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

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the New Regulatory Framework for Pacific Bell and Verizon California Incorporated.	Rulemaking 01-09-001 (Filed September 6, 2001)
Order Instituting Investigation on the Commission's Own Motion to Assess and Revise the New Regulatory Framework for Pacific Bell and Verizon California Incorporated.	Investigation 01-09-002 (Filed September 6, 2001)

INTERIM OPINION REGARDING SELECTED ISSUES RELATED TO THE AUDIT OF SBC PACIFIC BELL TELEPHONE COMPANY

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I. Summary

This decision addresses four of the 72 findings resulting from an audit of SBC Pacific Bell Telephone Company (Pacific or Pacific Bell)[1] that was conducted under the management of the Commission's Telecommunications Division (TD). All other audit findings were addressed in Phase 2B of this proceeding.

The four audit findings addressed by today's decision are that Pacific Bell significantly overstated the expenses that it reported during the three-year period of 1997 – 1999 for (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 (CHCF-B). Today's decision finds that Pacific properly reported its expenses for pensions and depreciation, but misstated the expenses that it reported for PBOPs and income taxes. The amount of misstated expenses was as follows:

	1997 (millions)	**1998 (millions)**	**1999 (millions)**	**Total (millions)**
Overstated/(Understated) Expenses	($7.9)	$285.3	$241.7	$ 519.1

Today's decision is being issued concurrently with the Commission's decision on Phase 2B audit issues. The Phase 2B audit decision finds that Pacific overstated its expenses by a total of $630.6 million during 1997 – 1999. Today's decision and the Phase 2B decision together increase Pacific's net operating income by $1.1497 billion during 1997 – 1999 ($519.1 million + $630.6 million) and result in $288.3 million of sharable earnings owed to ratepayers for 1998. Today's decision also finds that Pacific improperly

[1] SBC Pacific Bell was renamed "SBC" in December 2002.

withdrew $136.2 million from one of its PBOP trust funds in 1999. Pacific is ordered to refund $424.5 million ($288.3 million + $136.2 million) to its ratepayers and pay 10% interest on the refund in accordance with the instructions contained in the Commission's Phase 2B audit decision. The amount of the refund with interest through July 2003 is $661.1 million.

II. Background

A. The Triennial Review of NRF

The Commission adopted the New Regulatory Framework (NRF) for Pacific Bell and Verizon California Incorporated (Verizon)[2] in Decision (D.) 89-10-031. The centerpiece of NRF was the price-cap index that annually adjusted rates for individual services based on the following formula:

New Rate = Old Rate x (inflation – productivity +/- Z-Factors)

Inflation was measured by the gross national product price index (GNP-PI), productivity was initially set at 4.5%, and Z-Factors were other rate adjustments approved by the Commission.

NRF included an earnings-sharing mechanism structured around a benchmark rate of return (ROR) of 13.00% and a ceiling ROR of 16.50%. Pacific kept 100% of its earnings up to the benchmark ROR, shared 50% of its earnings with ratepayers between the benchmark and ceiling RORs, and refunded to ratepayers 100% of its earnings above the ceiling ROR. Any refund of sharable earnings was to be implemented by reducing customers' rates via a surcredit.

Services were classified into three categories. Basic monopoly services were classified as Category I services. Discretionary or partially competitive services were classified as Category II services. Fully competitive services were

[2] Verizon was formally known as GTE California Incorporated (GTEC).

classified as Category III services. The price for each Category I service was fixed except for an annual adjustment equal to the price-cap index. The price for each Category II service could vary within a price ceiling and price floor. The price floor was increased annually by inflation, and the price ceiling was revised annually by the price-cap index. Prices for Category III services were provided the maximum flexibility allowed by law.

Decision D.89-10-031 established a triennial review cycle for NRF. The first triennial review resulted in several significant changes to NRF. In D.93-09-038, the Commission allowed Verizon to keep all of its earnings up to the ceiling ROR, reduced Verizon's rates by $53 million, and increased the productivity factor in Verizon's price-cap index. In D.94-06-011, the Commission increased the productivity factor in Pacific's price-cap index; replaced GNP-PI in Pacific's price-cap index with the gross domestic product price index; reduced Pacific's benchmark ROR and ceiling ROR to 11.5% and 15%, respectively; and allowed Pacific to retain 70% of its earnings above the ceiling ROR, with the remaining 30% refunded to ratepayers.

In the second triennial review, the Commission in D.95-12-052 set the productivity factor equal to the inflation factor, which effectively suspended the price-cap index except for Z-Factor adjustments. In the third triennial review, the Commission in D.98-10-026 suspended the earnings-sharing mechanism, continued the suspension of the price-cap index, phased out then-existing Z-Factor adjustments, and replaced Z-Factor adjustments with a streamlined advice letter process for a limited set of exogenous costs and revenues.

The instant proceeding represents the fourth triennial review of NRF. This proceeding commenced on September 6, 2001, when the Commission issued the combined Order Instituting Rulemaking (OIR) 01-09-001 and Order Instituting

Investigation (OII) 01-09-002 (collectively, the "Order"). The Order divided this proceeding into three Phases. Phase 1, which is now complete, addressed factual issues related to the audit of Verizon that was conduced by the Commission's Office of Ratepayer Advocates (ORA).[3] The purpose of Phase 2 was to address factual issues related to (1) the audit of Pacific that was conducted under the management of TD, and (2) how service quality for Pacific's and Verizon's end-users has fared under NRF. The purpose of the forthcoming Phase 3 is to review and revise, as necessary, the major elements of NRF based, in part, on the record developed in Phases 1 and 2.

On April 24, 2002, the assigned Commissioner issued a ruling that bifurcated Phase 2. The scope of Phase 2A was limited to four of the 72 issues that arose from the TD-managed audit of Pacific Bell. These four issues, which are addressed by today's decision, consisted of audit findings that Pacific overstated the expenses that it reported for (1) pensions, (2) PBOPs, (3) depreciation, and (4) income taxes associated with pensions, PBOPs, and the CHCF-B. The remaining 68 audit issues and all Phase 2 service quality issues were assigned to Phase 2B.

Written testimony regarding Phase 2A issues was submitted by Overland Consulting (Overland), ORA, and Pacific in May 2002. Evidentiary hearings were held in May and June, 2002. Opening briefs were filed on June 14, 2002, by AT&T Communications of California, Inc. (AT&T), ORA, Pacific, and The Utility Reform Network (TURN). The same parties filed reply briefs on June 21, 2002.

[3] D.02-10-020. Rehearing denied in D.03-02-073.

B. The Audit of Pacific Bell

This proceeding represents the first comprehensive regulatory audit of Pacific Bell since NRF was implemented in 1990. The audit was conducted pursuant to Pub. Util. Code Section 314.5 and Decisions 94-06-011, 96-05-036, 98-10-019, and 98-10-026.

The audit process began in 1999 when ORA issued a Request for Proposal for an audit of Pacific Bell. Overland was selected to perform the audit. The start of the audit was delayed by approximately one year as Pacific litigated the scope of the audit and ORA's oversight of the audit. As a result of the litigation, the Commission transferred oversight of the audit from ORA to TD.

Overland sent its first data requests to Pacific Bell in April 2000. Between May 2000 and June 2001, Overland conducted audit fieldwork at Pacific Bell and SBC facilities in California, Texas, and Missouri.[4] Overland then spent some time analyzing data and writing its audit report. TD released Overland's audit report on February 21, 2002, and a supplemental audit report on May 8, 2002.

The audit covered the three-year period of 1997 through 1999. In its audit report, as supplemented, Overland recommended 72 corrections to Pacific Bell's reported revenues, expenses, and rate base. The 72 corrections, if adopted in full, would (1) increase Pacific's net operating income (NOI) by $2 billion during the audit period of 1997 through 1999, and (2) result in customer refunds of $345 million under the NRF earnings-sharing mechanism that was in effect during 1997 and 1998.[5] The four audit issues addressed by today's decision, if adopted in full, would (1) increase Pacific's NOI by $1.19 billion during 1997 -

[4] Today's decision refers to Pacific's current parent company as "SBC."

[5] Opening Testimony of Robert F. Welchlin, Phase 2B, pp. 5, 8. (Overland Exh. Phase 2B: 409.)

1999, and (2) result in customer refunds of $212 million for 1998 under the NRF earnings-sharing mechanism.[6]

C. Resolution of Issues Common to Phases 2A and 2B

For the sake of administrative efficiency and convenience, the following issues that are common to Phases 2A and 2B are addressed in the Commission's decision regarding Phase 2B audit issues:

- Overland's qualifications to perform the audit.
- The appropriate rate of interest to apply to sharable earnings.
- ORA's proposal to require Pacific to refund its earnings in 1999 and subsequent years in accordance with the earnings-sharing mechanism that was suspended by D.98-10-026.
- ORA's proposal to refund 18% of all underreported earnings during 1997 – 1999 in addition to any earnings that Pacific might have to share under (1) the earnings-sharing mechanism that was in effect during 1997 and 1998, and (2) ORA's proposal to require Pacific to refund its earnings in 1999 in accordance with the earnings-sharing mechanism that was suspended by D.98-10-026.[7]
- ORA's proposal to immediately reinstate the earnings-sharing mechanism, establish a memorandum account to track excess earnings, and make Pacific's earnings subject to refund.
- Allegations that Pacific Bell impeded the audit.
- The need for, and timing of, the next audit of Pacific Bell.

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6 Overland Exhibit Phase 2A: 400, p. 11.

7 In Phase 2A, ORA recommended that in the event there are no sharable earnings as a result of the audit adjustments adopted by the Commission, the Commission should flow-through at least some of the misreported earnings back to ratepayers. In Phase 2B, ORA revised its recommendation to require Pacific to refund 18% of all underreported earnings.

III. Audit Issues Re: Pension Costs and Pension Assets

A. Regulatory Accounting for Pension Costs

1. Audit Findings

In D.88-03-072, the Commission considered if the Aggregate Cost Method (ACM) that had been used for many years to determine Pacific's pension costs for regulatory purposes should be replaced with Generally Accepted Accounting Principles (GAAP) as set forth in Statement of Financial Accounting Standard No. 87 (SFAS 87). The Commission decided in D.88-03-072 that Pacific should continue to use the ACM for regulatory accounting and ratemaking purposes.[8]

A three-step process may be used to determine annual pension costs under the ACM. The first step is to calculate the present value of the total pension obligation, which consists of all future benefits expected to be paid to current retirees, employees, and other beneficiaries (e.g., the spouses of deceased retirees). The second step is to compute the net pension obligation by subtracting the pension assets (e.g., assets in pension trust funds) from the total pension obligation. The last step is to spread the net pension obligation over the future work lives of current employees.[9] The following formula provides a mathematical depiction of the ACM:

$$\textbf{Annual Pension Cost} = \frac{\textbf{Present Value of Pension Obligations} - \textbf{Pension Assets}}{\textbf{Average Remaining Working Lives of Current Employees}}$$

[8] Pacific is required to use SFAS 87 by the Federal Communications Commission (FCC) for FCC regulatory purposes and by the Securities and Exchange Commission (SEC) for external financial reporting purposes.

[9] The net pension obligation can be spread over (i) the average remaining work years of current employees, or (ii) the future compensation of current employees.

During the audit period of 1997 – 1999, Pacific's pension assets exceeded the present value of its pension obligations by several billion dollars. As a result, the numerator in the above formula was negative, causing the ACM formula to produce negative pension costs in the following amounts:

Pacific Bell's Negative Pension Costs Under the ACM Formula After-Tax Intrastate Regulated Amounts				
Year	**1997**	**1998**	**1999**	**Total**
Amount	($62,382,666)	($64,453,169)	($65,473,575)	($192,309,410)
Source: Overland Exhibit Phase 2A: 409, Tables 5, 6, and 7.				

Although the mechanical application of the ACM formula produced negative pension costs, Pacific reported zero pension costs during 1997, 1998, and 1999. This is because it was Pacific's policy to report zero pension costs for California regulatory purposes in years when Pacific did not contribute to its pension trusts. Pacific did not contribute to its pension trusts during 1997 – 1999 because its pension assets far exceeded its pension obligations during this period.

Overland states that there are several reasons why Pacific's pension assets exceeded its pension obligations during the audit period. First, the interest rates used in prior years to determine the present value of pension obligations were too low. As a result, Pacific's contributions to its pension trusts exceeded the levels needed to fund future benefits. Second, Pacific has reduced its work force over the years, which reduced Pacific's pension obligations. Finally, the conversion of Pacific Bell's management pension plan from a defined benefit plan to a cash balance plan further reduced Pacific's pension obligations.

Overland represents that the ACM amortizes the effects of inaccurate actuarial assumptions, force-reduction programs, and benefit changes as negative pension costs over the remaining work years of current employees.

Consequently, Pacific's decision to set its pension cost at zero when the ACM produces negative costs resulted in Pacific reporting more pension costs for regulatory purposes than the actual cost of providing pension benefits. Accordingly, Overland recommends that the Commission adjust Pacific's reported earnings during the audit period to reflect $192.3 million in negative pension costs as required by the ACM.

Overland states that the recognition of negative pension costs is consistent with GAAP. For example, during the audit period Pacific reported $760 million of negative intrastate pension costs to the FCC pursuant to SFAS 87, and a similar amount was reflected in the external financial statements of Pacific's parent company. Overland testified that the large negative pension costs that Pacific reported to FCC and on its external financial statements were consistent with the billions of dollars of surplus assets in Pacific's pension plans.

Overland represents that SFAS 87 requires a prepaid pension asset to be recorded on the balance sheet when contributions to pension trusts exceed the amount of pension costs recognized for accounting purposes. Overland says the same principle should apply when negative pension costs are recognized under the ACM. The prepaid pension asset would reflect the fact that contributions (zero) exceeded pension costs (a negative amount) during the relevant period.

Overland states the prepaid pension asset should be included in rate base because it represents an investment made by Pacific. Overland observes that the FCC requires Pacific to include its SFAS 87 prepaid pension asset in rate base,[10] and the Commission should do the same with the ACM prepaid pension asset.

[10] FCC Responsible Accounting Officer Letter 20, released May 4, 1992, and FCC Order 97-56, Paragraphs 12 and 19.

2. Position of the Parties

a. ORA

ORA agrees with Overland's audit finding that Pacific should have recognized negative pension costs during 1997 - 1999. ORA states that if Pacific's pension costs are deemed to be zero when it has billions of dollars of surplus pension assets, Pacific's pension costs will ultimately exceed the cost of the benefits provided. Such a result would be contrary to D.88-03-072 wherein the Commission held that only reasonable pension costs should be recognized for regulatory purposes.[11]

ORA believes that the failure to recognize negative pension costs is unfair to ratepayers because it results in the overstatement of pension expense and a corresponding reduction in the potential for shareable earnings. Additionally, Pacific's has reported negative pension costs under SFAS 87 for many years, which has benefited shareholders. These benefits should be shared with ratepayers, according to ORA, because ratepayers are exposed to the upward movement in pension costs.

ORA disputes Pacific's assertion that the ACM can never produce negative costs because the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC) prohibit withdrawals from pension funds except under specific conditions.[12] ORA posits that ERISA and the IRC do not limit the authority of regulators to adopt accounting methods that yield negative pension costs for regulatory purposes. For example, the FCC requires Pacific to use SFAS 87, and Pacific has reported negative pension costs under SFAS 87 without making any withdrawals from its pension funds. This shows that an accounting

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[11] D.88-03-072, 27 CPUC 2d 550, 554.

[12] Pacific Exhibit Phase 2A: 307, Q&A 22, and Exhibit Phase 2A: 310, Q&A 14-16.

method used for regulatory purposes may yield negative pension costs without a utility actually withdrawing assets from its pension funds. Moreover, Pacific has reported negative pension costs on the financial statements that it provides to the SEC and its own shareholders.[13] ORA states that ERISA and the IRC do not preclude negative pension costs in those contexts, and nor should they here.

ORA disagrees with Pacific's argument that the ACM cannot produce negative pension costs because contributions to pension trust funds cannot be less than zero. ORA maintains that the ACM is used by the Commission to determine Pacific's pension costs for regulatory accounting purposes. The fact that contributions to pension funds cannot be less than zero does not control the proper application of the ACM for regulatory accounting purposes. As mentioned previously, Pacific reports negative pension costs to the FCC under SFAS 87, which proves that regulators may use accounting methods that produce negative pension costs even though actual contributions cannot fall below zero.

b. Pacific

Pacific asserts that it is required by D.88-03-072 to use the ACM for regulatory accounting purposes in the same way that the ACM is used for pension funding purposes. Pacific explains that the amount contributed to its pension plans under the ACM is based on the value of pension plan assets and liabilities. If the pension plans' assets exceed the pension liabilities, as was the case with Pacific during the audit period, then Pacific contributes nothing to the pension plans and records zero pension costs.

Pacific contends that the ACM cannot produce negative costs because that would mean that funds must be withdrawn from Pacific's pension plans, just as

[13] Overland Exhibits Phase 2A: 404, pp. 7-12 and 7-13, and Phase 2A: 402, p. 14.

positive costs mean that funds must be contributed to the pension plans. Pacific states that the IRC and ERISA prohibit the withdrawal of assets from a pension plan unless the plan is completely terminated and all obligations to all participants and beneficiaries have been totally satisfied. Pacific represents that it has no intention of terminating its pension plans.

Pacific states that Overland wrongly claims that Pacific's pension plans were over funded. The reality, according to Pacific, is that its pension plans were not over funded. Rather, there was an unexpectedly high rate of return on pension assets, which created surplus funds. These surplus funds are not for the benefit of Pacific or its ratepayers, but for employees and retirees.

Even if there were surplus pension assets, Pacific asserts that the Commission knew when it issued D.88-03-072 that the ACM cannot produce negative costs when there are surplus pension assets. This is because Pacific's expert witnesses testified in the proceeding that led to D.88-03-072 that Pacific had surplus pension assets and that the amount of pension costs recognized for ratemaking purposes should match the amount actually contributed to pension trusts.[14] Consequently, it would be contrary to D.88-03-072 if the Commission were to now find that the ACM could produce negative pension expense.

Pacific represents that prior to the adoption of NRF in D.89-10-031, Pacific made no contributions to its pension plans and recorded zero pension costs in accordance with the ACM. As a result, Pacific's initial rates under NRF contained zero pension costs. If the Commission were to now recognize negative pension costs and thereby cause sharable earnings for Pacific, the Commission would be violating a basic tenet of NRF: that with the risk of cost recovery

[14] Pacific Exhibit Phase 2A: 307, p. 13, Attachment 3, p. 5, and Attachment 4, p. 16. See also D.88-03-072, which cites one of Pacific's witness at 27 CPUC 2d 550, 551.

comes a corresponding reward, namely, the potential for higher earnings. Pacific asserts that because it cannot withdraw funds from its pension trusts there can be no corresponding reward. If the Commission were to now recognize negative pension costs, it would be imposing a cost that Pacific can never recover.

Pacific asks the Commission to ignore Overland's and ORA's references to SFAS 87 in their attempt to show that negative pension costs are permissible. Pacific argues that because D.88-03-072 rejected SFAS 87 for regulatory purposes,[15] ORA's and Overland's references to SFAS 87 are irrelevant.

Pacific disputes ORA's assertion that the Commission requires the recognition of negative pension expense because "longstanding Commission policy allows recognition of only reasonable pension expenses."[16] Pacific argues that the Commission held in D.88-03-072 that the ACM produces reasonable pension costs.[17] Because Pacific used the ACM, its pension costs were, by definition, reasonable under D.88-03-072. Additionally, the IRC provides that only reasonable actuarial methods may be used for funding purposes. The ACM is an IRS-approved funding method, which demonstrates that it is a reasonable method. On the other hand, the IRS has ruled that "a reasonable funding method does not include any method that results in a negative normal cost."[18] Therefore, contrary to ORA's assertion, it would be unreasonable to use the ACM in a way that produces negative pension costs.

Pacific posits that the preclusion of negative pension costs does not result in an overstatement of pension costs as Overland and ORA contend. Their claim

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15 D.88-03-072, Ordering Paragraph (OP) 1, 27 CPUC 2d 550, 557.

16 ORA Brief, p. 5.

17 D.88-03-072, 27 CPUC 2d 550, 554.

18 Pacific Exhibit Phase 2A: 310, p. 8, quoting IRS Private Letter Ruling 9146005.

presumes that there will be surplus assets in Pacific's pension plans if and when the plans are terminated. This presumption is not realistic, as Pacific does not intend to terminate its pension plans. Furthermore, even though Pacific recorded zero pension costs in 1997 – 1999, Pacific's pension costs truly were zero. Zero was the amount recorded in Pacific's funding statements filed in accordance with ERISA and zero was the amount contributed to its plans.

Pacific disputes ORA's claim that "nonrecognition of negative pension costs means that ratepayers . . . cannot benefit from good returns on pension assets, but higher pension costs may be passed on to them through rates."[19] Pacific represents that there were zero pension costs in its NRF startup rates and that it has recorded zero pension costs every year since 1988. Thus, ratepayers have benefited. Moreover, there is no way under NRF to increase rates due to increases in pension costs, as NRF broke the link between rates and costs.

Pacific argues that its rate base should not include a prepaid pension asset as Overland suggests.[20] This is because the Commission determined in D.91-07-056 that the composition of rate base should be the same as that used to determine Pacific's startup revenue requirement in D.89-12-048.[21] Pacific states that a prepaid pension asset was not included in the rate base used to determine Pacific's startup revenue requirement, and Overland has not cited any Commission decision that includes a prepaid pension asset in rate base. As a result, Overland's proposal to include a prepaid pension asset in rate base constitutes retroactive ratemaking.

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[19] ORA Brief, p. 9.

[20] Overland Exhibit Phase 2A: 404, Volume 2, pp. 7-12.

[21] D.91-07-056, 41 CPUC 2d 89, 119.

Pacific argues that Overland fabricates an unnecessary step of the ACM calculation by using the unauthorized prepaid pension asset to reduce the assets in the numerator of the ACM formula. Pacific asserts that if pension assets exceed the present value of future benefits, as was the case with Pacific, the ACM will produce zero pension costs and there will be no prepaid pension asset to affect ACM calculations in future years.

