculated nine audit corrections to operating expenses. These include 1) removing $138 million in local number portability (LNP) costs from intrastate operating expenses that the FCC explicitly ruled should be assigned directly to the interstate jurisdiction; 2) removing $49 million in local competition implementation costs that should have been deferred and amortized over the period of CPUC-authorized surcharge recovery that began in 2001; 3) reducing operating expense by $35 million to reflect the allocation of merger savings between ratepayers and shareholders ordered in the CPUC decision that approved the merger of SBC and Pacific Telesis; 4) removing $41 million in cost associated with the shut down of an Advanced Communications Network that was never placed into service; 5) reducing operating expenses by $44 million to correct Pacific Bell's accounting for a December 1999 software buy-out agreement; 6) removing $103 million of unsupported and unauditable litigation and regulatory accruals from operating expense; 7) reducing incentive compensation accruals by $29 million to reflect the actual payout levels for the 1997, 1998 and 1999 performance years; 8) reducing 1997 and 1998 operating expense by $42 million to remove the cost of settlements paid to contract billing customers for an increase in uncollectible amounts attributable to 1996 operations; and 9) increasing operating expense by $19 million to correct the classification of traffic bound for internet service providers for separations purposes. In total these nine corrections reduce audit period intrastate regulated operating expense by $463 million.

In addition to the reserve deficiency adjustment discussed above, we made a correction to eliminate the impact of an accounting error associated with depreciation expense. The formula used to calculate the jurisdictional adjustment for intra-building cable amortization contained an error that resulted in a $61 million overstatement of 1997 and 1998 intrastate depreciation expense. We corrected this error.

6. Rate Base

We made five corrections to net plant that increased average audit period intrastate net plant by $34 million. A sixth correction involving Allowance for Funds Used During Construction (AFUDC) could not be quantified because the necessary information had not been provided at the time of this report.[5] Overland identified numerous errors in Pacific Bell's cash working capital lead-lag studies. The errors imply significant deficiencies in Pacific Bell's internal controls over the preparation of cash working capital studies. Cash working capital is impacted by other audit corrections to revenues and expenses. After considering these other audit corrections, Pacific Bell's corrected intrastate regulated cash working capital requirement averaged $149 million during the audit period, **$[Redacted]** lower than the average amount claimed by Pacific Bell.

B. Affiliate Transactions (Chapters 12 - 19)

Combined audit period corrections to affiliate transactions recorded in Pacific Bell's IEMR increased audit period regulated intrastate net operating income by $97 million. This discussion presents summarized findings and conclusions for our audit of Pacific Bell's affiliate transactions. It is divided into the following subjects:

- Internal Accounting Controls
- CPUC Regulatory Authority and Control
- Pacific Bell's Management Control
- Compliance with FCC and CPUC Affiliate Transaction Requirements
- Issues Affecting Markets and Competition
- Cross Subsidization
- Affiliate Transaction Audit Adjustments

1. Internal Accounting Controls

SBC and Pacific Bell had accounting systems in place during the audit period to identify and bill affiliate services in all of the areas we reviewed. However, we found a number of control weaknesses in these systems. Internal accounting controls were weakest with respect to the new shared services affiliates, SBC Services and SBC Operations. We did not conclude that internal control weaknesses affecting affiliate service transactions had a material impact on Pacific Bell's financial results reported to the

[5] Allowance for Funds Used During Construction includes the financing (interest) cost of funds employed to construct plant. It is usually calculated using the company's overall average interest rate on debt.

CPUC during the years 1997 through 1999. In part, this is because the level of transactions between Pacific Bell and affiliates, although growing at a rapid rate, was relatively small for most of the audit period. Significant transfers of telephone company assets to shared services affiliates, although pending, did not take place during the audit period. We were unable to evaluate the impact of transactions involving intellectual property and proprietary information because we did not have the time or the resources to effectively audit these areas and because Pacific Bell would not answer certain data requests.

2000 was a watershed year for Pacific Bell's affiliate relationships. There was significant movement of employees from the telephone company to the unregulated shared services affiliates at the end of 1999 and "advanced services", a significant component of the Pacific Bell's evolving telecommunications business, was transferred from Pacific Bell to SBC Advanced Solutions, Inc. (ASI).[6] The absolute value of reported income statement transactions between Pacific Bell and affiliates doubled between 1999 to 2000, from **$[Redacted]** to **$[Redacted]**. By 2000, services provided by affiliates constituted more than 25 percent of Pacific Bell's regulated operating expenses. SBC Services, which did not have sufficient accounting controls established during the audit period, increased its billings to Pacific Bell more than 30 fold in 2000, to **$[Redacted]**. It is reasonable to conclude that unless internal accounting controls improved, the impact of control weaknesses could have a growing and potentially significant impact on Pacific Bell's intrastate financial results in the years after 1999.

2. CPUC Regulatory Control

Because the affiliates to which Pacific Bell's functions are being transferred are unregulated and managed from the corporate level, the possibility exists that the CPUC could lose some or much of its ability to regulate traditional telephone operations. The Commission should consider the potential loss of authority to set accounting and operating standards and reporting requirements as a consequence of transferring functions out of the regulated telephone company. Pacific Bell's resistance to a review of its affiliate transactions is on the record at the CPUC and was evident to us during the audit. Prior to the audit Pacific Bell argued that affiliate transactions were not a legitimate component of an audit performed under California Public Utilities Code Section 314.5. At one point during the audit, Pacific Bell declared a moratorium on affiliate transaction data requests and requested that affiliate information already provided be returned. SBC and Pacific Bell would not or could not provide the information necessary to complete an audit of some affiliate issue areas.

Accounting procedures are also a concern as affiliate transactions grow. The corporate shared services affiliates to which telephone company functions are being transferred do not use the FCC's Part 32 Uniform System of Accounts. Certain cost information required by the CPUC is lost from Pacific Bell's general ledger when activities are transferred to affiliates and costs are incurred as inter-company charges. In most respects, affiliate transactions were more difficult to audit than transactions incurred within Pacific Bell.

Pacific Bell could not produce documentation describing SBC's organizational structure as it existed for inter-company billing purposes. It took months to acquire a database of SBC employees and weeks more to piece together the database codes that described the individual components of the organizations billed to Pacific Bell. An understanding of the components and activities of an affiliate's organization is an

[6] Scope limitations precluded us from determining whether Pacific Bell was compensated for the value of the business transferred to ASI.

absolute requirement to effectively audit the amounts billed to the telephone company. The lack of adequate affiliate organizational documentation is a notable internal control weakness.

3. Pacific Bell's Management Control

Pacific Bell's and PTG's management control of Pacific Bell's operations declined after the merger with SBC. Strategic decision making by PTG's corporate management, whose primary focus was Pacific Bell, was ceded to SBC executives in Texas after the merger. Shared services affiliates were established to run Pacific Bell's marketing, network, and general and administrative functions from a corporate perspective. Pacific Bell's internal management control continued to decline after the audit period as several thousand employees and additional telco departments migrated to affiliates controlled by SBC.

As management control of Pacific Bell shifts to SBC, Pacific Bell's unique interests become less significant in decision making. Corporate management's attention is naturally more focused on the interests of SBC as a whole. Although it is likely that consolidating telephone company functions into corporate shared services entities can produce economies of scope and scale for SBC, it is not at all certain that this will always have a positive impact on Pacific Bell. For example, after the SBC / PTG merger Pacific Bell's operating expenses increased because of a substantial increase in corporate charges. Pacific Bell's corporate charges increased from less than **$[Redacted]** in 1996, the year before the merger, to nearly **$[Redacted]** in 1999. Most of the increase was due to new and higher cost levels billed by SBC's Texas-based corporate organization, which was added to the California-based PTG organization that existed prior to the merger. Pacific Bell's corporate charges continued to climb in 2000. This occurred in part because cost allocations from Management Services Inc., SBC's Texas-based parent organization, were layered on top of costs being charged by PTG's parent organization prior to the merger.