3. Discussion

During the audit period of 1997 through 1999, Pacific's pension assets exceeded the present value of Pacific's pension obligations. When pension assets exceed pension obligations, the mechanical application of the ACM formula produces negative pension costs. The central issue is whether Pacific was required to report negative pension costs for regulatory accounting purposes as Overland and ORA contend, or zero pension costs as Pacific contends.

To resolve this issue, we turn to D.88-03-072. There, the Commission considered if the ACM should be replaced with SFAS 87 for regulatory accounting and ratemaking purposes. To reach a decision on this matter, the Commission employed several criteria. One criterion was that regulatory accounting for pensions should reflect the method used by utilities to fund their pension plans.[22] Because the ACM satisfied this criterion, while SFAS 87 did not, the Commission concluded that the ACM should continue to be used for regulatory accounting and ratemaking purposes.[23]

The guiding principle that emerges from D.88-03-072 is that Pacific was required during the audit period to use the ACM for regulatory accounting purposes in the same way that Pacific used the ACM for pension funding

[22] D.88-03-073, 27 CPUC 2d 550, 551-52, 553, 554-55, and 556.

[23] Id., 551, 555, 556, and 557.

purposes. Pacific adhered to this principle. In particular, Pacific made no contributions to its pension plans during the audit period because contributions are not necessary under the ACM when, as was the case with Pacific, pension assets exceed pension obligations.[24] Consistent with D.88-03-072, Pacific recorded zero pension expense under the ACM for regulatory accounting purposes because zero was the amount that Pacific contributed to its pension plans.

Although we conclude that Pacific properly recorded zero pension expense during the audit period, we find that the use of the ACM for regulatory accounting purposes in the same way that the ACM is used for pension funding purposes has several flaws that were not considered by D.88-03-072. All of the flaws are tied to the fact that Pacific's pension plans were significantly over funded during the audit period.

The record of this proceeding leaves no doubt that Pacific's pension plans were over funded. Overland testified that Pacific withdrew $99 million from one of its pension trusts in 1999.[25] In order to do so, Pacific Bell certified to the U.S. Department of Labor that its pension trust contained excess assets.[26] In addition, Overland's testimony shows that the fair market value (FMV) of Pacific's pension assets on December 31, 1999, exceeded by $4.8 billion the present value of all pension benefits that Pacific expected to pay to its then current retirees, employees, and other qualified beneficiaries.[27]

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[24] Pacific Exhibit Phase 2A: 310, pp. 7 - 8.

[25] Overland Exhibit Phase 2A: 404, Volume 2, pp. 7-28 and 7-31.

[26] Overland Exhibit Phase 2A: 402, Part 1, p. 16.

[27] $4.8 billion = $13.1 billion FMV of pension assets ($6.5 billion FMV of the assets in Pacific's management plan + 94% of the $7.0 billion FMV of the assets in Pacific's bargained-for plan) less $8.3 billion present value of projected benefits (PVPB) ($4.5 billion PVPB for the

Footnote continued on next page.

We are not persuaded by Pacific's argument that its pension plans were not over funded, but experienced unexpectedly high earnings on pension assets. This is a distinction without a difference. The purpose of funding a pension plan in accordance with the ACM is to provide a steady stream of contributions to the pension fund that, together with anticipated earnings on pension fund assets, will be sufficient to pay for all pension benefits that will eventually be provided to all current retirees, employees, and other qualified beneficiaries.[28] Thus, the amount of funding is inextricably linked to earnings on pension plan assets. If the pension assets earn more then anticipated, as was apparently the case with Pacific, then over funding occurs. Additionally, the over funded status of Pacific's pension plans was not due solely to high earnings on pension assets as Pacific seems to suggest. It was also caused by a reduction in Pacific's pension obligations due to Pacific's termination of thousands of employees.[29]

We disagree with Pacific's claim that the notion that Pacific has surplus pension assets presumes that Pacific will terminate its pension plans – something that Pacific does not intend to do. The funded status of Pacific's pension plans does not hinge on whether Pacific intends to terminate its plans. If Pacific's pension obligations exceed its pension assets, then its pension plans are under funded regardless of whether Pacific intends to terminate the plans. Likewise, if

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management plan + 94% of the $4.0 billion PVPB for the bargained-for plan). (Overland Exhibits Phase 2A: 402, Part 2, Attachment S7-2, Phase 2A: 403, p. 4, lines 5 – 10, and Phase 2A, 404, Attachment 7-3.) The PVPB is a measure of Pacific's pension obligations made in accordance with the ACM.

[28] D.90642, 2 CPUC 2d 89, 153.

[29] Overland Exhibit Phase 2A: 404, Volume 2, p. 7-10. Pacific Telesis' projected pension benefit obligation (PBO) declined from $8.2 billion in December 1997 to $7.6 billion in December 1999. (Id., Attachment 7.3.) Pacific Bell's PBO comprised 94% of Pacific Telesis' PBO as of December 31, 1999. (Id.) The PBO is a measure of Pacific's PBOP obligations made in accordance with SFAS 87.

Pacific's pension assets exceed its pension obligations, as was the case during the audit period, then Pacific's pension plans are over funded regardless of whether Pacific intends to terminate the plans.

Under D.88-03-072, Pacific's pension costs are equal to the amount that Pacific contributes to its pension plans. Because Pacific's pension assets exceeded its pension obligations, it is evident in retrospect that Pacific had previously contributed too much to its pension plans and, therefore, had recognized more pension costs for regulatory accounting purposes than the actual cost of providing pension benefits. The only way to amortize the over funding under D.88-03-072, which set pension expense equal to pension funding, is to use the surplus pension assets to offset new pension liabilities accrued in the future. In other words, the utility contributes nothing to its pension plans and records zero pension costs until such time as the surplus pension assets are consumed by new pension liabilities.

This approach is problematic for several reasons. First, the approach is ill suited to situations where a utility, such as Pacific, has accumulated far more pension assets than the actual cost of providing pension benefits to its current retirees, employees, and other beneficiaries. Without the ability to record negative pension costs, pension over funding can persist indefinitely as evidenced by Pacific's recording of zero pension costs every year since 1989.

Second, the method of pension accounting adopted by D.88-03-072 has resulted in a manifestly gross overstatement of Pacific's pension costs. It bears repeating that Pacific's pension assets in 1999 exceeded by $4.8 billion the present value of all future pension benefits that Pacific expected to pay to its then current retirees, employees, and other qualified beneficiaries. Put differently, the amount that Pacific previously contributed to its pension plans and recognized

as an expense for regulatory purposes exceeded by $4.8 billion the actual cost of providing pension benefits. We know of no situation outside the realm of pension accounting where such a gross overstatement of costs would be permitted to occur and remain uncorrected for an indefinite period of time.

Third, it was the Commission's intent in D.88-03-072 that the costs incurred by a utility to provide pension benefits to a utility employee be spread evenly over the career of the employee, just as depreciation expense is recognized over the life of the depreciable asset.[30] Thus, the Commission contemplated in D.88-03-072 that utilities would record a steady stream of positive pension expense under the ACM, just as utilities record positive depreciation expense year after year. The Commission's intent has not been realized, however, as Pacific has recorded zero pension expense under the ACM every year since 1989 because of pension over funding. An analogous situation would have occurred if Pacific had recorded zero depreciation expense every year since 1989 because Pacific had recorded too much depreciation expense in previous years.

Fourth, as pointed out by ORA, the use of the ACM in manner required by D.88-03-072 has an asymmetric effect on utility earnings and ratemaking. If under funding occurs because, for example, earnings on pension assets have been less than anticipated, the ACM amortizes the shortfall by increasing pension expense (and funding) over the remaining service lives of active employees. Conversely, if over funding occurs, the ACM amortizes the excess by decreasing pension expense (and funding) over the remaining service lives of active employees, subject to the limitation that pension expense (and funding)

[30] D.88-03-072, 27 CPUC 2d 550, 552, 554, 556.

cannot fall below zero. Thus, there is no limit on how much pension expense can increase to make up for under funding, but there is a floor on how much pension expense can decrease to make up for over funding. The result is a regulatory process that easily accommodates the full impact of pension under funding, but not pension over funding. Ratepayers are exposed to the risks associated with pension under funding, but do not participate fully in the benefits associated with pension over funding.

Finally, there is nothing in D.88-03-072 that can be reasonably interpreted as allowing Pacific to report higher costs to provide pension benefits than the actual cost of providing such benefits. To the contrary, the Commission repeatedly stated in D.88-03-072 that the function of the ACM as used for regulatory purposes is to evenly spread the costs incurred by utilities to provide pension benefits over the work years of the employees.[31] Thus, D.88-03-072 explicitly contemplated that the amount of pension costs recognized for regulatory purposes should equal the actual costs that utilities reasonably incur to provide pension benefits. Unfortunately, the very goal the Decision had in mind was inadvertently undermined by the Decision's determination to link pension expense to pension funding. Because utilities cannot readily withdraw surplus assets from their pension funds, the method of regulatory accounting for pension costs adopted by D.88-03-072 has resulted in far more pension costs being recognized for regulatory purposes than the actual cost of providing pension benefits to current retirees, employees, and other beneficiaries.

Having concluded that Pacific's pension plans were significantly over funded during the audit period, we next consider what course of action to take in

[31] D.88-03-072, 27 CPUC 2d 550, 551-52, 554, 555, 556, and 557.

light of the over funding. One possibility is to continue the current practice of amortizing the over funding, to the extent possible, by recording zero pension costs until such time as the over funding is consumed by new pension liabilities. We decline to adopt this approach because of its previously described flaws.

The other possibility is to prospectively recognize negative pension costs under the ACM in the manner proposed by Overland and ORA. The benefit of this approach is that it provides greater assurance that the pension costs that Pacific reports for regulatory accounting purposes will, over time, reflect the actual costs incurred by Pacific to provide pension benefits to its current retirees, employees, and other beneficiaries. This is a very significant benefit, as our ability to make informed decisions about the regulatory framework governing Pacific and the rates that Pacific should be allowed to charge millions of Californians depends on Pacific providing accurate information about the actual costs it incurs to provide utility services to the public.

We are not persuaded by Pacific's argument that the recognition of negative pension costs for regulatory accounting purposes would require Pacific to withdraw assets from its pension funds, which is generally prohibited by federal law except under specified circumstances. The record in this proceeding shows that Pacific has recognized negative pension costs for many years in the financial reports that it submits to the SEC, FCC, and its shareholders, and that doing so has not caused Pacific to withdraw assets from its pension funds or to violate federal laws.[32] Likewise, the recognition of negative pension costs for

[32] Overland Exhibits Phase 2A: 402, Part 1, p. 14, and Phase 2A: 404, Volume 2, pp. 7-12.

Commission regulatory accounting purposes should not require Pacific to withdraw assets from its pension funds or violate federal laws.[33]

We are not convinced by Pacific's argument that it is inappropriate to recognize negative pension costs for regulatory purposes because pension fund assets are held in trust for Pacific's current and future retirees, not Pacific or its ratepayers. Any suggestion that today's decision will reduce the pension assets available to Pacific's current and future retirees is misleading and incorrect. The recognition of negative pension costs will have no effect on pension assets for the reasons stated in the previous paragraph. Additionally, the Commission has the power to determine a reasonable level of pension costs for regulatory accounting purposes.[34] We conclude that a reasonable level of pension costs for regulatory purposes is the actual costs incurred by utilities to provide pension benefits to their current retirees, employees, and other beneficiaries. The ACM adopted by D.88-03-072 has not resulted in a reasonable level of pension costs for the reasons described previously, while the modified ACM adopted by today's decision should result in a reasonable level of pension costs over time.

We disagree with Pacific that it would be inconsistent with D.88-03-072 to recognize negative pension costs on a prospective basis. According to Pacific, the Commission knew when it issued D.88-03-072 that (1) Pacific had surplus

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[33] The amount of pension costs reflected in rates does not have to equal the amount that a utility contributes to its pension plans. For example, in D.93-11-011 the Commission found that the total amount of pension costs that Pacific recovered in rates during 1984 - 1993 exceeded its contributions by $570 million. (D.93-11-011, 51 CPUC 2d 728, 767, 773.) This shows that the amount of pension costs reflected in Pacific's rates can be different than the amount contributed to Pacific's pension plans, which indicates that it would be feasible to recognize negative pension costs for ratemaking purposes (e.g., via an earnings sharing mechanism), even if Pacific has not withdrawn funds from its pension plans.

[34] Pub. Util. Code Sections 701 and 728 provide the Commission with authority to determine what costs are just and reasonable**,** and to disallow costs not found to be just and reasonable. D.00-02-046, 2000 Cal. PUC LEXIS 239, *46.)

pension assets and (2) the existence of surplus assets does not result in negative pension costs under the ACM. Pacific's argument is premised on testimony that it submitted in the proceeding that led to D.88-03-072. However, in the portions of the testimony cited by Pacific, Pacific's witnesses essentially denied that Pacific had surplus pension assets.[35] Furthermore, D.88-03-072 never states that Pacific had surplus pension assets. In fact, the Decision expressed doubt about allegations by Commission staff that Pacific had surplus assets.[36] On the other hand, Pacific is correct that one of its witnesses in the proceeding that led to D.88-03-072 did testify that the ACM does not produce negative pension costs.[37] However, there is no indication that the Commission agreed with Pacific. To the contrary, the Commission in D.88-03-072 and D.92-12-015 held out the possibility of future disallowances of Pacific's pension costs due to surplus pension assets,[38] which suggests that the Commission foresaw the possibility of negative pension costs under the ACM.

We disagree with Pacific's contention that the recognition of negative pension costs is inconsistent with NRF, particularly if doing so results in sharable earnings. We conclude that it is necessary to recognize negative pension costs for regulatory purposes in order to reflect the actual costs incurred by Pacific to provide pension benefits. There is nothing inconsistent with NRF in recognizing the actual costs that Pacific incurs.

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35 Pacific Exhibit Phase 2A: 307, Attachment 4, p. 16, lines 22 - 25.

36 D.88-03-072, 27 CPUC 2d 550, 555. The reasons given for the Commission's doubt mirror Pacific's testimony in that proceeding. (Pacific Exhibit Phase 2A: 307, Attachment 4, p. 15, lines 5 – 22.)

37 Pacific Exhibit Phase 2A: 307, Attachment 3.

38 D.88-03-072, 27 CPUC 2d 550, 555. See also D.92-12-015, 46 CPUC 2d 499, 516.

For the preceding reasons, we will require Pacific to record and report negative pension costs and an offsetting prepaid pension asset under the ACM when pension assets exceed pension obligations. This requirement shall become effective beginning in the first full calendar year after the effective date of today's decision. Pacific does not persuade us that it is inappropriate to recognize a prepaid pension asset (PPA) for regulatory purposes. The recognition of PPAs is a well-established accounting practice.[39] Indeed, the record of this proceeding demonstrates that Pacific recorded a PPA, although it is unclear whether, and to what extent, Pacific reported the PPA for regulatory purposes.[40]

We agree with Pacific that recognizing negative pension costs does not mean that Pacific has actually received money by, for example, withdrawing assets from its pension trusts. Therefore, to the extent that recognizing negative pension costs results in lower rates, Pacific must finance the amount of negative pension costs reflected in rates. Accordingly, we will authorize Pacific to include a PPA in rate base in an amount not to exceed the cumulative negative pension costs actually passed through to ratepayers via an earnings-sharing mechanism or other regulatory procedure the Commission may implement in the future.[41]

Except for the amount of the PPA included in rate base, we adopt on a prospective basis Overland's method of determining the PPA and negative pension costs under the ACM. Thus, the PPA should equal the cumulative

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[39] Accounting Principles Board Opinion No. 8, Para. 18, Overland Exhibit Phase 2A: 408, p. 254; SFAS 87, Paras. 35, 101, and 103, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 22.

[40] Overland Exhibits Phase 2A: 404, Volume 2, pp. 7-29, and Phase 2A: 402, Part 2, p. S7-2.

[41] Pacific incurs no financial costs associated with negative pension costs that are not reflected in rates. Hence, there is no need to include such costs in rate base.

amount of negative pension costs, less any amortization,[42] and be included in rate base to the extent described previously. The PPA should also be used to reduce the value of pension assets included in the numerator of the ACM formula. All financial monitoring reports that Pacific submits in the future shall reflect pension costs and the PPA determined in accordance with today's decision.

As a final matter, we hereby direct the next audit of Pacific Bell to include an examination of Pacific's pension assets, obligations, and costs that Pacific reported during 2000 and subsequent years.[43] The amount of pension assets, obligations, and costs reported for these years should be adjusted, as appropriate, to reflect the audit findings. We are particularly interested in finding out how Pacific used its surplus pension assets during the period covered by the audit. If appropriate, the auditors should engage an enrolled actuary to assist in the audit. Pacific Bell shall cooperate fully with the audit by, for example, promptly providing whatever information the auditors deem necessary or relevant (unless the Commission determines that such information cannot be disclosed because of a valid legal privilege).

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[42] We adopt a two-pronged approach to amortizing the PPA. First, the PPA included in rate base should be amortized when positive pension costs are passed through to ratepayers via an earnings-sharing mechanism or other regulatory procedure. Second, positive pension costs that are not passed through to ratepayers should be used to amortize the portion of the PPA that is not included in rate base. In both cases, the positive pension costs would not be paid with new contributions to Pacific's pension trusts, but with the PPA (i.e., with assets that are already in the pension trusts).

[43] The pension audit may examine years prior to 2000 if the auditors determine this would be necessary or desirable for understanding Pacific's pension assets, obligations, and costs in 2000 and subsequent years.

B. Accounting for the Transfer of Pension Assets

1. Audit Findings

Decision 92-12-015 ordered Pacific to use surplus pension assets to pay for the costs that Pacific incurs to provide post-retirement benefits other than pensions (PBOPs)[44] to the extent allowed by the Internal Revenue Code (IRC) and employee unions.[45] Under IRC § 420, a company may annually make one non-taxable transfer of surplus assets in a pension trust to an IRC § 401(h) account. The transferred pension assets may only be used to pay for PBOP costs incurred during the year of transfer.

Pacific Bell's pension plan for salaried employees was merged into the SBC Cash Balance Plan on January 1, 1999. On December 21, 1999, the SBC Cash Balance Plan transferred $280 million to an IRC § 401(h) account as permitted by IRC § 420. The § 401(h) account was part of the pension trust, so no funds left the trust at this point. The § 401(h) account then disbursed $99 million to Pacific Bell to reimburse Pacific for contributions that it had made to a separate PBOP trust earlier in the year.[46] The funds were transferred to Pacific as cash available for unrestricted corporate use.[47] Pacific accounted for the transfer as a negative contribution to its pension trust. Pacific's accounting did not reduce its recorded expenses for pensions or PBOPs, or otherwise affect its net income.

Overland posits that the result of the transaction is clear: Pacific's pension assets decreased by $99 million, Pacific's unrestricted cash account increased by

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[44] The PBOPs provided by Pacific consist of (i) post-retirement discounts on telephone service and (ii) medical, dental, and life insurance benefits.

[45] D.92-12-015, OP 2.g., 46 CPUC 2d 499, 533.

[46] Overland Exhibit Phase 2A: 409, Table 7 of 7.

[47] The transfer of pension funds increased Pacific's taxable income in 1999 by $99 million. (Overland Exhibit Phase 2A: 402, Part 2, p. S7-3.) Pacific did not report the increased taxable income for regulatory purposes. (Overland Exhibit Phase 2A: 404, Volume 2, p. 7-28.)

$99 million, and the assets held by the PBOP trust did not change. Therefore, the effect of the transaction was to transfer $99 million from Pacific Bell's pension trust to Pacific's cash account as funds available for unrestricted corporate use. Overland concludes that Pacific Bell violated the Commission's policy regarding the proper use of surplus pension assets and recommends that the Commission reduce Pacific's 1999 after-tax intrastate regulated PBOP expense by $41 million.

Overland states that the following excerpt from SBC's 2001 Annual Report to Shareholders shows that pension trust withdrawals continued in 2000 and 2001:

> In December 2001 and 2000, under the provisions of Section 420 of the Internal Revenue Code, we transferred $286 (million) and $220 (million) in pension assets to a health care benefit account for reimbursement of certain retiree health care benefits paid by us.

The $99 million of pension assets received by Pacific Bell in 1999 represented 35% of the $280 million withdrawn from SBC's Cash Balance Plan in December 1999. Based on that percentage, Overland estimates that Pacific's portion of the 2000 and 2001 pension trust withdrawals totaled $177 million.

2. Position of the Parties

a. TURN

TURN supports Overland's recommendation to reduce Pacific's after-tax intrastate regulated expense for PBOPs by $41 million in 1999. TURN also questions the propriety of Pacific's use of pension assets. During the first year that sharing was suspended, Pacific used pension assets to pay for current PBOP expenses, which freed up an equivalent amount of cash for unrestricted corporate use. TURN states that the Commission should not allow Pacific to employ NRF as a means to transfer pension assets to the company's bottom line.

TURN is also concerned about the effect the transfer will have on future pension expense. By withdrawing assets from its pension fund, Pacific will have fewer pension assets to pay for pension costs in the future. Consequently, Pacific has used NRF to reap a cash windfall of $41 million while simultaneously increasing future pension costs by the same amount.

b. Pacific

Pacific states that IRC § 420 allows companies to use surplus pension assets to pay for PBOP costs and that D.92-12-015 encouraged utilities to do so.[48] Pacific asserts that its transfer of pension assets under § 420 did not increase Pacific's unrestricted cash accounts by $41 million as Overland and TURN contend because Pacific had expended the same amount of cash earlier in the year to pay for PBOP costs.

Pacific represents that the § 420 transfer had no impact on its PBOP costs because such costs are accounted for under SFAS 106 as required by D.92-12-015. The use of pension assets to pay for PBOP cost does not impact the SFAS 106 calculation. Similarly, the § 420 transfer had no impact on pension costs because the Commission requires pension costs to be determined in accordance with the ACM, and the § 420 transfer does not impact the ACM calculation. Accordingly, Overland's recommendation to reduce Pacific's recorded expenses in 1999 by $41 million lacks foundation.

Pacific acknowledges TURN's concern about the effect the transfer of pension assets might have on Pacific's pension costs in the future. Pacific states that it would be appropriate to reduce its pension costs in future years when the ACM results in pension costs that are higher than they otherwise would have

[48] D.92-12-015, 46 CPUC 2d 499, 515.

been had the § 420 transfer not occurred.[49] Thus, the § 420 transfer should have no impact on Pacific's future regulated earnings.