4. Compliance with FCC and CPUC Affiliate Transaction Requirements

Pacific Bell billed non-regulated affiliates the CPUC-mandated 10 percent markup on affiliate services. It did not bill the mark up for services provided to other regulated telephone companies. Fully distributed cost calculations used to establish transfer prices for services Pacific Bell provided to affiliates were based on what appeared to be a flawed methodology. Pacific Bell charged the 25 percent-of-salary fee for transferred employees; however, it sometimes billed the parent for employees transferred to other affiliates. In 1997 the parent charged some employee transfer fees back to Pacific Bell. Pacific Bell failed to accrue inter-company revenue for a large employee transfer that occurred in December, 1999.
Pacific Bell charged a CPUC-required fee to affiliates for sales referrals; however, the support Pacific Bell provided was insufficient to determine whether the fee was correctly calculated or applied to affiliate sales. Although Pacific Bell would not answer our data requests on the subject, it is possible or likely that SBC Operations' outbound call centers used Pacific Bell's customer database to sell services to non-regulated affiliates. It does not appear that SBC Operations or the non-regulated affiliates on whose behalf it provided marketing paid the 13 percent sales referral fee. SBC Operations or another shared services affiliate may eventually do all of Pacific Bell's telemarketing. Although similar in substance to the affiliate marketing conducted by Pacific Bell, it does not appear that the CPUC has specifically ordered SBC Operations to collect and pay a referral fee when it uses Pacific Bell's customer database to sell services to non-regulated affiliates.

SBC and its subsidiaries did not always comply with affiliate transaction requirements. SBC was unable to provide FCC-mandated documentation supporting the allocation of employee time among subsidiaries. Pacific Bell recorded or attempted to record certain below-the-line parent company charges in above-the-line regulated accounts and in some cases affiliates did not supply Pacific Bell with sufficient information to properly direct affiliate charges to the correct accounts or the correct regulatory category (above or below-the-line) . In some cases, the data available from the parent and shared services affiliates was insufficient to determine whether the charges to Pacific Bell were reasonable, consistent with FCC Part 64 attributable cost principles, or properly charged to customer (above-the-line), rather than shareholder (below-the-line), accounts. Most of our affiliate transaction audit adjustments related to improperly directed charges, and most misdirected charges were from the parent company. In some cases, affiliate employees did not properly track the nature of their costs; in others the costs were identifiable but Pacific Bell did not receive the information necessary to record the charges from the affiliate in the proper account.

5. Issues Affecting Markets and Competition

Because our audit was largely confined to transactions affecting Pacific Bell's accounts, it did not include an in-depth analysis of operations and business practices or the operational interaction between affiliates and Pacific Bell. As such, we did not determine whether competitive practices were reasonable. However, one of our audit objectives was to determine whether affiliate transaction procedures were sufficient to prevent anti-competitive behavior. In analyzing SBC's organization and the changes in affiliate structure, we identified several areas of concern. The most significant involved the transfer of telephone company marketing and network planning functions to SBC Operations and the transfer of "advanced services" to SBC Advanced Solutions Inc. (ASI).

a. Joint Marketing and Use of Telephone Company Customer Data

The transfer of the marketing function to SBC Operations creates a probability, if not a certainty, that telephone company customer data will be made available to non-regulated affiliates for marketing purposes. This could confer a competitive advantage on Pacific Bell's non-regulated affiliates. To the extent customer data is currently being shared with non-regulated affiliates, it raises customer privacy concerns, particularly for customers with unlisted phone numbers. Pacific Bell did not respond to our requests concerning customer data sharing. We recommend the CPUC consider the competitive consequences of transferring customer data collected in a regulated monopoly environment to an unregulated corporate affiliate, and the implications that the use of customer data by unregulated affiliates has for customers' privacy rights.