Finally, Pacific represents that there were no transfers of pension fund assets to Pacific after 1999 as Overland suggests. Although SBC did transfer additional assets from its pension trust pursuant to § 420 in 2000 and 2001, those transfers were to other SBC companies, not Pacific.

3. Discussion

The issue before us is whether Pacific should have reduced the PBOP costs that it reported for intrastate regulatory purposes in 1999 by the amount of such costs that were paid with assets transferred from one of Pacific's pension funds. We find that Pacific should have for the following reasons. First, D.92-12-015 ordered Pacific to use surplus pension fund assets to pay for PBOP costs to the extent allowed by the IRC and employee unions.[50] The obvious purpose of the Commission's order was to reduce the PBOP costs that Pacific reported for regulatory purposes.[51] Pacific Bell frustrated the intent of the Commission's order when it reported that it had incurred PBOP costs that were, in fact, paid with surplus pension assets. Furthermore, because Pacific's ratepayers provided the assets in Pacific's pension fund that were used to pay for PBOP costs, it was improper for Pacific to claim as an expense the PBOP costs that were not paid by Pacific, but with pension fund assets provided by ratepayers.

We are not persuaded by Pacific's argument that it was not enriched by the receipt of $41 million from the pension trust fund because Pacific had expended the same amount earlier in the year to pay for PBOP costs. Pacific treated the

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[49] The reduction would be reflected when the ACM produces positive pension costs.

[50] D.92-12-015, OP 2.g., 46 CPUC 2d 499, 533.

[51] D.92-12-015, 46 CPUC 2d 499, 516, 524, and 533.

$41 million as taxable income for federal tax purposes, which demonstrates that Pacific was, in fact, enriched by the transaction.[52] In any event, the issue is not whether Pacific was enriched by the transaction, but whether Pacific should have reduced its PBOP costs by the amount of such costs that were reimbursed with surplus pension assets. We find that Pacific should have.

Second, Pacific effectively double counted the costs that it reported for regulatory purposes to provide PBOP and pension benefits. Pacific first reported the costs as pension expense many years ago. The pension expense was recovered from ratepayers and placed into Pacific's pension funds, ultimately resulting in the accumulation of surplus pension fund assets. Pacific reported the costs a second time for regulatory purposes when it reported $41 million in intrastate PBOP expense that was actually paid with the pension fund assets that had been previously collected from ratepayers as a pension expense.[53]

Finally, Pacific claims that its pension expense for regulatory purposes is equal to the amount that it contributes to its pension funds. Pacific recorded the § 420 transfer as a negative contribution to its pension funds,[54] but Pacific did not reduce its pension expense to reflect the negative contribution. Pacific can not have it both ways – that positive contributions to its pension funds should be recorded as an expense while negative contributions should have no effect on Pacific's recorded expenses. We conclude that negative contributions (i.e.,

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[52] Overland Exhibit Phase 2A: 402, Part 2, p. S7-3. Pacific did not report the receipt of $41 million as taxable income for regulatory purposes (Overland Exhibit Phase 2A: 404, Volume 2, p. 7-28). Today's decision treats the $41 million as reduction in Pacific's tax-deductible PBOP costs, which is tantamount to treating the $41 million as taxable income.

[53] As TURN points out, Pacific might have reported the costs a third time if and when it reports positive pension costs that otherwise would have been paid with surplus pension assets that Pacific had previously used to pay for PBOP costs.

[54] Overland Exhibit Phase 2A: 402, Part 2, p. S7-2.

withdrawals) that are used for non-pension purposes should be recorded as a reduction in Pacific's expenses – in this case a reduction in Pacific's PBOP costs.

We accept at face value Pacific's representation that it did not use surplus pension assets to pay for PBOP costs in 2000 and 2001. Nevertheless, we will require that the next audit of Pacific include an examination of Pacific's pension funds to verify Pacific's representation. For all years beginning in 2000 and thereafter, Pacific shall reduce its reported PBOP costs by any amounts paid with pension fund assets as required by D.92-12-015.

C. Disposition of Surplus Pension Assets

1. Audit Findings

On December 31, 1999, the fair market value of the assets in Pacific Bell's pension trusts exceeded by $4.8 billion the present value of all pension benefits that Pacific expected to pay to its then-current retirees, employees, and other beneficiaries.[55] Overland states that Pacific's withdrawal of $99 million from one of its pension trusts in 1999 for general corporate purposes raises the concern about Pacific's commitment to using surplus pension assets for the sole purpose of providing retirement benefits. In light of this concern, Overland recommends that the Commission address the disposition of the surplus pension assets.

2. Position of the Parties

a. ORA

ORA agrees with Overland that Pacific's pension plans are over funded. Given the over funding, ORA recommends that the Commission "true-up" the surplus pension assets in Phase 3 of this proceeding.

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[55] See Footnote 27, *supra*. As of December 31, 1999, the fair market value of Pacific's pension assets exceeded Pacific's projected pension benefit obligation (PBO) by $5.9 billion. (Overland Exhibit Phase 2A: 404, Volume 2, pp. 7-12 and 7-13.) The PBO is a measure of Pacific's pension obligations made in accordance with SFAS 87.

b. Pacific

Pacific argues that the very notion of surplus pension assets hinges on the assumption that Pacific will terminate its pension plans, thereby freeing up the surplus assets. Pacific states that it has no plans to terminate its pension plans.

Pacific states that although its pension plans had surplus assets during the audit period, the financial status of its pension plans can change significantly over time. For example, during the two-year period ending on December 31, 2001, Pacific's pension assets decreased 22% while its pension obligations increased by $260 million. Pacific avers that the Commission recognized the ephemeral nature of surplus pension assets in D.92-12-015 when it stated that "[s]urplus pension assets generally result from volatile changes in the investment markets which cannot be predicted with any accuracy.[56]"

Pacific cautions against the adoption of ORA's proposal to true up the surplus pension assets in Phase 3. Pacific states that if the Commission were to reduce Pacific's rates for a true-up, the Commission may have to increase rates in the future should the value of Pacific's pension assets reach a point where positive funding is required. Pacific opines that opening this Pandora's box is against ratepayer interest and contrary to the fundamental principles of NRF.

3. Discussion

Pacific's pension plans were significantly over funded throughout the audit period of 1997 - 1999.[57] On December 31, 1999, the fair market value of Pacific's pension assets exceeded by $4.8 billion the present value of all pension

[56] D.92-12-015, FOF 32, 46 CPUC 2d 499, 530.

[57] Overland Exhibit Phase 2A: 404, Volume 2, pp. 7-12 and 7-13, and Attachments 7-3 and 7-4.

benefits that Pacific expected to pay to all of its then-current retirees, employees, and other beneficiaries.[58]

Because the surplus pension assets were accumulated over a period of many years with funds that were contributed by ratepayers, we agree with Overland that it is appropriate to prescribe the regulatory disposition of the surplus pension assets. Accordingly, we will order Pacific to use pension assets only for their intended purpose of providing pension benefits and, to the extent authorized by D.92-12-015, PBOPs to Pacific's employees, retirees, and their families. Any pension assets not used for this purpose shall be refunded to Pacific's ratepayers.

In its audit report, Overland noted that Pacific Bell did not have stand-alone actuarial reports for its pension plans. Instead, information concerning Pacific's pension plans was aggregated with those of Pacific Telesis, which hindered Overland's ability to determine the funded status of Pacific's pension plans.[59] We are concerned that auditing and monitoring Pacific's pension plans will be even more difficult in the future due to the merger of Pacific's pension plan for salaried employees with the SBC Cash Balance Plan. Therefore, to help ensure that pension assets funded by Pacific's ratepayers are used only for the purpose authorized by today's decision, we will require Pacific to (1) establish procedures to segregate its pension costs, assets, and obligations from SBC's other pension costs, assets, and obligations for actuarial, accounting, and reporting purposes, and (2) prepare an annual actuarial report, certified by an enrolled actuary, that shows Pacific's pension costs, assets, and obligations on

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[58] See Footnote 27, supra.

[59] Overland Exhibit Phase 2A: 403, p. 4. Pacific Telesis was Pacific's parent company prior to Pacific's merger with SBC.

a stand-alone basis. Pacific shall establish the aforementioned procedures within 60 days. Pacific shall commence the preparation of the stand-alone actuarial report beginning with calendar year 2004.

We decline to adopt ORA's proposal to true-up Pacific's pension assets in Phase 3 of this proceeding. We do not believe a true-up is necessary, as the ACM aligns pension obligations with the value of pension assets over time.[60]

IV. Audit Issues Re: Post Retirement Benefits Other than Pensions

A. Write Off of the PBOP Regulatory Asset in 1998

1. Audit Findings

Pacific Bell provides PBOPs to retired employees and their qualified beneficiaries. For many years Pacific funded its PBOP costs as the benefits were paid to retirees. This method of funding was referred to as pay-as-you-go, or PAYGO. Pacific's recognition of PBOP costs for accounting purpose mirrored PAYGO, and Pacific's rates were set in a way that provided Pacific with a reasonable opportunity to recover its PAYGO costs.

In 1990, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 106 (SFAS 106), which requires accrual accounting for PBOP costs. In D.92-12-015, the Commission replaced PAYGO accounting for PBOP costs with a modified form of accrual accounting based on SFAS 106.

Pacific Bell implemented SFAS 106 on January 1, 1993, for Commission regulatory purposes. Under SFAS 106, Pacific records PBOP costs as the PBOP

[60] For the reasons described previously, the ACM might not align pension assets and obligations over time if negative pension costs are not recognized under the ACM. Today's decision requires the recognition of negative pension costs.

benefits are earned by employees.[61] Thus, by the time an employee has retired, Pacific under SFAS 106 has already recorded as an expense all PBOP benefits owed to the employee. In contrast, the recognition of PBOP costs under PAYGO does not begin until PBOP benefits are actually paid to the retired employee.

Pacific's annual accruals of PBOP costs under SFAS 106 were initially higher than its PAYGO costs. This was because SFAS 106 required Pacific to recognize not only the cost of the PBOPs earned by employees during the year, but also a portion of the liability for PBOPs that were earned by employees and retirees prior to the adoption of SFAS 106. The liability for PBOPs earned by employees and retirees prior to the adoption of SFAS 106 is known as the Transition Benefit Obligation (TBO). Decision 92-12-015 required Pacific to amortize its TBO over 20 years for regulatory purposes.[62]

Decision 92-12-015 limited the amount of SFAS 106 costs that Pacific could record and report for regulatory accounting purposes to the amount of Pacific's tax-deductible contributions to independent PBOP trusts. Any SFAS 106 costs in excess of tax-deductible contributions were to be capitalized as a PBOP regulatory asset. The regulatory asset could be amortized as an expense and

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[61] The annual accrual of PBOP cost under SFAS 106 consists of the following elements: (1) service cost; (2) interest on the accumulated postretirement benefit obligation; (3) actual return on plan assets; (4) amortization of gains and losses due to plan changes or changes in actuarial assumptions; and (5) amortization of the transition benefit obligation. The annual service cost is the change in the expected benefit obligation (EBO) attributable to employee service during the year. (SFAS 106, Paragraph 47, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 25, Para. 46.) The EBO reflects the present value of the benefits expected to be paid to plan participants, including benefits attributable to future service. (Id., Paragraph 20.)

[62] D.92-12-015, OP 1.c., 46 CPUC 2d 499, 532. Pacific's TBO on January 1, 1993, was $2.4 billion. (Overland Exhibit Phase 2A: 404, Volume 2, p. 7-20, Table 7-5.)

"recovered" in future years to the extent that Pacific's contributions to PBOP trusts exceeded its SFAS 106 costs.[63]

Decision 92-12-015 authorized Pacific to recover some, but not all, of its SFAS 106 costs via the Z-Factor. In particular, D.92-12-015 limited recovery of SFAS 106 costs via the Z-Factor to the lesser of Pacific's (1) tax-deductible contributions to PBOP trust funds, or (2) SFAS 106 costs less PAYGO cost.[64]

Following the issuance of D.92-12-015, Pacific recovered $107.5 million in SFAS 106 costs via the Z-Factor in 1993[65] and $99.5 million per year during 1994 through 1998,[66] for a total of $605 million.[67] In D.98-10-026, the Commission eliminated Z-Factor recovery of SFAS 106 costs effective January 1, 1999. Importantly, D.98-10-026 did not alter the requirement adopted in D.92-12-015 to use SFAS 106 for regulatory accounting purposes.

Pacific recorded a PBOP regulatory asset equal to the difference between its PBOP costs determined in accordance with SFAS 106 and its tax-deductible contributions to external PBOP trusts. In October 1998, Pacific wrote off the balance of its PBOP regulatory asset. The pre-tax intrastate amount of the write-off was $400 million. Pacific's rationale for the write-off was as follows:

> Creation of the . . . [PBOP] regulatory asset was predicated on the . . . recovery of the incremental cost of adopting SFAS 106 . . . In D.98-10-026 (Ordering Paragraph 1.e.6), the [Commission] eliminated the $99.5 million annual revenue stream that had been established in D.92-12-015 for that express purpose. Without this PBOP cost recovery there

63 D.92-12-015, OP 4, 46 CPUC 2d 499, 533.

64 D.92-12-015, OP 8, 46 CPUC 2d 499, 533.

65 D.01-04-019, 2001 Cal. PUC LEXIS 306, *2; Resolution T-15160, *mimeo*., pp. 9 and 11.

66 D.98-10-026, 82 CPUC 2d 335, 366; Resolution T-15442, *mimeo*., pp. 3 5, and 7.

67 Overland Exhibit Phase 2A: 403, p. 6.

> was no basis for maintaining a regulatory asset[.]
> (Overland Exhibit Phase 2A: 404, Volume 2, p. 7-22.)

Overland states that it was improper for Pacific to write off its $400 million PBOP regulatory asset. According to Overland, D.92-12-015 limits the SFAS 106 costs that Pacific can claim for regulatory purposes in any year to the amount of Pacific's tax-deductible contributions to PBOP trusts. Overland recommends that the Commission require Pacific to record the write-off below the line[68] to the extent the write-off, when combined with Pacific's annual accrual of SFAS 106 costs, exceeded Pacific's tax-deductible contributions to PBOP trusts in 1998. As shown in Appendix F of today's decision, the after-tax intrastate regulated amount that Overland seeks to have recorded below the line is $165.6 million.

Overland does not believe that it was necessary for Pacific to write off its PBOP regulatory asset when Z-Factor recovery of SFAS 106 costs was terminated by D.98-10-026. Overland states that the SFAS 106 Z-Factor was not designed to recover the PBOP regulatory asset, but the difference between Pacific Bell's SFAS 106 costs and its PAYGO costs. Consequently, the existence of the PBOP regulatory asset was never predicated on Z-Factor recovery of SFAS 106 costs. Rather, the basis for recording the PBOP regulatory asset was the NRF price-cap formula, which provided Pacific with an opportunity to recover all of its SFAS 106 costs, including the PBOP regulatory asset. Thus, there was no need for Pacific to write off its regulatory asset when the Commission terminated Z-Factor recovery of SFAS 106 costs in D.98-10-026.

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[68] The term "below the line" describes revenues, costs, investments, and activities that are deemed to be imprudent or unnecessary to provision of utility service to the public. Items that are deemed to be "below the line" are generally segregated in, or excluded from, the financial reports that utilities submit to the Commission.

Overland recognizes that Ordering Paragraph (OP) 4 of D.92-12-015 required Pacific to establish a PBOP regulatory asset pursuant to SFAS 71, and that SFAS 71 requires utilities to write off a regulatory asset once it becomes apparent that the regulatory asset will not be recovered in future rates. Despite OP 4, Overland states that the Commission in D.92-12-015 explicitly rejected the conditioning of its PBOP accounting policy on compliance with SFAS 71.[69] Accordingly, the Commission did not intend for SFAS 71 to dictate regulatory accounting for SFAS 106 costs. Moreover, D.92-12-015 explicitly states that utilities subject to NRF should recognize a PBOP regulatory asset:

> The utilities under NRF should establish a regulatory asset in their regulatory financial statements to reflect yearly differences, if any, between their PBOP expense determined in accordance with [SFAS 106] and their allowable tax-deductible contributions. We advise these . . . utilities to provide similar treatment in their external financial statements. (46 CPUC 2d 499, 523.)

Overland believes that the words "we advise these . . . utilities to provide similar treatment in their external financial statements" implicitly contemplate the possibility that the utilities' regulatory assets might not meet the criteria of SFAS 71. Thus, this advisory language requires Pacific Bell to record a PBOP regulatory asset for Commission purposes, regardless of whether the regulatory asset complied with SFAS 71.

Overland observes that SFAS 71 acknowledges that regulatory accounting is determined by regulators, not SFAS 71. Paragraph 55 of SFAS 71 states:

> [SFAS 71] does not address an enterprises' regulatory accounting. Regulators may require regulated enterprises to

[69] D.92-12-015, 46 CPUC 2d 499, 522, and Conclusions of Law 8, 9, and 10 at 531-32.

> maintain their accounts in a form that permits the regulator to obtain the information needed for regulatory purposes. [SFAS 71] neither limits a regulator's actions or endorses them. (Pacific Exhibit Phase 2A: 333, Binder 2, Tab 21.)

Overland testified that for Commission regulatory purposes Pacific recognizes regulatory assets and liabilities for pension costs, deferred income taxes, plant impairment losses, and interest during construction because Pacific is required to do so by the Commission. On the other hand, Pacific does not recognize these regulatory assets and liabilities for external financial reporting purposes because Pacific has determined that they do not comply with SFAS 71. Thus, Pacific Bell's own accounting practices demonstrate that the Commission's accounting requirements are not governed by SFAS 71.

Overland states that Pacific Bell determined in 1993 that its PBOP regulatory asset did not comply with SFAS 71 and, therefore, should not be reported on the financial statements that Pacific provided to its shareholders and the SEC. Pacific's auditors concurred. Therefore, Pacific could not have relied on SFAS 71 as justification for the PBOP regulatory asset that it reported to the Commission up until September 1998, since Pacific had known since 1993 that the regulatory asset did not comply with SFAS 71.

Overland maintains that even if the existence of the PBOP regulatory asset was dependent on SFAS 71, the regulatory asset met the requirements of SFAS 71 after Z-Factor recovery of SFAS 106 costs was terminated by D.98-10-026. This is because the termination of the Z-Factor was part of a broader restructuring of NRF in D.98-10-026. Overland states that it was clearly the Commission's intent that the restructured NRF provide Pacific with adequate revenues to recover all of its costs, including the PBOP regulatory asset. The results of Overland's audit demonstrate that the restructured NRF has allowed Pacific to recover all of its

costs as shown by Pacific's high, audit-adjusted earnings. Therefore, the elimination of the SFAS 106 Z-Factor by D.98-10-026 does not justify the write-off of the PBOP regulatory asset. In any event, Overland says there is nothing in D.98-10-026 that repealed the requirement established by D.92-12-015 for Pacific to create and maintain the PBOP regulatory asset.

Overland notes that the FCC's Uniform System of Accounts (USOA) requires extraordinary losses to be charged to Account 7620, which is a below-the-line account. The USOA provides the following description of Account 7620:

> This account shall be debited with nontypical, noncustomary 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.

Overland believes that Pacific's write-off of the PBOP regulatory asset satisfies the requirements for inclusion in Account 7620, since the write-off was a material, nontypical, noncustomary, and infrequently recurring loss.[70] Therefore, if the Commission determines that it was proper for Pacific to write off its PBOP regulatory asset in 1998, Overland believes the entire write-off should be recorded in Account 7620.

Overland represents that Pacific Bell has charged similar SFAS 106-related losses to Account 7620 for FCC accounting purposes. In 1997, Pacific recorded a below-the-line extraordinary loss of $83 million to conform its SFAS 106 methodology for amortizing gains and losses to SBC's policies. In 1999, Pacific recorded a below-the-line extraordinary loss of $338 million to write off its

[70] Most, if not all, of the regulatory asset was due to a "curtailment loss" incurred in 1993 when Pacific announced a plan to significantly reduce its work force. Overland believes that Pacific should have recorded the curtailment loss below the line in Account 7620 in 1993. If Pacific had done so, there would have been no regulatory asset to write off in 1998.

SFAS 106 transition benefit obligation (TBO).[71] Pacific did not recognize the 1997 and 1999 extraordinary losses for Commission accounting purposes.

2. Position of the Parties

a. ORA

ORA believes that Pacific improperly relies on SFAS 71 to justify its above-the-line write-off of the PBOP regulatory asset in 1998. ORA states that SFAS 71 does not govern regulators' authority to set rates or determine regulatory accounting requirements.[72] Although OP 4 of D.92-12-015 ordered Pacific to record a PBOP regulatory asset pursuant to SFAS 71 – a fact much cited by Pacific – OP 4 itself states that Pacific may recover its regulatory asset only to the extent that its tax-deductible contributions to PBOP trusts exceeded its SFAS 106 costs. If tax-deductible contributions did not exceed SFAS 106 costs, no recovery would occur.[73] ORA argues that it is illogical to conclude that OP 4, by ordering Pacific to establish a regulatory asset pursuant to SFAS 71, ensured Pacific would recover its regulatory asset when the very mechanism established by OP 4 to recover the asset did not ensure recovery.

ORA states that although OP 8 of D.92-12-015 authorized Pacific to recover some of its SFAS 016 costs via the Z-Factor, there was no guarantee that the Z-Factor would provide Pacific with sufficient funds to recover the entire regulatory asset. Therefore, when the Commission eliminated the Z-Factor, it is not reasonable to assume, as Pacific did, that the write-off should be recorded above the line. If anything, Pacific's above-the-line write-off violated D.92-12-015

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[71] The TBO is a liability that consists of all PBOP obligations that existed but had not yet been recognized by Pacific at the time it implemented SFAS 106.

[72] SFAS 71, Paragraph 55, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 21.

[73] D.92-12-015, Conclusion of Law (COL) 12 and OP 4.

because the Decision limited the SFAS 106 costs that Pacific could report for regulatory purposes to the amount of its tax-deductible contributions, and the write-off of the PBOP regulatory asset in 1998 exceeded Pacific's tax-deductible contributions during the year.