b. Advanced Services

The transfer of Pacific Bell's advanced services (digital subscriber line, frame relay and cell relay services) to ASI was mandated by the FCC as a condition of the 1999 SBC / Ameritech merger. Because these services have better potential to become competitive than many local exchange services, the relationship between ASI and Pacific Bell has a direct bearing on whether the NRF goal of "opening telecommunications markets to competition" is met. The affiliate relationship created by the transfer produces a significant increase in the co-mingling of telephone company and affiliate activities and raises some important competitive and cross subsidy concerns. These include Pacific Bell's ownership of the network underlying advanced services that it does not control, the identification of Pacific Bell network components and activities indirectly supporting ASI's advanced services and the separation of these elements and activities from those charged to Pacific Bell's customers, the joint marketing of "advanced" telephone company services, and affiliate and competitor access to the network and Pacific Bell's operational support systems. Some of these issues are addressed in Appendix C of the FCC's SBC / Ameritech merger order. Audit scope limitations precluded us from reviewing the working relationship and transactions that have occurred between ASI and Pacific Bell since the advanced services transfer. We recommend the CPUC review the Pacific Bell / ASI relationship to determine whether concerns relating to competitive practices in California are properly addressed.

c. Purchase and Control of Competitors

In September, 2000, SBC announced a $150 million, 6 percent investment stake in Covad Communications, a company that describes itself as "the leading national broadband service provider of high-speed internet and network access utilizing Digital Subscriber Line technology."[7] Covad is one of SBC's local exchange competitors. In December, 2001, after Covad received court approval of a plan to emerge from bankruptcy, SBC and Covad closed on the planned funding.[8] The benefits of competition can be negated if potential competitors are simply purchased or otherwise controlled by the incumbent provider with which they are supposed to compete. The Commission should consider monitoring the ownership and management control relationships between SBC and other California local exchange companies so that it may take these relationships into account when evaluating the extent of local exchange competition in the state.

6. Cross-Subsidies

Notwithstanding the possibility that affiliates benefited from uncompensated use of Pacific Bell's customer database and other intellectual property and proprietary data (areas in which we were unable to complete our analysis), the audit period inter-affiliate cross subsidies we quantified were relatively minor. Examples included Pacific Bell being charged for SBC corporate acquisition investigation costs and for corporate executive awards for accomplishments unrelated to Pacific Bell.

We found other cross subsidies flowing from Pacific Bell's customers to SBC shareholders. Examples included parent company political and legislative influence costs and secondary cost allocations of parent company "management fees" charged to Pacific Bell's customer (above-the-line) accounts. We were unable to determine whether transfer-priced services provided by Pacific Bell and Southwestern Bell Telephone resulted in cross subsidies because support for the units of affiliate service was inadequate. The potential for affiliate cross-subsidies increased significantly after the audit period with the planned transfer of several thousand telephone company employees to shared services affiliates and the transfer of advanced services to ASI. As marketing functions are transferred to SBC Operations, Pacific Bell will probably lose the revenue from fees Pacific Bell collects for sales referrals to non-regulated affiliates. In addition, it appears unlikely that SBC Operations is compensating Pacific Bell for the use of its customer database.

The transfer of advanced services to ASI represents a transfer of a business opportunity. When Pacific Bell made a similar transfer of its voice mail business to PBIS in 1992, the CPUC ordered PBIS to reimburse Pacific Bell for the going-concern value of the business transferred. To the extent Pacific Bell's regulated operations are not reimbursed for ADSL's development costs, Pacific Bell's regulated customers have cross-subsidized ASI by at least **$[Redacted]**. The precedent established in CPUC Decision 92-07-072, which addressed the transfer of Pacific Bell's Information Services Group to PBIS, suggests that ASI should reimburse Pacific Bell for the going-concern value of the advanced services transferred, an amount that could be significantly greater than audit period development costs.

Time and scope constraints prevented us from assessing the potential for cross-subsidies relating to the transfer of intellectual property and proprietary information. Although difficult to quantify for accounting

[7] Covad Communications Press Release, December 13, 2001.