ORA argues that if the Commission allows Pacific to write off the regulatory asset, the write-off should be recorded below the line. ORA states that an above-the-line write-off would require ratepayers to fund indirectly some portion of the write-off due to the diminished opportunity to participate in sharable earnings in 1998. ORA maintains that because the Commission eliminated the SFAS 106 Z-Factor without providing any replacement method for recovering the PBOP regulatory asset, it is clear that the Commission did not intend for ratepayers to fund any of the remaining PBOP regulatory asset.

b. TURN

TURN states that when the Commission adopted SFAS 106 in D.92-12-015, it limited the SFAS 106 costs that utilities could recover in rates to the amount of their tax-deductible contributions to external PBOP trusts (hereafter, "contributions").[74] TURN avers that this is the central rule of D.92-12-015 for regulatory purposes: the SFAS 106 costs recognized for regulatory purposes are limited to actual contributions. Thus, to the extent the write-off of Pacific's PBOP regulatory asset exceeded Pacific's contributions, it violated the central rule of D.92-12-015 that limited Pacific's SFAS 106 costs to its actual contributions.

TURN disagrees with Pacific's position that the elimination of the SFAS 106 Z-Factor by D.98-10-026 nullified the central rule of D.92-12-015 that limited Pacific's SFAS 106 costs to its contributions. TURN opines that a more

[74] D.92-12-015, 46 CPUC 2d 499, 520.

reasonable reading of D.98-10-026 is that the Decision retained the central rule of D.92-12-015, but replaced direct recovery of PBOP costs via the Z-Factor with indirect opportunities to recover these costs. The indirect opportunities included (1) the potential for significantly higher earnings due to the absence of sharing and the productivity factor — a potential being realized by Pacific, and (2) the PAYGO costs built into Pacific's rates. TURN adds that the proper regulatory presumption under NRF is that all costs are being recovered under existing rates.

TURN claims that Pacific was not required by SFAS 71 to write off its entire PBOP regulatory asset. According to TURN, SFAS 71 does not govern the treatment of PBOP costs for regulatory purposes.[75] This is clear from Conclusion of Law 8 of D.92-12-015, which states:

> Commission policy should not be governed by whether or not utilities can record a regulatory asset under SFAS 71. (46 CPUC 2d 499, 531.)

TURN states that in the proceeding leading to D.98-10-026, the Commission asked Pacific to identify the ratemaking impacts that would result from eliminating the SFAS 106 Z-Factor. In its response, Pacific indicated that the only effect, either historically or prospectively, would be to decrease rates by the amount of the Z-Factor, which was $99.5 million at the time.[76] Pacific never mentioned the "requirement" under SFAS 71 to write off the entire regulatory asset of $400 million, which would have had, at a minimum, the effect of reducing Pacific's earnings and potential sharing.

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[75] D.92-12-015, COL 10, 46 CPUC 2d 499, 532.

[76] ORA Exhibit Phase 2A: 118, Attachment 3, last 2 pages, and "Question 4 – Impact of Eliminating Z-Factors."

TURN argues that if Pacific had truly believed that the elimination of the SFAS 106 Z-Factor would require the immediate write-off of its $400 million regulatory asset, it would have informed the Commission. Pacific's silence on this point in the proceeding leading to D.98-10-026 demonstrates that Pacific believed at the time that no write-off was required. The other likely explanation is that Pacific knew at the time that elimination of the Z-Factor would require Pacific to write off its $400 million regulatory asset, but Pacific chose not to provide this information to the Commission even when specifically asked to identify such impacts. Either way, TURN believes that the Commission should reject Pacific's current position.

c. Pacific

Pacific states that it was required by D.92-12-015 to establish and maintain a PBOP regulatory asset in accordance with SFAS 71.[77] The primary requirement for the establishment of a regulatory asset under SFAS 71 is regulatory assurance that the asset will be recovered in future rates. Pacific states that the Commission provided such assurance in D.92-12-015 by establishing the SFAS 106 Z-Factor for the express purpose of recovering Pacific's regulatory asset.

Pacific contends that when the Commission eliminated the SFAS 106 Z-Factor in D.98-10-026, Pacific no longer had assurance that it would be able to recover the PBOP regulatory asset in future rates. At that point, Pacific's regulatory asset no longer met the requirements of SFAS 71 and Pacific had no choice but to write off the regulatory asset as required by SFAS 71.

Pacific argues that there are several reasons why it was appropriate to write off its PBOP regulatory asset above the line. First, D.98-10-026 did not

[77] D.92-12-015, 46 CPUC 2d 499, at 520-523, and 533.

prohibit an above-the-line write-off. Second, D.92-12-015 found that SFAS 106 costs are a legitimate cost of providing service.[78] Finally, because SFAS 106 costs are a legitimate expense, the failure to recognize the expense above the line would constitute an improper ratemaking adjustment under NRF. The following passage from the Workshop III Report, adopted by the Commission in D.91-07-056,[79] explains why ratemaking adjustments are improper under NRF:

> Any inclusion of ratemaking adjustments…is…a strike at the very core of [NRF] and a return to a system which, in the language of the decision, 'relies instead on short term gains, and regulatory detection of inefficient operations.' **Including those adjustments in the earnings calculation would be an anachronistic, unnecessary, and improper holdover from a displaced regulatory philosophy.** (Pacific Exhibit Phase 2A: 333, Tab 18, p. 19. Emphasis added.)

Pacific disputes Overland's and TURN's claim that it was unnecessary for Pacific to write off its PBOP regulatory asset because Pacific allegedly had ample opportunity to recover the regulatory asset in the absence of Z-Factor recovery. Pacific states that if their argument had merit, it would have been unnecessary for D.92-12-015 to authorize Z-Factor recovery of SFAS 106 costs. The fact that D.92-12-015 did authorize Z-Factor recovery demonstrates the fallacy of Overland's and TURN's claim.

Pacific states that although D.92-12-015 limited Z-Factor recovery of SFAS 106 costs to the amount of tax-deductible contributions,[80] ORA and TURN wrongly assert that this limitation also applies to Pacific's ability to record PBOP

[78] D.92-12-015, 46 CPUC 2d 499, 516, 530.

[79] D.91-07-056, COL 57, 41 CPUC 2d 89, 128.

[80] D.92-12-015, 46 CPUC 2d 499, 520.

expenses. While D.92-12-015 limited rate recovery, it placed no limitation on expense recognition. Decision 92-12-015 addressed each separately.

Pacific disputes ORA's claim that allowing Pacific to record the write-off above the line will require ratepayers to fund indirectly some portion of the write-off because of a diminished opportunity to participate in sharable earnings during 1998.[81] Pacific states there are two flaws in ORA's logic. First, Pacific had to write off the PBOP regulatory asset because rate recovery of the asset had been discontinued. Thus, the write-off was not a form of rate recovery. In fact, just the opposite is true. Second, there is no proof that ratepayers were required to fund a portion of the write-off through the earnings-sharing mechanism. Even ORA's witness admitted that Pacific's rate of return is composed of various items of investment, revenues, and expenses.[82] Thus, a particular item cannot be singled out as having raised Pacific's rate of return to sharable levels.

Pacific disagrees with ORA's claim that because D.92-12-015 required Pacific to establish and maintain a regulatory asset, it was improper to write off the asset pursuant to SFAS 71. ORA cites Paragraph 55 of SFAS 71, which states that SFAS 71 does not control the actions of regulatory agencies.[83] This is true, unless of course the regulator orders a utility to follow SFAS 71 accounting requirements with respect to the PBOP regulatory asset, as the Commission did in D.92-12-015.[84] Because the Decision ordered Pacific to follow SFAS 71, and SFAS 71 required Pacific to write off the regulatory asset, Pacific states that the write-off was proper.

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81 ORA Brief, p. 18.

82 6 TR 508.

83 6 Tr. 518.

84 D.92-12-015, OP 4, 46 CPUC 2d 499, 533.

Pacific also disputes TURN's suggestion that the Commission might have done something different in D.98-10-026 if it had known that Pacific was going to write off the PBOP regulatory asset immediately.[85] Pacific states there was no need for the Commission to provide a detailed discussion of the write-off because it was not at issue in D.98-10-026. But the Commission in D.92-12-015 did order Pacific to record its regulatory asset in conformance with SFAS 71, and SFAS 71 did require the write-off. Moreover, D.92-12-015 contains a detailed discussion of the requirements of SFAS 71.[86] Thus, the Commission was well aware in D.98-10-026 that Pacific would have to write off its PBOP regulatory asset pursuant to SFAS 71 if rate recovery of the asset was discontinued.

3. Discussion

The issue before us is whether it was proper for Pacific to write off its PBOP regulatory asset in 1998. The pre-tax intrastate regulated amount of the write-off was $400 million.[87] If the write-off was proper, we must then consider if the write-off should have been recorded above or below the line.

a. Whether It Was Proper for Pacific to Write Off Its PBOP Regulatory Asset

Pacific argues that its regulatory asset was subject to SFAS 71 because OP 4 of D.92-12-015 explicitly ordered Pacific to establish and maintain a PBOP regulatory asset pursuant to SFAS 71.[88] Pacific further contends that its recovery of the PBOP regulatory asset depended entirely on the SFAS 106 Z-Factor, and

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85 TURN Brief, p. 10.

86 D.92-12-015, 46 CPUC 2d 499, 520-525.

87 Overland Exhibit Phase 2A: 404, Volume 2, p. 7-27, Table 7-8.

88 D.92-12-015, OP 4, 46 CPUC 2d 499, 533.

that Pacific was required by SFAS 71 to write off the regulatory asset when the Z-Factor was terminated by D.98-10-026.

We begin our analysis of Pacific's argument by noting that Pacific determined in 1993 that its PBOP regulatory asset did not comply with SFAS 71 and, therefore, should not be reported on the financial statements that Pacific provided to its shareholders and the SEC. Pacific's auditors concurred.[89] We find that Pacific's own accounting practices demonstrate conclusively that its PBOP regulatory asset did not satisfy the requirements of SFAS 71. Therefore, if Pacific's PBOP regulatory asset was subject to SFAS 71, it never should have recorded the regulatory asset pursuant to SFAS 71 because the regulatory asset did not meet the requirements of SFAS 71.

Although Pacific's PBOP regulatory asset did not satisfy SFAS 71, it was clearly the Commission's intent in D.92-12-015 that Pacific should record a PBOP regulatory asset for regulatory accounting purposes. This is evident from Conclusions of Law (COLs) 8 and 10 of D.92-12-015, which state as follows:

> **COL 8:** Commission policy should not be governed by whether or not utilities can record a regulatory asset under Statement No. 71.
>
> **COL 10:** Utilities should establish a [PBOP] regulatory asset for regulatory accounting purposes. (46 CPUC 2d 499, 531 – 32.)

We find that COLs 8 and 10 required Pacific to record a PBOP regulatory asset even if the regulatory asset did not satisfy the requirements of SFAS 71.

Having concluded that Pacific's regulatory asset was not subject to SFAS 71, it logically follows that Pacific was not required by SFAS 71 to write off

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[89] Overland Exhibit Phase 2A: 402, Part 1, pp. 27 and 28.

its regulatory asset when the Commission terminated the SFAS 106 Z-Factor in D.98-10-026.[90] However, SFAS 71 does offer some guidance for determining whether, and to what extent, it was appropriate for Pacific to write off its PBOP regulatory asset when the Commission terminated the SFAS 106 Z-Factor. In particular, SFAS 71 provides that in order to establish a regulatory asset there must exist reasonable assurance that the asset will be recovered in future rates. SFAS 71 also provides that a regulatory asset must be written off to the extent that assurance of recovery in future rates is lost.[91] Thus, SFAS 71 suggests that it was appropriate for Pacific to write off its PBOP regulatory asset to the extent that Pacific's ability to recover the asset in future rates was lost when the Commission eliminated the SFAS 106 Z-Factor in D.98-10-026.

Pacific argues that its recovery of the PBOP regulatory asset depended entirely on the SFAS 106 Z-Factor and, therefore, the entire regulatory asset had to be written off when the Z-Factor was eliminated. We are not convinced that Pacific's argument is altogether true. Under D.92-12-015, recovery of the PBOP regulatory asset was to occur when Pacific's tax-deductible contributions to PBOP trusts exceeded its SFAS 106 costs.[92] The Decision also provided that the SFAS 106 Z-Factor could never exceed SFAS 106 costs.[93] Because recovery of the regulatory asset could occur only when contributions exceeded SFAS 106 costs,

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[90] If Pacific's PBOP regulatory asset had been subject to SFAS 71, the regulatory asset would not have met the requirements of SFAS 71 for the reasons stated previously. As a result, Pacific would not have been able to record a PBOP regulatory asset and there would not have been a $400 million regulatory asset for Pacific to write off in 1998.

[91] SFAS 71, Paragraph 10, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 21.

[92] D.92-12-015, OP 4, 46 CPUC 2d 499, 533.

[93] The SFAS 106 Z-Factor was limited to the lower of (i) tax-deductible contributions to PBOP trusts, or (ii) SFAS 106 costs less PAYGO costs. (D.92-12-015, OP 8, 46 CPUC 2d 499, 533.)

and the Z-Factor could never exceed SFAS 106 costs, it was impossible for the Z-Factor to provide enough revenues to recover the entire regulatory asset.

In D.92-12-015, the Commission provided Pacific with two sources of revenues to recover its SFAS 106 costs, including the regulatory asset. One source was the PAYGO costs built into Pacific's initial rates under NRF.[94] The second source was the SFAS 106 Z-Factor.[95] Therefore, when the Commission eliminated the Z-Factor in D.98-10-026, Pacific still had PAYGO revenues to recover its SFAS 106 costs, including the regulatory asset. Only that portion of the regulatory asset that was to be recovered via the Z-Factor should have been written off in accordance with the guidance provided by SFAS 71.

In order to determine how much of the regulatory asset was to be recovered via the Z-Factor, it is necessary to determine the amount of future Z-Factor revenues that were lost when the Commission terminated the Z-Factor.[96] In D.92-12-015, the Commission anticipated that the Z-Factor would decline over time for the following reasons:

> We note that [PAYGO] costs are projected to increase over time. Furthermore, if we retained [PAYGO] accounting, any increase in [PAYGO] 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 [SFAS 106] and what their [PAYGO] costs otherwise would

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[94] D.97-04-034 indicates that the amount of intrastate PAYGO costs included in Pacific's rates was $166 million. ($318 million – $152 million, D.97-04-034, 71 CPUC 2d 653, 659.)

[95] The SFAS 106 Z-Factor provided Pacific with $99.5 million in annual revenues. (D.98-10-026, 82 CPUC 2d 335, 366.)

[96] For the purpose of our discussion we assume that all future Z-Factor revenues would have been used to recover the PBOP regulatory asset had the Z-Factor not been eliminated by D.98-10-026. It is quite likely, however, that at least some portion of future Z-Factor revenues would not have been used to recover the regulatory asset.

> have been. It appears that the difference between the amount required for PBOP costs under [SFAS 106] and the amount required under [PAYGO] may decrease over time. Indeed, we have earlier noted evidence that [SFAS 106] would eventually be less expensive than [PAYGO]. Therefore, we should not authorize NRF utilities to recover as a permanent Z factor the increase in rates for PBOP necessary during the first year. If we did that, the NRF utilities might realize a windfall. Accordingly, it appears that yearly adjustments to the Z factor recovery for PBOP costs will be required. Our decision today will order such annual adjustments[.] (D.92-12-015, 46 CPUC 2d 499, 528.)

Although the above passage indicates the SFAS 106 Z-Factor was expected to decline over time,[97] the record in Phase 2A is not sufficient to determine the total amount of future revenues that were lost by Pacific when the Z-Factor was terminated by D.98-10-026.[98] Consequently, it is not possible to determine how much of Pacific's PBOP regulatory asset should have been written off in accordance with the guidance provide by SFAS 71 when the SFAS 106 Z-Factor was terminated by D.98-10-026.[99]

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[97] The Commission twice deferred the establishment of procedures for making annual adjustments to the SFAS 106 Z-Factor – once in D.92-12-015 (46 CPUC 2d 499, 528), and again in D.97-04-043 (71 CPUC 2d 653, 668-69). The SFAS 106 Z-Factor was eliminated before any annual adjustment could be implemented.

[98] As discussed later in today's decision, the record indicates that when the SFAS 106 Z-Factor was eliminated Pacific was recovering more revenues from the Z-Factor than authorized by D.92-12-015. Therefore, it appears that the revenues that Pacific could have reasonably expected in the future from the SFAS 106 Z-Factor were substantially less than the $99.5 million in annual revenues that Pacific was recovering from the Z-Factor when it was eliminated by D.98-10-026.

[99] D.92-12-015 anticipated the possibility that the Z-Factor might someday be negative (i.e., Pacific's rates would be reduced) if PAYGO costs exceeded SFAS 106 costs as was expected. As a result, the elimination of the SFAS 106 Z-Factor potentially increased, rather than decreased, Pacific's recovery of SFAS 106 costs in the future, since Pacific would no longer have to implement a negative Z-Factor (i.e., reduce rates) if and when Pacific's PAYGO costs exceeded its SFAS 106 costs. Thus, it is possible that Pacific might have realized a gain from

Footnote continued on next page.

Fortunately, it is not necessary to reach a decision on this matter. For the reasons set forth below we conclude that the write-off of Pacific's PBOP regulatory asset in 1998 should have been recorded below the line to the extent the write-off, together with Pacific's other SFAS 106 costs in 1998, exceeded Pacific's tax-deductible contributions to PBOP trusts in 1998. Because ratepayers are unaffected by the below-the-line write-off, it is unnecessary to expend further effort on examining whether, and to what extent, it was proper for Pacific to have written off its PBOP regulatory asset.

b. Whether the Write-Off of the PBOP Regulatory Asset Should Have Been Recorded Above or Below the Line

Pacific argues that D.98-10-026 did not prohibit an above-the-line write-off. We agree. By the same token, the Decision did not prohibit a below-the-line write-off. In fact, the Decision did not address this issue at all. Consequently, the Decision does not provide explicit guidance on whether the write-off should have been recorded above or below the line.

Pacific also asserts that the Commission in D.92-12-015 found that SFAS 106 costs are a legitimate cost of service.[100] Pacific argues that because SFAS 106 costs are a legitimate cost, it would be an improper ratemaking adjustment under NRF to record the write-off below the line. We agree that SFAS 106 costs are a legitimate cost of service. We disagree, however, that all SFAS 106 costs should be reflected above the line. Decision 92-12-015 limited the SFAS 106 costs that Pacific could recover in rates to the amount of its

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the elimination of the SFAS 106 Z-Factor that offset, at least in part, the write-off of the PBOP regulatory asset.

[100] D.92-12-015, 46 CPUC 2d 499, 516, 530.

tax-deductible contributions.[101] As shown in Appendix F of today's decision, the after-tax intrastate regulated amount of Pacific's SFAS 106 costs in 1998, including the write-off of the PBOP regulatory asset, exceeded Pacific's contributions during 1998 by $165.6 million.[102] Based on the foregoing, we conclude that Pacific is prohibited by D.92-12-015 from recovering $165.6 million of SFAS 106 costs in 1998.

The write-off of Pacific's regulatory asset above the line in 1998 could be recovered in rates to the extent it reduced sharable earnings.[103] Therefore, to ensure that Pacific does not recover any of its SFAS 106 costs in excess of contributions through the earnings-sharing mechanism, we conclude that $165.6 million of the write-off should be recorded below the line. This does not constitute an impermissible ratemaking adjustment under NRF as Pacific claims. Decision 92-12-015 limited the SFAS 106 costs that could be recovered during any year to the amount of tax-deductible contributions. The Commission's policy would be thwarted if Pacific were allowed to recover from ratepayers through the earnings-sharing mechanism any portion of the write-off that exceeded tax-deductible contributions.[104]

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[101] D.92-12-015, OPs 2.b., 4, and 8, 46 CPUC 2d 499, 532 - 33.

[102] The "tax-deductible contributions" used to derive the figure of $165.6 million include transfers of funds in 1998 from Pacific's Voluntary Employee Benefit Association No. 3 (VEBA 3) trust to Pacific's VEBA 5 trust. Additionally, the regulatory asset used to derive the figure of $165.6 million excludes SFAS 106 costs associated with Pacific's capitalization of the contributions to its VEBA 3 trust in 1989 and 1990. Both of these adjustments, which are addressed later in today's decision, reduce the size of the below-the-line write-off.

[103] Under the NRF earnings-sharing mechanism that was in effect during 1998, Pacific was required to refund to ratepayers 50% of its earnings between the benchmark and ceiling rates of return (RORs) of 11.5% and 15.0%, respectively, and 30% of its earnings in excess of the ceiling ROR of 15%. (D.94-06-011, 55 CPUC 2d 1, 33, 60, 61.)

[104] D.92-12-015, OPs 2.b, 4, and 8, 46 CPUC 2d 499, 532 – 33. Although OP 4 of D.92-12-015 ordered Pacific to record a PBOP regulatory asset, OP 4 itself states that Pacific may recover

Footnote continued on next page.

Pacific asserts that an above-the-line write-off will not require ratepayers to fund some portion of the write-off through the NRF earnings-sharing mechanism. According to Pacific, its rate of return (ROR) is composed of many different items of revenue, expense, and rate base, and it is inappropriate to single out the effect the write-off might have had on Pacific's sharable earnings. We are not persuaded. To begin with, Pacific cites no precedent for its claim. Indeed, the Commission routinely singles out various items of utility revenues, expenses, and rate base for special regulatory treatment. The unique regulatory treatment of SFAS 106 costs is but one example. Furthermore, the fact that Pacific's ROR consists of an amalgam of items does not prevent the Commission from examining how any one item affects Pacific's ROR. Pacific's vigorous opposition to below-the-line treatment of the write-off is undoubtedly driven in large part by its concern that doing so could result in sharable earnings owed to ratepayers, which shows that a single item can affect sharable earnings.

Our conclusion that the write-off of the PBOP regulatory asset in excess of contributions should be recorded below the line is reinforced by the Commission's holding in D.92-12-015 that the amount of SFAS 106 costs recoverable in rates should be limited to "reasonable costs" defined as follows[105]:

> Reasonable PBOP costs are defined to be those PBOP costs applicable to regulated services that meet the [SFAS 106] criteria as modified by this order and **are invested in tax-deductible plans** . . . . (D.92-12-015, Finding of Fact 52, 46 CPUC 2d 499, 530 -31. Emphasis added.)

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its regulatory asset only to the extent that its tax-deductible contributions to PBOP trusts exceeded its SFAS 106 costs.

[105] D.92-12-015, 46 CPUC 2d 499, 522, 532 – 33.

The SFAS 106 costs that Pacific claimed in 1998 exceeded its tax-deductible contributions by $165.6 million. Pursuant to D.92-12-015, the extra $165.6 million claimed by Pacific is not a "reasonable cost," and, therefore, should not be recognized above the line for regulatory purposes.[106]

Pacific argues that because its PBOP regulatory asset was subject to SFAS 71, and SFAS 71 required Pacific to write off the regulatory asset, the entire write-off should be recognized above the line. We disagree that Pacific's regulatory asset was subject to SFAS 71 for the previously stated reasons. But even if it were, there is nothing in SFAS 71 that requires write-offs to be reflected above the line for regulatory purposes. If anything, SFAS 71 implies that write-offs should be recognized below the line, since if costs associated with a regulatory asset were going to be recovered in rates there would be no need to write off the asset under SFAS 71. Regardless, SFAS 71 itself acknowledges that the Statement does not govern regulators' authority to determine regulatory accounting requirements. Paragraph 55 of SFAS 71 states:

> This Statement does not address an enterprise's regulatory accounting. Regulators may require regulated enterprises to maintain their accounts in a form that permits the regulator to obtain the information needed for regulatory purposes. This Statement 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

[106] If the entire $165.6 million below-the-line write-off were reflected in the earnings-sharing mechanism, the amount of earnings that Pacific might have to share with its ratepayers could be reduced by an amount equal to 50% of the write-off, or $82.8 million, depending on Pacific's ROR. Such a large reduction in sharable earnings does not comport with the Commission's determination in D.92-12-015 that the maximum rate increase for PBOP costs in any year should be limited to 1% of Pacific's prior year's price-cap revenue base. (D.92-12-015, OP 2.f., 46 CPUC 2d 499, 533.) Pacific's price-cap revenue base for 1998 was $6,050,461,000 (Resolution T-16102, OP 5), and 1% of its revenue base was $60.5 million.

> effects of different types of rate actions are reported in general-purpose financial statements. (Pacific Exhibit Phase 2A: 333, Binder 2, Tab 21.)

As described previously, we conclude that the write-off of Pacific's regulatory asset in 1998 should have been recorded below the line to the extent the write-off, together with Pacific's other SFAS 106 costs, exceeded Pacific's tax-deductible contributions during 1998. Nothing in SFAS 71 compels a different result.

Pacific states that although D.98-10-026 did not address whether Pacific was required by SFAS 71 to write off the PBOP regulatory asset, the Commission knew in D.98-10-026 that Pacific would have to write off its PBOP regulatory asset pursuant to SFAS 71 when D.98-10-026 terminated the SFAS 106 Z-Factor. Pacific's argument amounts to speculation and we accord it no weight. Moreover, it is unlikely that the Commission in D.98-10-026 considered the ramifications of SFAS 71 because (1) Pacific's PBOP regulatory asset was not subject to SFAS 71 for the reasons stated previously, (2) there is no mention of SFAS 71 in D.98-10-026, (3) Pacific never informed the Commission of Pacific's belief that it was required by SFAS 71 to write off its $400 million PBOP regulatory asset,[107] and (4) all of the Commissioners who voted on D.92-12-015, which authorized Pacific's regulatory asset, had left by the time D.98-10-026 was issued. But even if the Commission had SFAS 71 silently in mind when it terminated the SFAS 106 Z-Factor in D.98-10-026, it is reasonable to assume that

[107] As TURN points out, the Commission asked Pacific in the proceeding leading to D.98-10-026 to identify the ratemaking impacts that would result from the elimination of the SFAS 106 Z-Factor. Pacific responded by stating that the only effect would be to decrease rates by the amount of the Z-Factor, which was $99.5 million at the time. (ORA Exhibit Phase 2A: 118, Attachment 3, last 2 pages.) Pacific did not inform the Commission that Pacific's would have to write off its $400 million PBOP regulatory asset, which would have had the effect of significantly reducing Pacific's earnings and potential sharing.

the Commission also had in mind all of the previously described factors that lead to our conclusion today that Pacific should have recorded the write-off of its PBOP regulatory asset below the line.

As a final matter, we note that when the SFAS 106 Z-Factor was terminated by D.98-10-026, the Z-Factor was providing Pacific with $99.5 million per year in revenues. In D.92-12-015, the Commission set the Z-Factor at the lower of (1) Pacific's annual tax-deductible contributions to PBOP trusts, or (2) Pacific's annual SFAS 106 accrual less its PAYGO costs. Based on these parameters, it appears that Pacific's Z-Factor in 1997 and 1998 should have been $52.1 million and $29.0 million, respectively,[108] not $99.5 million that was in effect.

In D.98-10-026 and Resolution T-16102, the Commission indicated that it would consider if Pacific had recovered an excessive amount of SFAS 106 costs via the Z-Factor,[109] but set no timetable for doing so. To date the Commission has not considered this matter in any proceeding. Therefore, to fulfill our duty to consider every element of the public interest affected by our decisions, regardless of whether each element is raised by a party,[110] parties may address in Phase 3B the issue of whether Pacific recovered more revenues from the SFAS 106 Z-Factor than authorized by D.92-12-015 and, if so, whether the excess revenues should be refunded to Pacific's ratepayers, how the refund should be implemented, and what rate of interest should apply to the refund.

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[108] Appendix G of today's decision.

[109] D.98-10-026, 82 CPUC 2d 335, 366-67, and 371; Resolution T-16102, *mimeo.*, pp. 6-9, 18 and 20.

[110] Northern California Power Agency v. Pub. Util. Comm., 5 Cal. 3d 370, 379-381 (1971).

B. Accounting for PBOP Costs in 1999

1. Audit Findings

Overland believes that D.92-12-015 limited the SFAS 106 costs that Pacific could report for regulatory purposes in 1999 to no more than the amount of Pacific's tax-deductible contributions to PBOP trusts during the year. Overland provided information which indicates that the amount of SFAS 106 costs that Pacific reported in 1999 exceeded its contributions by $91 million.[111]

2. Position of the Parties

a. ORA

ORA agrees with Overland that D.92-12-015 limited the SFAS 106 costs that Pacific could claim for regulatory purposes in 1999 to the amount of Pacific's tax-deductible contributions. ORA argues that allowing Pacific to report SFAS 106 costs in excess of its contributions is contrary to the Commission's disposition of a similar issue in D.01-06-077 regarding Roseville Telephone Company (RTC). There, the Commission addressed a situation where RTC had recovered SFAS 106 costs via the Z-Factor but had failed to make tax-deductible contributions to PBOP trusts. The Commission concluded that RTC should refund all Z-Factor revenues not invested in PBOP trusts as required by D.92-12-015.[112] ORA states that although D.01-06-077 dealt with a different company, the Decision demonstrates that the amount of SFAS 106 costs allowable for regulatory purposes is limited to tax-deductible contributions.

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[111] $91 million = $171 million - $80 million. The intrastate regulated amount of Pacific's SFAS 106 accrual (including depreciation) in 1999 was $171 million ($176 million from Overland Exhibit Phase 2A: 404, Volume 2, Attachment 7-8, plus $2 million from Pacific Exhibit Phase 2A: 307, p. 25, lines 10 - 15, minus $7 million from Appendix I, line 11, of today's decision). The intrastate regulated amount of Pacific's tax-deductible contributions to PBOP trusts in 1999 was $80 million. (Overland Exhibit Phase 2A: 404, Vol. 2, Attach. 7-8.)

[112] D.01-06-077, *mimeo.*, pp. 78-80. Rehearing denied in D.01-12-024.

b. TURN

TURN asserts that Pacific violated D.92-12-015 in 1999 when it claimed SFAS 106 expenses greater than its tax-deductible contributions. TURN also believes that it is in the ratepayers' interests to limit PBOP regulatory expenses to the amount of contributions.

c. Pacific

Pacific states that D.92-12-015 adopted SFAS 106 for regulatory accounting purposes but limited the SFAS 106 costs that NRF utilities could recover in rates to the amount of their tax-deductible contributions.[113] Thus, while it is true that D.92-12-015 limited Pacific's recovery of SFAS 106 costs, the recognition of SFAS 106 costs for regulatory accounting purposes, which does not equate to recovery, was not limited.

Pacific contends that D.01-06-077 involving RTC is irrelevant. RTC had recovered SFAS 106 costs in rates via the Z-Factor but had not invested all of the Z-Factor revenues in PBOP trusts. The Commission held in D.01-06-077 that RTC should recover its SFAS 106 costs in rates to the extent of its tax-deductible contributions, and ordered RTC to refund all of its SFAS 106 revenues in excess of tax-deductible contributions.[114] Pacific's situation in 1999 was entirely different. Pacific could not recover its SFAS 106 costs in rates because the Commission had eliminated the SFAS 106 Z-Factor and the earnings-sharing mechanism. Thus, the amount of SFAS 106 costs that Pacific reported in 1999 (or contributed to PBOP trusts) had no effect on the rate recovery of such costs.

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[113] D.92-12-015, 46 CPUC 2d 499, 517.

[114] D.01-06-077, *mimeo.*, pp. 78-80.

3. Discussion

The issue before us is the proper amount of SFAS 106 costs that Pacific should have reported for regulatory purposes in 1999. Overland, ORA, and TURN state that the amount of SFAS 106 costs that Pacific was allowed to report was limited by D.92-12-015 to Pacific's tax-deductible contributions to PBOP trusts. Pacific maintains that it was proper to report all of its SFAS 106 costs, regardless of its actual contributions.

To resolve this issue, we turn to D.92-12-015 and D.98-10-026. In D.92-12-015, the Commission adopted SFAS 106 for regulatory accounting purposes, but limited the SFAS 106 costs that Pacific could recover in rates to the amount of its tax-deductible contributions to PBOP trusts.[115] However, D.98-10-026 effectively ended the use of SFAS 106 for ratemaking purposes with respect to Pacific by abolishing the SFAS 106 Z-Factor and suspending the earnings-sharing mechanism. Importantly, D.98-10-026 did not affect the use of SFAS 106 for regulatory accounting purposes. Because D.98-10-026 ended the use of SFAS 106 for ratemaking purposes, but not for accounting purposes, we conclude that it was proper for Pacific to report its full SFAS 106 accrual in 1999 of $171 million,[116] regardless of its actual tax-deductible contributions.

We are not persuaded by ORA that allowing Pacific to claim its full SFAS 106 accrual in 1999 is inconsistent with D.01-06-077. There, the

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[115] D.92-12-015, 46 CPUC 2d 499, 505, 517, 523, 531, 532. As described earlier in today's decision, D.92-12-015 also required Pacific to reduce the SFAS 106 costs that it reported for regulatory accounting purposes by the amount of SFAS 106 costs that were (i) funded with surplus pension assets, and (ii) capitalized as a regulatory asset.

[116] $171 million was the pre-tax, intrastate, regulated amount of Pacific's SFAS 106 accrual in 1999, and included depreciation of previously capitalized SFAS 106 costs. The figure of $171 million is equal to $176 million (Overland Exhibit Phase 2A: 404, Vol. 2, Attachment 7-8) plus $2 million (Pacific Exhibit Phase 2A: 307, p. 25, lines 10 –15) minus $7 million (Appendix I, line 11, of today's decision).

Commission addressed a situation where the amount of SFAS 106 costs that RTC had recovered from the Z-Factor exceeded its tax-deductible contributions to PBOP trusts. The Commission concluded that RTC should refund all Z-Factor revenues not invested in PBOP trusts as required by D.92-12-015.[117]

Unlike the situation in D.01-06-077, we are not being called upon to decide if Pacific recovered too much of its SFAS 106 costs via the Z-Factor in 1999, since Pacific did not have a SFAS 106 Z-Factor in effect during 1999. Rather, the issue before us in this proceeding is the proper amount of SFAS 106 costs that Pacific should have reported for regulatory accounting purposes in 1999. Accordingly, the provision in D.92-12-015 that limited Z-Factor recovery of SFAS 106 costs to actual contributions, which was dispositive of the issue in D.01-06-077, is not relevant here.

Although SFAS 106 is no longer used to set rates for Pacific, this may change depending on the revisions to NRF that are adopted by the Commission in Phase 3B of this proceeding. In particular, if the Commission reinstates an earnings-sharing mechanism, the amount of SFAS 106 cost reported by Pacific could have a significant effect on the amount of earnings that Pacific might have to share with its ratepayers. Therefore, if the Commission does reinstate an earnings-sharing mechanism, the SFAS 106 costs that Pacific records and reports for regulatory purposes shall be limited to its tax-deductible contributions for the reasons stated in D.92-12-015. Consistent with D.92-12-015, any SFAS 106 costs in excess of both (1) tax-deductible contributions and (2) PBOP costs funded with surplus pension assets may be carried forward and recognized for regulatory

[117] D.01-06-077, *mimeo.*, pp. 78-80.

accounting purposes in future years to the extent that Pacific's tax-deductible contributions to external PBOP trusts exceed its SFAS 106 costs.

As a final matter, we are concerned about the dramatic fall in Pacific's contributions to its PBOP trusts in 1999. Overland reports that Pacific reduced its contributions to PBOP trusts from $179 million in 1998 to $80 million in 1999,[118] even though Pacific's SFAS 106 costs increased from $155 million in 1998[119] to $171 million in 1999.[120] Moreover, as described later in today's decision, Pacific withdrew $136 million from one of its PBOP trusts in 1999 to pay for non-PBOP costs. The net effect of Pacific's actions in 1999 was to increase its unfunded PBOP liability by (1) not funding all of the PBOP liabilities that were accrued in 1999 under SFAS 106, and (2) diverting PBOP trust assets to non-PBOP purposes.

We believe that it would be prudent for Pacific to fully fund its SFAS 106 accrual, which totaled $171 million in 1999,[121] in order to ensure that it has sufficient assets in the future to pay its PBOP obligations. To this end, D.92-12-015 authorized Pacific to fund its SFAS 106 costs and provided Pacific with the means to do so. Decision 98-10-026 eliminated the SFAS 106 Z-Factor but adjusted other parts of NRF (e.g., suspended the earnings-sharing mechanism and eliminated the price-cap index) in order to provide Pacific with the means to fully fund its SFAS 106 costs over the long run.

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[118] Overland Exhibit. Phase 2A: 404, Vol. 2, Attachments 7-7 and 7-8. A substantial portion of Pacific's contributions to PBOP trusts in 1999 was reimbursed via the $99 million that Pacific withdrew from one of its pension trust funds in 1999. The pre-tax, intrastate regulated amount of the withdrawal was $69 million. (Overland Exhibit Phase 2A: 409, Table 7 of 7.)

[119] Appendix G of today's decision, Line 13.

[120] $171 million = $176 million (Overland Exhibit Phase 2A: 404, Volume 2, Attachment 7-8) plus $2 million (Appendix G of today's decision, Line 11) minus $7 million (Appendix I of today's decision, Line 11).

[121] $171 million was the pre-tax, intrastate, regulated amount of SFAS 106 costs for 1999.

Because ratepayers have provided Pacific with adequate resources to fully fund its SFAS 106 costs, but Pacific has chosen not to do so, we conclude that it is necessary to protect ratepayers from the financial consequences of Pacific's actions. In particular, to the extent that Pacific incurs SFAS 106 costs in 1999 and subsequent years that are not funded and/or diverts PBOP trust fund assets to non-PBOP purposes, as was the case in 1999, the resulting unfunded PBOP liability (as measured by SFAS 106) shall be the sole responsibility of Pacific. With one exception, which is described at the end of this paragraph, Pacific may not adjust future rates to recover any costs associated with such unfunded liabilities, including any interest on the liabilities. Likewise, should the Commission reinstate an earnings-sharing mechanism, any costs associated with unfunded PBOP liabilities incurred after 1998 and prior to the reinstatement shall not be included in the determination of sharable earnings. The issue of whether costs associated with unfunded PBOP liabilities accrued after the reinstatement of an earnings-sharing mechanism should be included in the mechanism should be decided by the Commission if and when the sharing mechanism is reinstated.

So that we may monitor Pacific's compliance with today's decision, we will require Pacific to establish procedures to segregate its PBOP costs, assets, and obligations from SBC's other PBOP costs, assets, and obligations for actuarial, accounting, and reporting purposes. Pacific shall implement the aforementioned procedures within 60 days from the effective date of today's decision. Pacific shall also prepare an annual actuarial report, certified by an enrolled actuary, that shows Pacific's PBOP costs, assets, and liabilities on a stand-alone basis. The requirement to prepare a stand-alone actuarial report shall begin with calendar year 2004.

C. Refund to Ratepayers of VEBA 1 Trust Withdrawal

1. Audit Findings

Pacific Bell has several PBOP trusts known as Voluntary Employee Benefit Association (VEBA) trusts. Pacific uses VEBA Trust No. 1 (VEBA 1) to fund life insurance benefits provided to its retirees. All of the contributions to the VEBA 1 trust were recorded as expenses and included in rates prior to the adoption of SFAS 106 by D.92-12-015.

Pacific's VEBA 1 trust was significantly over funded during the audit period. The SFAS 106 actuarial report for 1999 indicates that the value of the assets for the life insurance component of the PBOP plan exceeded the related obligation by $190 million as of January 1, 1999.

Pacific Bell withdrew $180 million from its VEBA 1 trust in December 1999. Pacific did not use the withdrawn funds to pay for PBOP costs (i.e., life insurance benefits provided to its retirees). Rather, Pacific used these funds to reimburse itself for active employees' healthcare costs that Pacific had paid earlier in 1999.

Pacific implemented the withdrawal in a two-step process. First, Pacific amended the VEBA 1 trust agreement to allow payment of active employees' healthcare costs. Second, the trust transferred $180 million to Pacific's unrestricted cash account in December 1999. Pacific accounted for the withdrawal as a negative contribution to its VEBA 1 trust. Pacific's accounting did not change its operating expenses or net income for regulatory purposes.[122]

Overland believes that Pacific's withdrawal of $180 million from the VEBA 1 trust was subject to OP 3 of D.92-12-015, which states as follows:

[122] The VEBA 1 withdrawal increased Pacific Bell's 1999 taxable income by $180 million. Pacific did not report the increased income tax expense for regulatory purposes.

> To the extent that PBOP trust assets cannot or are not used for PBOP obligations, then those assets shall be returned to ratepayers as allowable by law. Utility rates are hereafter made subject to refund, but only to the extent necessary to allow such a return to ratepayers of any PBOP assets that cannot be used for PBOP expenses or that have been used for other purposes. (46 CPUC 2d 499, 433.)

Overland states that OP 3 required Pacific Bell to use the assets in the VEBA 1 trust, which is a PBOP trust, to fund PBOP obligations. Any VEBA 1 assets not used for this purpose had to be refunded to ratepayers. Because the $180 million that Pacific Bell withdrew from its VEBA 1 trust was not used for PBOP obligations, Overland concludes that Pacific should return $180 million to the VEBA 1 trust or, alternatively, refund the withdrawn assets to ratepayers as required by OP 3 of D.92-12-015. The calculation of the refund is shown below:

1999 VEBA 1 Trust Fund Withdrawal Refund Owed to Ratepayers	
Description	**Amount**
VEBA 1 Trust Fund Withdrawal	$180,000,000
Intrastate Factor	0.8043
Intrastate Portion	$144,774,000
Regulated Factor	0.9409
Intrastate Regulated Refund	$136,218,000
Source: Overland Exhibit 402, Part 2, p. S7-11, Table 7S-2.	

Overland states that if the Commission does not require Pacific Bell to return $180 million to the VEBA 1 trust or refund $136 million to ratepayers, then Pacific should be required to reduce the intrastate regulated PBOP expense that it reported in 1999 by $136 million. This is because D.92-12-015 limits annual SFAS 106 costs that Pacific can claim for regulatory purposes to the amount of

Pacific's tax-deductible contributions to PBOP trusts. The $180 million that Pacific withdrew in December 1999 represents a reduction in Pacific's contributions to its PBOP trusts and, in turn, a reduction in the amount of PBOP expense that it can claim for regulatory purposes.

Finally, Overland states that Pacific may have withdrawn additional funds from its PBOP trusts in 2000 and 2001. In a response to a data request, Pacific informed Overland that withdrawals in 2000 were contingent on the value of VEBA 1 trust assets in December 2000.

2. Position of the Parties

a. TURN

TURN supports Overland's recommendations. TURN disagrees with Pacific's argument that the withdrawal of assets from the VEBA 1 trust does not impact PBOP expense, but only the PBOP liability.[123] According to TURN, Pacific's argument boils down to "rates won't go up, but current rates will have to be paid longer in order to fund of the liability." TURN states that whether rates go up today, or stay at current levels (rather than declining) for a longer period than they would otherwise, ratepayers are worse off.

TURN believes that OP 3 of D.92-12-015, which requires PBOP trust assets not used to pay for PBOP obligations to be returned to ratepayers, applies all PBOP trust assets, not just those assets acquired after D.92-12-015. Support for this interpretation is found in D.91-07-006 where the Commission determined that SFAS 106 requires PBOP plan assets to be "segregated and restricted, usually in a trust, to be used only for post-retirement benefits." In addition, the Commission noted IRS, ERISA, and NLRA requirements "ensure that PBOPs

[123] Pacific Exhibit Phase 2A: 308, p. 34.

assets are used for only PBOPs benefits.[124]" Based on these findings, the Commission concluded that the safeguards already in place would "ensure that funds placed in a PBOPs plan will be used only for PBOPs benefits.[125]" Nowhere in D.91-07-006 is there anything that distinguishes between PBOP trusts funded prior to a given point in time and PBOP trusts funded thereafter.

TURN states that Pacific attempts to obfuscate the issue by contending that the VEBA 1 trust would have been liable for unrelated business income tax had Pacific not made the $180 million withdrawal. TURN believes the Commission should focus on the substance of transaction, which was to enrich Pacific by $180 million by having the VEBA 1 trust, instead of Pacific, pay for the healthcare costs of Pacific's active employees.

b. Pacific

Pacific stipulates that it amended its VEBA 1 trust agreement in 1999 so that VEBA 1 trust assets could be used to pay for healthcare benefits provided to Pacific's active employees. As a result of the amendment, the VEBA 1 transferred $180 million in December 1999 to reimburse Pacific for active employee healthcare expenses that Pacific had paid earlier in year.