[8] Covad Communications Press Release, December 20, 2001.

purposes, SBC's reorganization of major telephone company marketing, network and administrative functions into corporate shared services subsidiaries creates a significant potential for affiliate cross subsidies in the form of uncompensated or under-compensated transfers of intellectual property, customer and network data, telco operating know how and trade secrets.

7. Audit Adjustments to Affiliate Transactions Recorded in Pacific Bell's Accounts

We adjusted affiliate transactions billed by and to Pacific Bell to bring the charges on Pacific Bell's books and audit period IEMRs into compliance with attributable cost principles and CPUC policy on regulated cost recovery. The majority of audit adjustments to expense involved costs that were either not attributable to Pacific Bell or were attributable to SBC shareholders, rather than Pacific Bell's regulated customers. Audit adjustments reduced affiliate amounts charged to Pacific Bell's intrastate regulated expenses by $19.4 million, $64.9 million and $51.9 million in 1997, 1998 and 1999, respectively. An audit adjustment increased Pacific Bell's inter-company revenue by $30.7 million in 1999. Audit adjustments to affiliate revenues and charges are discussed in detail Chapters 13 through 18.

C. Regulated and Non-Regulated Cost Allocations (Chapter 20)

The majority of Pacific Bell's procedures for allocating cost between regulated and non-regulated activities were well controlled and consistent with CPUC requirements and FCC Part 64 attributable cost principles. The most significant control weakness in the overall process was Pacific Bell's failure to maintain the Profitability Information (PI) system required by the CPUC to allocate costs to specific services. It is unclear whether the service-specific embedded cost allocations produced by PI continue to serve a purpose. Notwithstanding this overall conclusion, we found a number of allocation procedures that were not consistent with attributable cost principles and we found costs that were incorrectly classified between regulated and non-regulated categories. In most cases in which Pacific Bell failed to employ procedures consistent with Part 64 cost allocation requirements, the result was an over-statement of above-the-line operating expense and an understatement of regulated earnings. Corrections to audit period cost allocations increased regulated intrastate net operating income by $44 million.

D. Pacific Bell's NRF Monitoring Program (Chapter 21)

The NRF monitoring program, last revised in 1992, does not provide sufficient relevant information to assist the Commission in meeting all of its NRF goals. Neither the program itself nor the content of existing reports have been modified to adapt to changes in the telecommunications industry. More than half of the total reports submitted during the audit period were service-specific "embedded cost" reports produced by a system (the Profitability Information system) that Pacific Bell no longer maintains. Some of the monitoring reports Pacific Bell filed bore only a tangential relationship to NRF regulatory goals. At the same time, data that appear critical to evaluating the success of NRF, including statistics to measure technological advancement and customer satisfaction, were sometimes lacking even though required by the monitoring program. Some reports appeared to be missing because Pacific Bell placed a strict, limiting interpretation on what it was required to file with the CPUC.

The CPUC identified "opening telecommunications markets to competition" as a regulatory goal. Statistics necessary to objectively evaluate the progress of competition in California are not available from the monitoring reports filed by Pacific Bell. A "Competitive Environment Report" Pacific Bell submitted as a monitoring report was a white paper advocating further deregulation of Pacific Bell. Monitoring reports in the area of technological advancement produced a small fraction of the information required in the May, 1992 NRF Monitoring Report Assessment. Pacific Bell failed to file the results of customer surveys it conducted during the audit period as required by the monitoring program. We requested, but did not receive, copies of the customer surveys Pacific Bell conducted during the audit period.

Financial reports filed in the monitoring program were obtuse and inadequate for the purpose of evaluating Pacific Bell's financial position and results in accordance with CPUC specific requirements. Some of the earnings adjustments Pacific Bell included in its audit period IEMRs were made to achieve regulatory objectives, rather than reflect the impact of CPUC rules and decisions on regulated earnings. As a result, absent an audit for CPUC policy compliance, IEMR results cannot be relied upon as an objective measure of Pacific Bell's regulated intrastate earnings.