Pacific explains that it used its own cash to pay approximately $200 million in healthcare costs for its active employees during 1999. The amendment to the VEBA 1 trust agreement allowed those same costs to be paid by the VEBA 1 trust. A transfer was made in December 1999 from the VEBA 1 trust to Pacific's cash accounts to reimburse Pacific for the healthcare costs that it had paid previously in 1999. Thus, the assets withdrawn from the VEBA 1 trust were spent on the plan beneficiaries as required by the amended VEBA 1 trust

[124] 40 CPUC 2d 638, 658.

[125] 40 CPUC 2d 638, 658.

agreement and did not enrich Pacific. Moreover, had the transfer not occurred, Pacific's expenses would be considerably higher as a result of the VEBA 1 trust being subject to the unrelated business income tax.

Pacific contends that its withdrawal of $180 million from the VEBA 1 trust did not violate OP 3 of D.92-12-015. Ordering Paragraph OP 3 made rates "hereafter" subject to refund for the purpose of returning to ratepayers any PBOP assets not used to provide PBOP benefits. Pacific states that the use of the word "hereafter" by OP 3 means that OP 3 applies prospectively. Since all of the assets in the VEBA 1 trust were contributed prior to D.92-12-015, OP 3 does not apply to the VEBA 1 trust.

Pacific represents that its withdrawal of assets from the VEBA 1 trust did not increase Pacific's PBOP costs as TURN claims. This is because the regulatory accounting for PBOP costs is subject to SFAS 106 pursuant to D.92-12-015. Under SFAS 106, PBOP costs are equal to the PBOP benefits earned by employees. The funds in the VEBA 1 trust are just a source for the payment of PBOP benefits, not a measure of the cost that is incurred. Thus, the VEBA 1 withdrawal in 1999 did not impact the amount of expense recognized under SFAS 106.

3. Discussion

The issue before us is whether Pacific's withdrawal of $180 million from its VEBA 1 trust in 1999 was subject to OP 3 of D.92-12-015. Ordering Paragraph 3 states as follows:

> To the extent that PBOP trusts assets cannot or are not used for PBOP obligations, then those assets shall be returned to ratepayers as allowed by law. Utility rates are **hereafter** made subject to refund, but only to the extent necessary to allow such a return to ratepayers of **any** PBOP assets that cannot be used for PBOP expenses or that have been used for other purposes. (46 CPUC 2d 499, 533. Emphasis added.)

The first sentence of OP 3 requires any PBOP trust assets that are not used to provide PBOP benefits to be returned to ratepayers. The first sentence clearly applies to Pacific's withdrawal of $180 million from the VEBA 1 trust in 1999, since the VEBA 1 trust is a PBOP trust and Pacific did not use the $180 million withdrawal to pay for PBOPs provided to retirees, but to reimburse Pacific for the cost of non-PBOP benefits provided to active employees.

Pacific Bell claims that OP 3 does not apply to assets contributed to PBOP trusts prior to D.92-12-015. This is because the second sentence of OP 3 makes rates "hereafter" subject to refund. Since all of the assets in the VEBA 1 trust were contributed prior to D.92-12-015, Pacific believes that OP 3 does not apply to the VEBA 1 trust. We disagree. Ordering Paragraph 3 does not distinguish between PBOP trusts assets contributed prior to D.92-12-015 and those contributed afterwards. What the second sentence of OP 3 does is to make any PBOP trust assets, regardless of when they were contributed, "hereafter" subject to refund to the extent that such assets are not used to provide PBOPs. The effect of OP 3 is that PBOP trust assets used for non-PBOP purposes prior to D.92-12-015 were not subject to refund, but any PBOP trust assets used for non-PBOP purposes after D.92-12-015 had to be refunded to ratepayers.

Our conclusion that OP 3 applies to PBOP trust assets contributed prior to D.92-12-015 is compelled by the fact that, contrary to Pacific's sworn testimony and representations in its legal briefs,[126] the withdrawal of assets from the VEBA 1 trust did increase Pacific's PBOP costs under SFAS 106. As Pacific is undoubtedly aware, SFAS 106 provides that earnings on PBOP trust assets should be used to reduce PBOP costs. By withdrawing $180 million from the

[126] Pacific Phase 2A reply brief, pp. 31 – 33; Pacific Exhibit Phase 2A: 308, p. 34.

VEBA 1 trust, Pacific reduced the amount of assets available to produce earnings to offset future PBOP costs, thereby increasing overall costs under SFAS 106.[127]

In D.92-12-015, the Commission authorized utilities to implement large rate increases in order to accumulate funds to pay for future PBOP costs. It is simply not credible to believe, as Pacific suggests, that the Commission in OP 3 of D.92-12-015 would have allowed utilities to increase PBOP costs and rates even further by diverting PBOP trust funds collected from ratepayers prior to D.92-12-015 to non-PBOP purposes. To prevent such an outcome, the only reasonable interpretation of OP 3 is that it applied to PBOP trust assets that were contributed prior to D.92-12-015. Moreover, there was no reason for the Commission in D.92-12-015 to apply a different policy to PBOP trust fund assets depending on when the assets were contributed. The purpose of OP 3 was to ensure that ratepayer funded contributions to PBOP trusts were actually used to pay for PBOPs. There is no suggestion in D.92-12-015 that PBOP trust fund assets collected from ratepayers prior to D.92-12-015 should receive less protection than PBOP trust fund assets collected after the Decision.

We agree with TURN that D.91-07-006 supports the conclusion that the protections established by OP 3 of D.92-12-015 apply to all PBOP trust assets, regardless of when the assets were contributed. In D.91-07-006, which was issued in the same proceeding as D.92-12-015, the Commission determined that SFAS 106 required PBOP assets to be "segregated and restricted, usually in a trust, to be used only for post-retirement benefits." The Commission also noted that IRS, ERISA and NLRA requirements "ensure that PBOP assets are used for

[127] Pacific's use of VEBA 1 trust assets for non-PBOP purposes also increased Pacific's aggregate unfunded PBOP liability under SFAS 106.

only PBOP benefits.[128]" The Commission concluded in D.91-07-006 that these requirements would "ensure that funds placed in a PBOP plan will only be used for PBOP benefits.[129]" In sum, the Commission manifestly expected that all PBOP trust fund assets, regardless of when they were contributed, would only be used to provide PBOPs.[130] To ensure that its expectation came to pass, the Commission in OP 3 of D.92-12-015 ordered utilities to either use their PBOP trust fund assets to provide PBOPs or refund the assets to ratepayers.

For the preceding reasons, we conclude that Pacific is required by OP 3 of D.92-12-015 to refund $180 million to ratepayers. The intrastate regulated portion of the refund is equal to $136 million.[131] The VEBA 1 refund of $136 million shall be added to the refund of sharable earnings that is addressed later in today's decision and accrue interest at the same rate of interest as the refund of sharable earnings.[132]

The record suggests that the VEBA 1 refund of $136 million might be subject to taxes. If so, Pacific may reduce the refund by the amount of taxes that it actually pays on the refund. In order to determine the amount of taxes, Pacific shall submit a compliance report that shows the amount of the taxes, if any, and

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[128] D.91-07-006, 40 CPUC 2d 638, 658. The Commission further concluded in D.91-07-006, COL 3, that utilities should be authorized to recover their "pre-funded tax-deductible contributions placed in a PBOPs plan as long as the utilities implement safeguards to ensure that contributions are used for only reasonable PBOPs benefits." (Id., 664.)

[129] D.91-07-006, 40 CPUC 2d 638, 658. See also FOFs 19 and 59, Id., 662 and 663.

[130] D.92-12-015, FOF 55, 46 CPUC 2d 499, 531.

[131] Overland Exhibit 402, Part 2, p. S7-11, Table 7S-2.

[132] Arguably, the amount of Pacific's healthcare costs for active employees recognized for regulatory purposes in 1999 should be reduced by the amount of such costs paid with VEBA 1 assets. However, because today's decision orders Pacific to refund to ratepayers the amount of VEBA 1 assets that were used to pay for the healthcare costs of active employees, we conclude that it is unnecessary to reduce the amount of Pacific's healthcare costs recognized for regulatory purposes by the amount of the refund.

contains all supporting work papers. Pacific shall file and serve the report within 30 days from the effective date of today's decision. Parties may file and serve comments and reply comments regarding Pacific's report. The comments and reply comments shall be due 20 days and 30 days, respectively, after the report is filed. Any taxes that Pacific claims but later does not pay shall be refunded to ratepayers and accrue interest in the same manner as the VEBA 1 refund.

The record also suggests that Pacific may have withdrawn additional funds from its VEBA 1 trust subsequent to 1999 for non-PBOP purposes. To determine if this was the case, we will require Pacific to file and serve a compliance report no later than 30 days from the effective date of today's decision stating whether, and to what extent, it has withdrawn funds from the VEBA 1 trust since 1999 for non-PBOP purposes. Parties may file and serve comments and reply comments regarding Pacific's report. Comments will be due 20 days after the report is filed, and reply comments will be due 30 days after the report is filed. To the extent there were such withdrawals, Pacific shall refund the intrastate regulated portion of such amounts to ratepayers in accordance with the procedure previously described for refunding the VEBA 1 withdrawal in 1999. Any withdrawals from Pacific's VEBAs after the effective date of today's decision that are not used to provide PBOPs shall be refunded to ratepayers immediately in a manner consistent with today's decision.

As a final matter, we are troubled by Pacific's use of PBOP trust assets for non-PBOP purposes. As described previously, Pacific incurred substantial new PBOP liabilities in 1999, which Pacific chose not to fund. We believe that it is likely that Pacific could have used the "surplus" VEBA 1 assets to fund some or all of the new PBOP liabilities incurred in 1999. Instead, Pacific chose to divert the surplus VEBA 1 assets to pay for the healthcare costs of its active employees.

We agree with TURN that the transaction enriched Pacific, since Pacific used VEBA 1 trust assets, and not its own cash, to pay for these medical costs. Pacific's diversion of PBOP trust assets to non-PBOP purposes also weakened Pacific's ability to pay for PBOP costs as they come due.

We suspect that economic incentives embedded in the current NRF structure might have played a role in Pacific's decision to divert PBOP trust assets to non-PBOP purposes. Lax Commission oversight of Pacific's PBOP trusts might have been a factor as well. We invite parties to address in Phase 3B whether, and to what extent, it is necessary to revise NRF and/or monitor Pacific's management of PBOP trusts in order to ensure PBOP trust assets are not diverted to non-PBOP uses in the future.

D. Accounting for Contributions to the VEBA 3 Trust

1. Audit Findings and Pacific's Response

Pacific established the VEBA 3 trust in 1989 to "pre-fund" future healthcare benefits provided to retired union employees. Pacific contributed $117 million to the VEBA 3 Trust in 1989 and $91 million in 1990, for a total of $208 million. There were no contributions to the VEBA 3 Trust after 1990. Pacific requested authority to recover the contributions as a Z-Factor, but the request was denied in D.92-12-015.[133]

Pacific Bell recorded the contributions to its VEBA 3 trust in 1989 and 1990 as a prepaid PBOP asset. This had the effect of increasing Pacific's transition benefit obligation ("TBO") by $208 million when SFAS 106 was adopted for Commission purposes on January 1, 1993. The Commission required the TBO to be amortized over 20 years for the purpose of determining SFAS 106 costs for

[133] D.92-12-015, OP 6, 46 CPUC 2d 499, 533.

regulatory purposes.[134] As a result, the capitalization of the VEBA 3 contributions in 1989 and 1990 increased the amount of TBO amortization expense included in Pacific's annual SFAS 106 accrual by $10.4 million ($208 million divided by the 20-year amortization of the TBO) in 1993 and subsequent years. As shown in Appendix I of today's decision, the after-tax intrastate regulated amount of the increase in annual TBO amortization expense was $4.3 million.

Overland provides several reasons why Pacific should have expensed the VEBA 3 contributions in 1989 and 1990 instead of capitalizing the contributions as a prepaid PBOP asset and amortizing the prepaid asset over 20 years beginning in 1993. First, at that time Pacific recorded the contributions to its VEBA 1 life insurance trust as an expense. Overland states that Pacific should have accounted for the contributions to its VEBA 3 trust in the same manner as it accounted for the contributions to its VEBA 1 trust.

Second, Pacific recorded the VEBA 3 contributions as an expense for FCC regulatory purposes. Overland believes that Pacific should have done the same for Commission purposes.

Third, the Commission did not authorize Pacific to capitalize the VEBA 3 contributions or to recover the capitalized amounts in future years. Thus, there was no accounting basis for deferring the cost of the VEBA 3 contributions as a prepaid PBOP asset.

Fourth, Pacific Bell sought to recover the VEBA 3 contributions as a Z-Factor over a 12-month period.[135] According to Overland, Z-Factor recovery is only allowed for costs that can be recognized under the Commission's

[134] D.92-12-015, OP 1.c, 46 CPUC 2d 499, 532.

[135] D.91-07-006, OP 4, 40 CPUC 2d 638, 646.

accounting policies during the surcharge period. The fact that Pacific Bell sought Z-Factor recovery of the contributions over a 12-month period represents a tacit admission that the contributions were properly charged to expense when made.

Finally, D.91-07-006 authorized utilities subject to traditional regulation to recover their PBOP pre-funding over a short period.[136] Overland believes that the Commission would not have allowed accelerated recovery of PBOP pre-funding unless the pre-funding was an expense.

Pacific responds that it properly capitalized the contributions to its VEBA 3 trust in 1989 and 1990 as a prepaid PBOP asset. This is because Pacific placed the contributions into a trust to pay for future PBOP costs. As such, the contributions were appropriately recorded as a prepaid PBOP asset.

2. Discussion

The issue before us is whether it was proper for Pacific to have capitalized the contributions to its VEBA 3 trust in 1989 and 1990 as a prepaid PBOP asset. Pacific made the contributions to pre-fund its PBOP obligations. In D.91-07-006, the Commission found that it was appropriate for utilities to pre-fund their PBOP obligations because, in part, PBOP obligations are analogous to pension and nuclear decommissioning obligations. The Commission allows utilities to pre-fund their pension and nuclear decommissioning obligations and requires utilities to record the pre-funded amounts as an expense for regulatory purposes.[137] We conclude that because the pre-funding of PBOP obligations was analogous to the pre-funding of pension and nuclear decommissioning

[136] D.91-07-006, OP 4, 40 CPUC 2d 638, 664.

[137] D.91-07-006, 40 CPUC 2d 639, 649, 650, 662. See also D.92-12-015, FOF 16, 46 CPUC 2d 499, 529.

obligations that are recorded as an expense, Pacific should have recorded the contributions to its VEBA 3 trust in 1989 and 1990 as an expense.[138]

Our conclusion that Pacific should have recorded the VEBA 3 contributions as an expense is reinforced by several other factors. First, Pacific recorded the VEBA 3 contributions as an expense for FCC regulatory purposes.[139] We believe that our accounting should conform to the FCC's in this particular instance. Second, Pacific recorded the contributions to its VEBA 1 life insurance trust as an expense.[140] Pacific should have accounted for the contributions to its VEBA 3 trust in the same manner as it accounted for the contributions to its VEBA 1 trust. Finally, the Commission did not authorize Pacific to capitalize the VEBA 3 contributions or to amortize the capitalized amounts in future years. Hence, there was no Commission authority or accounting basis for recording the VEBA 3 contributions as a prepaid PBOP asset and then amortizing the cost of the prepaid asset in future years.

Our conclusion that Pacific should have expensed the contributions to its VEBA 3 trust in 1989 and 1990 instead of capitalizing the contributions has the effect of (1) reducing Pacific's TBO by $208 million, (2) decreasing Pacific's annual PBOP costs under SFAS 106 by $4.3 million for intrastate regulatory purposes in 1993 and subsequent years,[141] (3) decreasing Pacific's PBOP

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[138] Although Pacific's contributions to its VEBA 3 trust should have been expensed, the earnings on the VEBA 3 assets should be included in the annual calculation of SFAS 106 costs.

[139] Overland Exhibits Phase 2A: 402, Part 2, p. S7-14, and Phase 2A: 404, Volume 2, pp. 7-18 and 7-19. See also FCC Order 90-845, Paras. 306 and 307.

[140] Overland Exhibit Phase 2A: 402, Part 2, p. S7-8.

[141] The amount of SFAS 106 costs that Pacific reported for regulatory purposes during 1997 and 1998 was equal to its tax-deductible contributions which, in turn, exceeded its SFAS 106 accrual for each of these years. (Overland Exhibit Phase 2A: 404, Vol. 2, pp. 7-25 to 7-28.) Since the amount of SFAS 106 costs that Pacific reported in 1997 and 1998 was based on its

Footnote continued on next page.

regulatory asset by $25.8 million, which is the cumulative reduction in SFAS 106 costs during the years 1993 through 1998,[142] and (4) reducing the write-off of Pacific's PBOP regulatory asset in 1998 by $25.8 million.[143]

We will require Pacific to file revised financial monitoring reports for every year beginning in 1997 that report annual SFAS 106 costs, including the write-off of the PBOP regulatory asset in 1998, as if the VEBA 3 contributions in 1989 and 1990 had been expensed. The adopted revisions to Pacific's net operating income (NOI) associated with the VEBA 3 contributions in 1989 and 1990 are shown in Appendix I of today's decision.

As a final matter, we are concerned that Pacific's decision to capitalize the VEBA 3 contributions in 1989 and 1990 might have resulted in a violation of D.92-12-015. In particular, D.92-12-015 prohibited Pacific from recovering any of its VEBA 3 contributions via the Z-Factor. Ordering Paragraph 6 of D.92-12-015 states, in relevant part, as follows:

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tax-deductible contributions, and not its SFAS 106 accrual, it is unnecessary to revise Pacific's reported SFAS 106 costs for these years by $4.3 million to reflect the corrections to Pacific's TBO adopted by today's decision. However, for the reasons stated in the following footnote, the adopted corrections to the TBO affect both the size of Pacific's PBOP regulatory asset and the size of the regulatory asset write-off in 1998.

[142] The PBOP regulatory asset in 1998 was equal the cumulative excess of SFAS 106 costs over tax-deductible contributions during 1993 - 1998. Therefore, reducing SFAS 106 costs during 1993 – 1998 (by reducing TBO amortization expense) reduces the size of the PBOP regulatory asset in 1998 as well as the size of the regulatory asset write-off in 1998.

[143] For the reasons described earlier in this decision, Pacific is required to record below the line $165.6 million of PBOP costs in 1998. This figure is equal to the amount by which the write-off of Pacific's PBOP regulatory asset in 1998, together with Pacific's other SFAS 106 costs in 1998, exceeded Pacific's tax-deductible contributions in 1998. The determination of the below-the-line write-off excludes the TBO adjustment discussed above from the regulatory asset used to compute the write-off. This exclusion of this adjustment reduces the size of the below-the-line write-off, and was done so as not to double count the revision to Pacific's NOI for the TBO adjustment with the below-the-line write-off in 1998.

> Pacific Bell shall not be authorized to recover [its] pre-funded PBOP costs [i.e., the VEBA 3 contributions] through the Z factor . . . . (46 CPUC 2d 499, 533.)

Decision 92-12-015 authorized Pacific to recover its SFAS 106 costs via the Z-Factor within certain limitations.[144] As described previously, Pacific's decision to capitalize its VEBA 3 contributions increased Pacific's SFAS 106 costs by $4.3 million per year. If Pacific calculated its Z-Factor based on SFAS 106 costs that improperly reflected an additional $4.3 million per year for the capitalized VEBA 3 contributions, Pacific might have recovered some of its VEBA 3 contributions via the Z-Factor in violation of D.92-12-015.[145]

We are not able to determine based on the record in Phase 2A whether Pacific recovered any of its VEBA 3 contributions via the SFAS 106 Z-Factor. Accordingly, parties may address this matter in Phase 3B. If its turns out that Pacific violated D.92-12-015 by recovering some of its VEBA 3 contributions via the Z-Factor, then parties may also address whether Pacific should be required to pay a monetary penalty pursuant to Pub. Util. Code Section 2107 and, if so, the amount of the penalty. Any party that proposes a monetary penalty should demonstrate how its proposal satisfies the criteria set forth in D.98-12-075.

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[144] D.92-12-015, OP 8, 46 CPUC 2d 488, 533.

[145] The Z-Factor authorized by D.92-12-015 could not exceed the lesser of (i) SFAS 106 costs less PAYGO costs, or (ii) tax-deductible contributions to external PBOP trusts. As shown in Appendix G of today's decision, Pacific's tax-deductible contributions to PBOP trusts in 1997 and 1998 exceeded the $99.5 million in annual revenues provided by Pacific's SFAS 106 Z-Factor, which suggests that the Z-Factor was set equal to Pacific's SFAS 106 costs less its PAYGO costs. If this was the case, and capitalized VEBA 3 contributions were included in the determination of Pacific's SFAS 106 costs, then Pacific would have recovered at least some of its VEBA 3 contributions via the SFAS 106 Z-Factor.

E. Accounting for the Transfer of VEBA 3 Trust Assets

1. Audit Findings

Pacific established the VEBA 3 trust in 1989 to "pre-fund" future healthcare benefits provided to retired union employees. In 1995, Pacific established the VEBA 5 trust to fund retiree healthcare benefits provided to union employees. In 1997, Pacific began transferring assets from the VEBA 3 trust to the VEBA 5 trust (referred to hereafter as "VEBA 3 transfers"). The amount of the VEBA 3 transfers was $13 million in 1997, $79 million in 1998, and $90 million in 1999.[146]

Decision 92-12-015 limited the SFAS 106 costs that Pacific could report for regulatory purposes in 1997 and 1998 to the amount of Pacific's tax-deductible contributions to PBOP trusts. Pacific classified the VEBA 3 transfers in 1997 and 1998 as "tax-deductible contributions to PBOP trusts" for the purpose of determining its reportable SFAS 106 under D.92-12-015. Pacific did not use the VEBA 3 transfers in 1999 to determine reportable SFAS 106 costs for that year.

Overland states that it was improper for Pacific to classify the VEBA 3 transfers in 1997 and 1998 as "tax-deductible contributions to PBOP trusts" for the purpose of determining the amount of SFAS 106 costs that it could report under D.92-12-015. Overland represents that the VEBA 3 transfers were not tax-deductible. Nor were the VEBA 3 transfers "contributions" to PBOP trusts, since the transfers did not increase the total assets available to fund Pacific's PBOP obligations, but merely shifted assets from one VEBA trust to another.

[146] As shown in Appendix H of today's decision, the after-tax intrastate regulated amount of the VEBA 3 transfers in 1997, 1998, and 1999 was $5.8 million, $35.6 million, and $40.3 million, respectively.

2. Position of the Parties

a. ORA

ORA agrees with Overland that the VEBA 3 transfers were not tax-deductible contributions and, therefore, should not have been used by Pacific to determine reportable SFAS 106 costs under D.92-12-015 during 1997 and 1998.

b. Pacific

Pacific states that it established the VEBA 3 trust in 1989 to pre-fund future retiree healthcare benefits provided to union employees, and that it made contributions to the VEBA 3 trust in 1989 and 1990. Pacific's request to recover the contributions as a Z-Factor was denied in D.92-12-015.

In D.92-12-015, the Commission provided Pacific with prospective authority to recover SFAS 106 costs via the Z-Factor to the extent of its tax-deductible contributions. In response to D.92-12-015, Pacific established the VEBA 5 trust in 1993 to receive the tax-deductible contributions recovered via the Z-Factor. Because the assets in Pacific's VEBA 5 trust had been recovered from ratepayers, Pacific wanted to keep those assets separate from the funds in the VEBA 3 trust that Pacific had not recovered from ratepayers.

Pacific states that it made contributions to the new VEBA 5 trust for two distinct purposes. One purpose was to pay for current year PAYGO benefits, which Pacific did not recover from the SFAS 106 Z-Factor. Pacific was not required to fund the VEBA 5 trust for this purpose, but Pacific elected to do so anyway. The second purpose was to accumulate assets to pay for future PBOP benefits. Pacific was required by D.92-12-015 to fund the trust to pay for future benefits to the extent such funds were recovered from ratepayers.

Beginning in 1997, Pacific began transferring assets from the VEBA 3 trust to the VEBA 5 trust. Pacific states that the purpose of the transfers was to pay for current-year PAYGO benefits. To ensure compliance with D.92-12-015, the

PAYGO funds in the VEBA 5 trust were segregated from the funds that Pacific recovered from the SFAS 106 Z-Factor.

Pacific disputes Overland's and ORA's claim that the VEBA 3 transfers do not constitute "tax-deductible contributions" and, therefore, cannot be used to determine reportable SFAS 106 costs under D.92-12-015. Pacific states that because the VEBA 3 transfers were used to pay for PAYGO costs, any restrictions imposed by D.92-12-015 do not apply. Moreover, the earnings on the assets in the VEBA 3 trust were used to offset other SFAS 106 costs, so it was reasonable for Pacific to use the VEBA 3 transfers to determine reportable SFAS 106 costs.

3. Discussion

Decision 92-12-015 limited the SFAS 106 costs that Pacific could report for regulatory accounting purposes in 1997 and 1998 to the amount of Pacific's tax-deductible contributions to external PBOP trusts.[147] The issue before us is whether it was proper for Pacific to treat the VEBA 3 transfers in 1997 and 1998 as "tax-deductible contributions" to PBOP trusts for the purpose of determining the amount of SFAS 106 costs that Pacific was allowed to report for regulatory accounting purposes under D.92-12-015.[148] The after-tax intrastate regulated amount of the VEBA 3 transfers in 1997 and 1998 was $5.8 million and $35.6 million, respectively.

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[147] D.92-12-015, 46 CPUC 2d 499, 523, 532, and 533. Under the regulatory asset mechanism established by D.92-12-015, all SFAS 106 costs in excess of tax-deductible contributions had to be capitalized as a regulatory asset. The capitalized SFAS 106 costs could be reported as an expense in future years to the extent that tax-deductible contributions exceeded SFAS 106 costs in future years.

[148] There is no issue regarding the VEBA 3 transfers in 1999 because of the finding reached earlier in today's decision that the amount of PBOP costs recognized for regulatory accounting purposes in 1999 should equal Pacific's SFAS 106 accrual in 1999 regardless of Pacific's actual tax-deductible contributions.

We conclude that Pacific's treatment of the VEBA 3 transfers as "tax-deductible contributions" for regulatory accounting purposes in 1997 and 1998 was improper in two respects. First, the transfers were not tax deductible.[149] Second, the transfers were not "contributions," but the shifting of assets from one VEBA trust to another.[150] Pacific violated D.92-12-015 when it treated the VEBA 3 transfers in 1997 and 1998 as "tax-deductible contributions" for regulatory accounting purposes. We will consider in Phase 3B whether Pacific should be penalized for its violation of D.92-12-015 pursuant to Pub. Util. Code Section 2107. Any party that proposes a monetary penalty should demonstrate how its proposal satisfies the criteria set forth in D.98-12-075.

We will require Pacific to file revised financial monitoring reports for every year beginning in 1997 that exclude the VEBA 3 transfers from the tax-deductible contributions used to determine the annual SFAS 106 costs recognized for regulatory purposes under D.92-12-015 in 1997 and 1998.[151] The adopted revisions to Pacific's net operating income associated with the VEBA 3 transfers in 1997 and 1998 are shown in Appendix H of today's decision.

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[149] Overland Exhibit Phase 2A: 404, Volume 2, pp. 7-26 and 7-27.

[150] Pacific's transfer of assets from the VEBA 3 trust to the VEBA 5 trust did not increase the total amount of assets available to fund Pacific's PBOP obligations. (Overland Exhibit Phase 2A: 404, Volume 2, pp. 7-26 and 7-27.)

[151] For the reasons described earlier in this decision, Pacific is required to record below the line $165.6 million of PBOP costs in 1998. This figure is equal to the amount by which the write-off of Pacific's PBOP regulatory asset in 1998, together with Pacific's other SFAS 106 costs in 1998, exceeded Pacific's tax-deductible contributions in 1998. The VEBA 3 transfers in 1998 are included in the tax-deductible contributions used to compute the size of the below-the-line write-off in 1998. This adjustment reduces the size of the below-the-line write-off, and was done so as not to double count the adjustment to Pacific's NOI for the VEBA 3 transfers in 1998 with the below-the-line write-off in 1998.

F. Capitalization of PBOP Costs

1. Audit Findings and Pacific's Response

Pacific Bell capitalizes the wages and benefits of employees who work on construction projects. The capitalized wage and benefit costs are recorded in construction or plant accounts and included in future depreciation expense.

Pacific capitalized 8% of its SFAS 106 accruals during the audit period.[152] Overland states that because D.92-12-015 limits the SFAS 106 costs that can be recognized for regulatory purposes to the amount of Pacific's tax-deductible contributions, it is the contributions, not the SFAS 106 accruals, that should be used to determine the amount of SFAS 106 costs that should be capitalized. Thus, the amount of SFAS 106 costs that should be recognized for regulatory purposes is the tax-deductible contributions less the capitalized portion of the contributions. Overland's audit adjustment, if adopted, would reduce Pacific's intrastate regulated SFAS 106 costs in 1997 and 1998 by $19 million each year.[153]

Pacific opposes Overland's proposal to capitalize a portion of contributions instead of SFAS 106 accruals. Pacific states that it is improper to capitalize contributions to PBOP trusts because the trust assets are already recorded on the balance sheet as an offset to the SFAS 106 liability.

2. Discussion

Decision 92-12-015 authorized utilities to recover their SFAS 106 costs to the extent of their tax-deductible contributions, with certain limitations.[154] We interpret this provision as authorizing utilities to fully recover their current tax-deductible contributions (within the limits prescribed by D.92-12-015) with

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[152] Pacific Exhibit Phase 2A: 307, p. 33-34.

[153] Pacific Exhibit Phase 2A: 307, Attachment 6-16, line 4.

[154] D.92-12-015, COL 7 and OPs 2.b and 8, 46 CPUC 2d 399, 531, 532, 533.

no reduction for capitalized amounts. Consequently, we decline to adopt Overland's recommendation to capitalize a portion of Pacific's tax-deductible contributions during the audit period. Pacific should continue its practice of capitalizing a portion of its SFAS 106 accruals.

V. Audit Issues Re: Write Down of Plant Assets

A. Audit Findings

Pacific Bell recorded a $4.8 billion write-down of its assets for external financial reporting purposes in 1995. The intrastate regulated portion of the write-down was $3.7 billion. Pacific Bell's 10-K report for 1997 provided the following explanation for the write-down:

> The increase in accumulated depreciation of [$4.8 billion] reflected the effects of adopting depreciable lives for PacBell's plant categories which more closely reflect the economic and technological lives of the plant. The adjustment was supported by a discounted cash flow analysis that estimated the amounts of telephone plant that may not be recoverable from future discounted cash flows. The analysis included consideration of the effects of anticipated competition and technological changes on the plant lives and revenue. (1997 Pacific Bell 10-K, Footnote 2, Discontinuance of Regulatory Accounting, Overland Exhibit Phase 2A: 404, p. 8-12.)

The $4.8 billion write-down was based on a "discounted cash flow study" that assumed that most of Pacific Bell's access lines would be replaced by the new Advanced Communications Network (ACN) by 2010. The study projected a significant reduction in net cash flow from existing access lines as customers moved to the ACN. The amount of the write-down in 1995 was equal to the difference between the net book value of Pacific's existing access lines and the discounted cash flow from the access lines projected by the study.

In 1999, Pacific Bell implemented a plan to amortize over a six-year period what Pacific termed a "depreciation reserve deficiency." The amount of the depreciation reserve deficiency (DRD) was $3.7 billion, which equaled the intrastate portion of the $4.8 billion write-down that Pacific recognized for external financial reporting purposes in 1995. The six-year amortization of the DRD increased Pacific's intrastate regulated expense by $612 million annually in 1999 through 2004. Pacific Bell did not amortize the DRD for FCC purposes.

Overland represents that the six-year amortization of the DRD that Pacific Bell implemented in 1999 was based entirely on the $4.8 billion write-down in 1995. None of the factors used to calculate the write-down in 1995 were updated in 1999. The 1995 write-down was predicated on a forecasted decline in revenue from the existing access lines as customers migrated to the new ACN. However, Pacific abandoned construction of the ACN in 1997. As a result, the number of access lines did not decline as forecasted in 1995. In fact, as shown in the following table, the number of access lines served by Pacific Bell grew annually between 1996 and 2000:

Pacific Bell Switched Access Lines	
1996	16,277,368
1997	17,452,364
1998	17,915,591
1999	18,425,343
2000	18,810,937
Source: Overland Exh. Phase 2A: 404, Vol. 2, p. 8-19.	

Overland reports that Pacific's 2000 Capital Budget forecasted a further increase in switched access lines in 2001.

Overland states that most of the DRD relates to alleged obsolescence and replacement of digital electronic switching equipment, circuit equipment, cable, and conduit. Overland asked Pacific to provide its plans to replace these assets. Pacific responded that it had no plans to replace these assets on a large-scale.

Overland concludes that there is no sound basis for Pacific's annual reserve deficiency amortization (RDA) expense of $612 million. In Overland's view, the RDA is a phantom expense that Pacific reported to the Commission in violation of generally accepted accounting principles (GAAP) and Commission accounting policy. Overland recommends, therefore, that the RDA not be recognized for intrastate regulatory purposes.

Overland disagrees with Pacific's contention that D.98-10-026 authorized Pacific to implement the RDA. According to Overland, the depreciation authority granted by D.98-10-026 was prospective in nature and did not allow amortization of reserve deficiencies caused by past inadequacies in depreciation rates.[155] Overland states that D.98-10-026 instructed Pacific to use the following procedure to address alleged reserve deficiencies resulting from past inadequacies in depreciation rates:

> The scope of this proceeding does not include resolution of stranded costs for investment and depreciation up to January 1, 1999. Rather, Pacific . . . may file an application for consideration of past stranded costs as permitted by, and pursuant to the conditions in, D.96-09-089. Evaluation of any such claim will be undertaken in those applications, not here. (D.98-10-026, 82 CPUC 2d 335, 362.)

Pacific did not use the above procedure when it implemented the RDA in 1999.

[155] D.98-10-026, 82 CPUC 2d 335, 361 - 62.

Overland believes that an FCC order cast doubt on Pacific's decision to implement the RDA in 1999. Paragraph 16 of FCC Order 99-397 states:

> Given the significant uncertainty . . . in forecasting plant replacement over the next fifteen years, we do not find that the carriers . . . have met their burden. Depreciation reserves are at . . . an all time high, and have increased for each of the past five years. There is no evidence that . . . [a] large wave of plant replacements . . . which should result in increased retirements, has begun or is about to begin.

Overland represents that Pacific is required by the FCC to record reserve deficiency adjustments such as the RDA in below-the-line accounts for FCC purposes. The FCC's reasons for doing so are set forth in Paragraphs 26 and 28 of FCC Order 99-397 which state, in relevant part, as follows:

> In the early 1990's many of the largest incumbent LECs wrote-off billions of dollars from their [external] financial books through adjustments to their depreciation reserves. Because they did not make comparable write-offs on their regulatory books, there are significant differences in depreciation reserve between their financial and regulatory books. The . . . LECs [may] eliminate this disparity by increasing the depreciation reserve on [their] regulatory books by a below-the-line write-off . . . [and by using] the same depreciation factors and rates for both regulatory and financial purposes. Using the same factors and rates will ensure that established accounting practices are followed.
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> * * * *
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> These . . . conditions are imposed in order to guard against adverse impacts on consumers and competition. Without these conditions, the largest incumbent LECs could . . . drastically [increase] their annual depreciation expenses. Large increases in depreciation expense . . . could trigger a low-end adjustment, or could lead to carriers seeking recovery through exogenous cost treatment or above-cap filings. These recovery mechanisms, if granted, could enable

> incumbent LECs to increase prices they charge for access services and rates they charge for unbundled network elements (UNEs) and interconnection. Increases in access service prices, which could be substantial, would be imposed on purchasers of access and passed on to their customers. The harmful impact that increased charges could have on competition is also substantial. State regulatory commissions have set rates for interconnection and UNEs, and in many cases have based the rates on [FCC] prescribed depreciation factors. Incumbent LECs, acting as wholesale providers of critical facilities to their competitors, could independently establish depreciation rates that could result in unreasonably high interconnection and UNE rates, which competitors would be compelled to pay in order to provide competing local exchange service.

Overland states that the FCC subsequently affirmed that reserve deficiency adjustments should be recorded below the line. This occurred when SBC and three other LECs requested permission to record reserve deficiency adjustments in above-the-line accounts. The FCC denied the request because of the risk that it might negatively impact ratepayers. Paragraphs 6 and 7 of FCC Order 00-396 state, in relevant part, as follows:

> [S]ignificant concerns were raised by state regulatory commissions, consumer groups, and industry participants about the effect that the proposed above-the-line accounting treatment would have on local and interstate rates, unbundled network element (UNE) and interconnection rates, and universal service support.
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> * * * *
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> Our review of the record finds that the parties have raised sufficient concerns that warrant our taking a cautious approach in this matter. We are concerned about assertions the proposed accounting . . . lacks the inherent protections that are provided for in . . . our December 1999 Order. In light of the concerns expressed by various parties,

> particularly our state colleagues, we decline to adopt the proposed [above-the-line accounting treatment].

If the Commission allows Pacific to proceed with its RDA, Overland states there are several reasons why it should be recorded below the line. First, such treatment is consistent with the Commission's determinations in D.98-10-026 that (i) Pacific should bear full responsibility for decisions regarding depreciation expense,[156] and (ii) Pacific's decisions regarding depreciation expense should have no affect on ratepayers.[157] Second, recording the RDA below the line would avoid distorting Pacific Bell's reported rates of return. Third, it would highlight and isolate the impact of the RDA in future proceedings involving a variety of matters, such as setting rates for UNEs and deciding whether to reinstate an earnings-sharing mechanism. Finally, recording the RDA below the line would be consistent with the FCC's policy of requiring incumbent LECs to record reserve deficiency adjustments below the line for FCC purposes.

B. Position of the Parties

1. AT&T

AT&T observes that the Commission stated in D.98-10-026 that the scope of the Decision did not include issues associated with historic stranded costs. To resolve these issues, D.98-10-026 authorized Pacific to file an application to recover past stranded costs.[158] AT&T opines that Pacific's unilateral implementation of the RDA circumvented the application procedure specified in D.98-10-026 for addressing historic stranded costs.

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[156] D.98-10-026, 82 CPUC 2d 335, 361, 362, 363, and 377.

[157] D.98-10-026, 82 CPUC 2d 335, 362.

[158] D.98-10-026, 82 CPUC 2d 335, 361-62.

2. ORA

ORA doubts that Pacific has a depreciation reserve deficiency. Overland documented the speculative nature of the alleged reserve deficiency by demonstrating that the massive wave of retirements anticipated by Pacific in 1995 when it wrote off $4.8 billion has not occurred.[159] Overland also showed that Pacific continues to use the assets that it wrote off in 1995 and has no plans for the wholesale replacement of these assets.[160] ORA's own testimony shows that Pacific's depreciation reserve ratio grew from 43.84% in 1997 to 54.72% in 2001. The growth in the reserve ratio demonstrates that (1) no massive retirement of assets has occurred, and (2) Pacific is recovering its existing investment in intrastate plant more rapidly than it is investing in new plant. ORA also provided a recent FCC study that demonstrates that Pacific has a negative reserve deficiency (i.e., has depreciated more plant than warranted).

ORA states that Pacific is required by GAAP to write off the alleged depreciation reserve immediately and not over six years. So even if there were a reserve deficiency in 1995, it is inappropriate to write off this cost in 1999 through 2004 when the reserve deficiency could not possibly have occurred. Moreover, Part 32.2000(c)(1) of the USOA requires the cost of Telecommunication Plant to be "allocated in a rational and systematic manner to the future periods in which it provides benefits." The RDA, by definition, has no future benefit. Thus, the amortization of the RDA over a six-year period does not reflect a rational and systematic allocation of the cost of plant to the periods benefited by the plant. Consequently, the RDA violates not only GAAP, but the USOA as well.

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[159] Overland Exhibit Phase 2A: 402, p. 27.

[160] Overland Exhibit Phase 2A: 404, p. 8-21.

ORA argues that D.98-10-026 did not authorize Pacific to implement the RDA. The depreciation flexibility granted by D.98-10-026 was prospective in nature and did not apply to past inadequacies in depreciation rates. The RDA is clearly retrospective in nature, as it is based on a plant write-down recorded in 1995 for external financial reporting purposes that was designed to correct alleged inadequacies in the depreciation rates in 1995 and prior years.

ORA contends that although D.98-10-026 eliminated Commission review and approval of depreciation expenses, this does not mean that Pacific can manipulate its reported earnings by arbitrary amortization of unsubstantiated reserve deficiency estimates. ORA states that if Pacific truly believed its assets were impaired, it should have recorded a one-time extraordinary charge below the line to recognize the impairment. In ORA's view, Pacific's motive for amortizing the alleged reserve deficiency over a six-year period is to systematically understate its regulated earnings.

ORA disputes Pacific's claim that D.98-10-026 responded to comments on the draft decision (that later became D.98-10-026) by granting Pacific freedom to implement the RDA. ORA acknowledges that certain parties did state in their comments on the draft decision that "if the Commission is, in fact, granting Pacific . . . complete discretion over [its] existing depreciation expense . . . [the Commission] will have relieved itself of any responsibilities over the stranded investment [that Pacific] may claim.[161]" However, rather than embracing this position, D.98-10-026 responded by stating that "if relevant, parties may make

[161] Pacific Exhibit Phase 2A: 332, pp. 9-10.

that argument in protest to any application that might be filed pursuant to Ordering Paragraph 7 of D.96-09-089.[162]"

ORA provides several reasons why Pacific should record its RDA below the line. First, if the Commission relies on Pacific's reported earnings for any purpose during 1999 through 2004 when Pacific's earnings are artificially depressed by the RDA, Pacific might indirectly receive regulatory relief to which it is not otherwise entitled. Second, the RDA is least likely to harm ratepayers (as required by D.98-10-026) if it is booked below the line where such accruals will not distort Pacific's reported earnings. Third, recording the RDA below the line does not deny Pacific the ability to mitigate stranded costs because revenues do not change under NRF while the earnings-sharing mechanism is suspended. Finally, ORA is concerned that recording the RDA above the line will mask Pacific's excessive earnings until after the current NRF review is complete. As shown in ORA's testimony, the RORs that Pacific reported in 2000 and 2001 would improve from 12.8% and 12.5%, respectively, to 15.7% and 14.8% without the RDA. ORA also provided testimony that shows how the RDA allows Pacific to create the appearance of stable and moderate earnings in the face of dramatically improving cash flow.

ORA urges the Commission to keep the RDA in mind when considering revisions to NRF in Phase 3 of this proceeding. In particular, the Commission should consider if there should be rate reductions or other comparable measures timed to coincide with the expiration of the RDA. Absent such measures, Pacific will reap windfall profits once the RDA has expired, causing NRF to produce benefits that are unreasonably skewed toward shareholders.

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[162] D.98-10-026, *mimeo.*, p. 54.

3. TURN

TURN states there are several Commission decisions that are relevant to Pacific's RDA. In D.89-10-031, the Commission declined to allow the NRF utilities to file applications to reduce "the so-called reserve deficiency.[163]" In D.96-09-089, the Commission relented slightly by allowing NRF utilities to file applications to (1) show whether the NRF-established depreciation methods deprive them of the ability to earn a fair return on their regulated assets, and (2) recommend appropriate recovery mechanisms to mitigate such adverse effects.[164] In D.98-10-026, the Commission eliminated its review and approval of depreciation expense for assets acquired after the Decision. To resolve issues associated with assets acquired prior to D.98-10-026, the Decision directed Pacific to file an application in accordance with the instructions in D.96-09-089.[165] TURN argues that the RDA implemented by Pacific constitutes the type of unilateral accounting change prohibited by D.89-10-031 and D.98-10-026.

TURN disputes Pacific's contention that it has only put into effect the "mitigation" of stranded costs called for in D.98-10-026. TURN responds that the reference to "mitigation" in D.98-10-026 does not authorize Pacific to implement the RDA. Instead, the Commission merely reminded Pacific that any application it might file to recover stranded costs pursuant to D.96-09-089 must describe the mitigation efforts the utility has considered to reduce its stranded costs, even if not undertaken.[166] TURN states that D. 98-10-026 is clear on how to proceed—

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163 D.89-10-031, FOF 53, 33 CPUC 2d 43, 217.

164 D.96-09-089, OP 7, 68 CPUC 2d 209, 239.

165 D.98-10-026, *mimeo.*, p. 54.

166 D.98-10-026, *mimeo.*, pp. 54-55.

and how not to proceed—regarding stranded costs. In TURN's opinion, Pacific is attempting to pull a $3.7 billion end run of Commission-mandated procedure.

TURN notes that while the Commission in D.98-10-026 did not describe appropriate mitigation measures, it has addressed similar issues in other decisions. For example, in D.95-12-063 the Commission required electric utilities to offset the costs of uneconomic assets against the benefits associated with economic assets in order to determine the net amount subject to rate recovery.[167] In addition, the Commission reduced the authorized return on equity as an inducement for electric utilities to minimize transition costs and, ultimately, the rate impact of those costs.[168] In D.97-06-060, the Commission rejected requests by electric utilities for freedom to manage the recovery of transition costs in favor of a process that allowed the Commission to determine what transition costs are reasonable and truly uneconomic.[169] TURN believes there is no distinction between the uneconomic investments at issue in the electric industry and the investments reflected in Pacific's alleged depreciation reserve deficiency that would warrant a careful, hands-on approach by the Commission on the electric side but no Commission oversight of Pacific.

TURN asserts that Pacific's contention that D.98-10-026 authorizes the RDA contradicts Pacific's own statements during the proceeding leading to D.98-10-026. Pacific stated at that time that problems associated with "under depreciated assets" were beyond the scope of the proceeding.[170] Decision 98-10-026 cites Pacific's representations on this point with approval.

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[167] D.95-12-063, 64 CPUC 2d 1, 59.

[168] D.95-12-063, 64 CPUC 2d 1, 62.

[169] D.97-06-060, *mimeo.*, p. 50-51.

[170] TURN Exhibit Phase 2A: 503, pp. 19 and 31.

TURN believes that Pacific misled the Commission in the proceeding leading to D.98-10-026. In that proceeding, Pacific submitted comments that supposedly informed the Commission about the impact that granting Pacific depreciation freedom would have on Pacific's earnings. Pacific's comments included a chart that showed a range of potential earnings, but there is no indication that the RDA was included in the chart.[171] Because the RDA was apparently not in the chart, Pacific misled the Commission about the impact that granting Pacific depreciation freedom would have on Pacific's earnings.

4. Pacific

Pacific argues that D.98-10-026 provided Pacific with authority to set its own depreciation expense without Commission review or approval.[172] The Decision specifically states that this authority "applies to all plant."[173] Pacific contends that Overland's citation of FCC requirements is irrelevant because the Commission never adopted the FCC approach.

Pacific disputes the claim by AT&T, ORA, and TURN that the depreciation freedom granted by D.98-10-026 applies only to investments made after January 1, 1999. The Decision explicitly states that the depreciation freedom applies to all plant, not just plant acquired after January 1, 1999.[174]

Pacific maintains that in exchange for granting Pacific freedom to set its own depreciation expense, D.98-10-026 foreclosed any stranded investment claims associated with investments made after January 1, 1999. However, D.98-10-026 did not rule out stranded investment claims for investments made

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171 Pacific Exhibit Phase 2A: 118, Attachment 3.

172 D.98-10-026, *mimeo.*, pp. 26-27, 53, and 93.

173 D.98-10-026, *mimeo.*, p. 54.

174 D.98-10-026, 82 CPUC 2d 335, 361.

prior to 1999, but instructed Pacific to continuously mitigate the depreciation reserve deficiency problem associated with that period.[175]

Pacific argues that the Commission's expectation in D.98-10-026 that Pacific take action to mitigate the reserve deficiency required Pacific to record the RDA above the line. Pacific states that because the earnings-sharing mechanism has been suspended, above-the-line treatment of the RDA will not affect ratepayers. Conversely, below-the-line treatment would not mitigate the costs associated stranded investments. Were the Commission to follow this approach, a substantial liability would be preserved, which would unnecessarily expose ratepayers to a potential stranded investment claim of $3.7 billion.

Pacific disagrees with Overland's and ORA's recommendation to record the RDA below the line, lest the Commission be misled by the financial results reported by the company. Pacific states that the information that Overland and ORA seek to convey is easily calculable from Pacific's reports or can be obtained with a simple data request.

Pacific also disputes allegations that there is no support for its decision to implement the RDA in 1999. The original write-down of $4.8 billion in 1995 on Pacific's external financial reports was found to be in conformity with GAAP when audited by Coopers & Lybrand and filed with the SEC. Despite the amount not being recalculated in 1999, the amount is reasonable. As part of this proceeding, Pacific performed an analysis of the total write-down reflecting conditions as of January 1, 1999. The recent analysis showed the range of the depreciation reserve deficiency to be between $4.4 billion and $5.1 billion as of January 1, 1999, which is consistent with the $4.8 billion write-down in 1995.

[175] D.98-10-026, *mimeo.*, p. 54.

Pacific disputes TURN's suggestion that Pacific misled the Commission in the proceeding leading to D.98-10-026. Pacific states that it disclosed the impact of depreciation freedom in its comments on the draft D.98-10-026.

C. Discussion

The issue before us is whether D.98-10-026 provided Pacific with authority to record an annual RDA accrual of $612 million over a six-year period beginning in 1999. We find that the Decision did provide such authority. This is clearly evident from the Commission's determination in D.98-10-026 that Pacific should have freedom to use any depreciation rates it chooses for all of its plant.[176]

Any doubt that D.98-10-026 granted Pacific authority to set its own depreciation expense for assets acquired prior to D.98-10-026 is removed by reviewing the comments on the draft decision that became D.98-10-028 and the resulting discussion of those comments in the final D.98-10-026. The comments stated, in relevant part, as follows[177]:

> The [draft D.98-10-026] concludes that 'We do not only suspend, however but permanently eliminate depreciation reviews and approval.' By this it appears that Pacific . . . would have complete discretion to set depreciation rates and the lives for all of [its] depreciation assets. This would include, it appears, the discretion to alter existing depreciation rates on existing investment. However, in its discussion of stranded investment the Commission states that:
>
> > With today's order, Pacific . . . will set [its] own depreciation rates and accruals. [It] may use economic

[176] D.98-10-026, 82 CPUC 2d 335, 361. The RDA achieves the same result as adjusting depreciation rates. (8 TR 660-661.)

[177] Opening Comments of MCI Telecommunications Corporation (U 5011 C), Sprint Communications Company LP (U 5112 C) and AT&T Communications of California, Inc. (U 5002 C) on the Draft Decision of Commissioner Knight, dated September 8, 1998. (Pacific Exhibit Phase 2A: 332, pp. 9-10.)

> lives, or any other basis with the attendant risks and rewards of that decision. As such, there will be no more stranded cost problem for new plant investments, or depreciation rates, from today forward. [Citation omitted.]
>
> This is confusing because it suggests that Pacific . . . would only have discretion over the depreciation of assets purchased subsequent to the effective date of this decision . . . If the Commission intends to grant Pacific . . . complete discretion over the depreciation of all existing investment, this modification does, in fact, have a significant impact on historic investment. Consequently, if the Commission is, in fact, granting Pacific . . . complete discretion over [its] existing depreciation expense streams and the coordinating reserves, [the Commission] will have relieved itself of any responsibilities over the stranded investment [that Pacific] may claim. (Pacific Exhibit Phase 2A: 332, pp. 9-10.)

In response to the above comments, the Commission stated in D.98-10-026:

> In comments on the draft decision, [several parties] seek clarification of whether elimination of depreciation reviews and approvals applies to all plant, or just new plant. **It applies to all plant.**
>
> Elimination of depreciation reviews and approvals will be effective January 1, 1999. This allows a smooth transition to this new policy, with a clear effective date for each utility to take responsibility for depreciation decisions.
>
> * * * *
>
> With today's Order, Pacific . . . will set [its] own depreciation rates and accruals. **[Pacific] may use economic lives, or any other basis**, with the attendant risks and rewards of that decision. (D.98-10-026, 82 CPUC 2d 335, 361. Emphasis added.)

The previously cited comments on the draft D.98-10-026 and the discussion of those comments in the final D.98-10-026 show that Pacific was granted unfettered

authority to set its own depreciation rates for all of its plant, including plant acquired prior to D.98-10-026. Thus, Pacific's decision to amortize its alleged depreciation reserve deficiency of $3.7 billion over a six-year period was within the scope of authority granted by D.98-10-026.[178]

Overland, AT&T, ORA, and TURN believe that the scope of authority granted by D.98-10-026 did not extend to "stranded costs" such as the alleged depreciation reserve deficiency. Rather, they believe that D.98-10-026 authorized Pacific to file an application to recover stranded costs in accordance with the instructions contained in D.96-09-089. We find that Overland and the parties have misinterpreted D.98-10-026. The Decision distinguished between Pacific's authority to record depreciation expense and Pacific's authority to recover such costs in rates. In particular, D.98-10-026 authorized Pacific to set its own depreciation expense for all of its assets, but the Decision did not authorize Pacific to recover any increase in depreciation expense (e.g., the RDA) in rates.[179] The matter of rate recovery of historic stranded costs such as the RDA was explicitly deferred to the application procedures set forth in D.96-09-089.[180]

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[178] Today's decision makes no findings as to whether Pacific did, in fact, have a depreciation reserve deficiency during the audit period.

[179] D.98-10-026, 82 CPUC 2d 335, 363. There is no evidence in the record of Phase 2A that any of Pacific's RDA has been recovered in rates.

[180] D.96-09-089, 68 CPUC 2d 209, OP 7, states: "[Verizon] and Pacific Bell are each permitted to file an application, no earlier than January 1, 1997, to show whether our adopted new regulatory program embodied in the roadmap proceedings combined with the NRF-established depreciation methods will deprive them of the opportunity to earn a fair return on their 'regulated assets.' The carriers may concurrently recommend recovery mechanisms to mitigate any adverse effects of our regulatory policies. The carriers should specify who would be charged for the recovery. In their applications, the carriers should also specify what portion of their 'regulated assets' subject to our revised regulatory program should be considered in determining the impact of our policies."

Overland, ORA, and TURN present numerous reasons why they believe the RDA is unreasonable and should be recorded below the line. We conclude that it is unnecessary to assess the reasonableness of the RDA or whether the RDA should be recorded below the line. Decision 98-10-026 authorized Pacific to set its own depreciation expense. Implicit within this authority is that Pacific may record its depreciation expense above the line. The *quid pro quo* is that Pacific is permanently precluded from obtaining rate recovery for any "stranded investment" associated with (1) all assets acquired after December 31, 1998, and (2) assets acquired prior to 1999 to the extent that depreciation expense, including the RDA, for pre-1999 assets is reflected above the line.

Finally, it is important to note that the Commission's primary reason for eliminating depreciation reviews and approvals in D.98-10-026 was as follows:

> Depreciation reviews and approvals are largely necessary only in connection with sharing. As we said in D.89-10-031: "Because depreciation accruals will directly affect sharable earnings, we believe that depreciation rates should be examined annually to ensure their continued reasonableness." 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. Now, however, as Pacific says: "when earnings are not regulated, the need to calculate and control depreciation lives for telecommunications equipment disappears." [Citation omitted.] Thus, suspension of sharing permits the parallel suspension of depreciation reviews and approvals. (D.98-10-026, 82 CPUC 2d 335, 360-61.)

In Phase 3B of this proceeding we will consider whether to reinstate an earnings-sharing mechanism. If we decide to reinstate sharing, it will be necessary to also consider whether, and to what extent, to reinstate Commission

review and approval of depreciation expense. Accordingly, we invite parties to address this matter in Phase 3B.

VI. Audit Issues Re: Income Taxes

Pursuant to the assigned Commissioner's ruling dated April 24, 2002, the scope of Phase 2A encompasses findings in Overland's Audit Report that Pacific did not properly report income tax expenses associated with (1) pension costs, (2) PBOP costs, and (3) the California High Cost Fund-B (CHCF-B). The issues related to income taxes addressed by today's decision fall into two broad categories. The first is whether Pacific was required to account for income taxes using the flow-through method or the normalization method. The second is whether the unique attributes of the CHCF-B call for the associated income taxes to be accounted for in accordance with the normalization method, even if the taxes associated with pensions and PBOPs are accounted for in accordance with the flow-through method. Each of these two broad categories of issues is addressed separately below.

A. Flow-Through vs. Normalized Tax Accounting

1. Audit Findings

There are two methods to account for income tax expense for regulatory purposes. Under the flow-through method, the income tax expense recognized for regulatory purposes during a given period is equal to the taxes that are assessed and paid during the period. Under the normalization method, the income tax expense for a given period is based on the net income recognized for regulatory accounting purposes during the period, regardless of when the taxes associated with the accounting income are actually paid. The flow-through method can be viewed as cash-basis accounting, while the normalization method reflects accrual accounting.

Overland states that it is the Commission's policy to use flow-through tax accounting to the extent permitted by law.[181] However, Pacific did not follow the Commission's flow-through policy during the audit period. As shown in the following table, Pacific's intrastate regulated income tax expense during the audit period would be reduced by $50.4 million by applying flow-through tax accounting to (1) the adjustments to Pacific's recorded PBOP costs adopted by today's decision, (2) Pacific's recorded PBOP costs, net of the adopted adjustments, (3) Pacific's recorded pension costs, and (4) CHCF-B revenues:

[181] D.87-12-063, *mimeo.*, pp. 18 and 21.

Increase/(Decrease) in Income Tax Expense Obtained by Applying Flow-Through Tax Accounting to the Following:	**1997 ($000)**	**1998 ($000)**	**1999 ($000)**	**Total ($000)**
I. Adopted Adjustments to Pacific's Recorded PBOP Costs				
• *SFAS 106 – Reg. Asset Write Off* [1]	- -	113,900	- -	113,900
• *SFAS 106 – VEBA 3 to VEBA 5 Transfer* [2]	4,009	24,453	- -	28,462
• *SFAS 106 – Reduction in TBO Amortization* [3]	- -	17,663	2,944	20,607
• *Decrease in PBOP Costs from Transfer of Pension Assets* [4]	- -	- -	28,012	28,012
Subtotal	4,009	156,016	30,956	190,981
II. Recorded Costs and Revenues				
• *Recorded PBOP Costs, Net of the Adopted Adjustments* [5]	(11,447)	(3,130)	(890)	(15,467)
• *Recorded Pension Costs* [6]	25,200	43,691	(91,172)	(22,281)
• *CHCF-B Revenues* [7]	- -	(98,999)	(104,619)	($203,618)
Subtotal [8]	13,753	(58,438)	(196,681)	($241,366)
Total Increase/(Decrease) in Income Tax Expense [9]	**$17,762**	**$97,578**	**($165,725)**	**($50,385)**

Note 1 – Source: Appendix F, Line 7 – Line 9; Appendix K, Table for 1998.
Note 2 – Source: Appendix H, Line 5 – Line 7 (1997) and Line 12 – Line 14 (1998).
Note 3 – Source: Appendix I, Line 14 – Line 15 (1998) and Line 11 – Line 13. (1999).
Note 4 – Source: Appendix K, Table for 1999.
Note 5 – Source: Appendix J, Tables for 1997, 1998, and 1999, Column L, Line 2.
Note 6 – Source: Appendix J, Tables for 1997, 1998, and 1999, Column L, Line 1.
Note 7 – Source: Appendix J, Tables for 1998 and 1999, Column L, Line 3.
Note 8: Ties to Appendix D, Line 5.
Note 9: Ties to Appendix L, Column D.

The adopted adjustments to Pacific's recorded PBOP costs were addressed earlier in today's decision. Applying flow-through tax accounting to these adjustments would have increased Pacific's tax expense during the audit period by $190,981,000 compared to normalization. The adopted adjustments to

Pacific's PBOP costs listed in Appendix D of today's decision are shown net of normalized tax expense (i.e., net of $190,988,000).

Applying flow-through tax accounting to Pacific's recorded PBOP and pension costs, net of the adopted adjustments to these costs, would have decreased Pacific's income tax expense during the audit period by $37,748,000 ($15,467,000 + $22,281,000) compared to normalization.[182] Likewise, applying flow-through tax accounting to CHCF-B revenues instead of normalized tax accounting would have reduced Pacific's reported income tax expense during 1998 and 1999 by $203,618,000.[183]

Overland asked Pacific Bell to explain why it had deviated from the Commission's flow-though policy. Pacific responded that the FCC had adopted Statement of Financial Accounting Standard No. 109 (SFAS 109), which requires Pacific to use normalized tax accounting for external financial reporting purposes. The FCC had also amended its USOA to implement SFAS 109 on a revenue-neutral basis. Pacific told Overland that the Commission had adopted SFAS 109 and the FCC's related amendments to the USOA in Resolution F-634, dated January 5, 1995. As a result, Pacific was required by Resolution F-634 to use normalized tax accounting for Commission regulatory purposes.

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[182] Today's decision adopts Pacific's recorded pension cost of "zero" during each of the years 1997, 1998, and 1999. Under normalized tax accounting, Pacific should have recorded zero income tax expense for pension costs during 1997 – 1999. However, for reasons that are not stated in the record, Pacific recorded $22.3 million of normalized income tax expense for pension costs during 1997 – 1999. ($22,281,000 = -25,200,000 - $43,691,000 + 91,172,000; Appendix J, Tables for 1997 – 1999, Column K, Line 1.)

[183] As discussed in more detail later in today's decision, the sole issue with respect to CHCF-B revenues is whether the associated income tax expense should have been accounted for in accordance with the flow-through method instead of the normalized method that was actually used by Pacific.

Overland disagrees with Pacific's position that Resolution F-634 required Pacific to use normalized tax accounting. What the Resolution did, according to Overland, was to adopt the refinements to flow-through tax accounting prescribed by SFAS 109 and the FCC's related amendments to the USOA. The Resolution describes these refinements as follows:

> **[SFAS 106] Requires that a deferred tax liability be recognized for tax benefits flowed through to ratepayers. Previously, deferred taxes were not recognized for items accounted for under the flow through method**. (Resolution F-634, *mimeo.*, p. 3. Underline and quotation marks in the original. Bold emphasis added.)
>
> *** * * ***
>
> The FCC adopted SFAS 109 for interstate accounting purposes in Report and Order 94-28 . . . The FCC order contains the following key provisions:
>
> 1. Revenue Neutrality: The FCC concluded that the adoption of SFAS 109 should be revenue neutral. To accomplish this goal, the FCC established three balance sheet accounts associated with SFAS 109 which are to be excluded from interstate rate base and revenue requirement determinations:
>
>   a. Account 1437 (Deferred Tax Regulatory Asset) will be used to record amounts of future revenue that will be needed to pay future taxes payable.
>
>   b. Account 4341 (Net Deferred Tax Liability Adjustments) **will reflect adjustments in deferred taxes caused by** items such as tax rate changes and **items accounted for under the flow-through method**.
>
>   c. Account 4361 (Deferred Tax Regulatory Liability) will be used to record future revenue reductions attributable to a decrease in future taxes payable. (Resolution F-634, *mimeo.*, pp. 2-3. Underline in original. Bold emphasis added.)

Overland represents that the three new FCC accounts described in the previously quoted passages of Resolution F-634 allowed flow-through tax accounting to continue. In particular, the new FCC accounts established regulatory assets and liabilities to reflect future rate increases and decreases resulting from the use of flow-through tax accounting. The deferred taxes for items given flow-through treatment were to be recorded in the regulatory asset and liability accounts instead of the deferred tax expense accounts. As a result, total income tax expense continued to reflect flow-through accounting. Thus, the Commission's adoption of SFAS 109 and the FCC's related amendments to the USOA did not modify the Commission's generic flow-through policy.[184]

Overland states that additional evidence that Resolution F-634 maintained flow-through tax accounting comes from the fact that the Resolution required SFAS 109 to be implemented on a revenue-neutral basis. Resolution F-634 states that "Pacific and [Verizon] have . . . ensured that SFAS 109 is revenue neutral for interstate purposes through the use of the appropriate accounts, as mentioned above. . . . Both Pacific and [Verizon] request that adoption of SFAS 109 for intrastate . . . purposes be revenue neutral.[185]" Resolution F-634 concludes:

[184] Overland states that Pacific admitted that (i) prior to Resolution F-634, the "CPUC directed flow-through treatment of timing differences." (Overland Exhibit Phase 2A: 404, Volume 2, p. 9-15.), and (ii) the Commission had only authorized normalized tax accounting for two items prior to the adoption of Resolution F-634. Those two items were federal accelerated depreciation and the California Corporate Franchise Tax accrual. (Overland Exhibit Phase 2A: 402, Part 2, p. S9-1.)

[185] Resolution F-634, *mimeo.*, p. 3.

> Parties have requested and we agree that adoption of SFAS 109 for intrastate accounting purposes should be revenue neutral. It has been established that adopting SFAS 109 will not impact interstate or intrastate rates for the two largest telephone utilities, Pacific and [Verizon]. The responding small and mid-sized local exchange carriers have also indicated that SFAS 109 is revenue neutral and will not impact rates.
>
> Consistent with the FCC, we are adopting SFAS 109 for accounting purposes for fiscal years beginning on or after December 15, 1992, with earlier adoption permitted, for **all** telephone utilities under our jurisdiction that are subject to FCC Part 32 Uniform System of Accounts. (Resolution F-634, *mimeo.*, p. 5. Emphasis added.)

Ordering Paragraph 1 of Resolution F-634 states:

> [SFAS 109] and the [FCC] amendments to its [USOA] contained in CC Docket No. 89-360 [are] adopted for accounting purposes for **all** telephone utilities subject to FCC Part 32 USOA . . . under this Commission's jurisdiction, for fiscal years beginning on or after December 15, 1992. (Resolution F-634, *mimeo.*, p. 6. Emphasis added.)

Overland states that the previously quoted passages from Resolution F-634 demonstrate that the Resolution adopted two new accounting requirements for all telephone companies: (1) SFAS 109, and (2) the related amendments to the FCC's USOA. The Resolution also required that the new accounting requirements be implemented on a revenue-neutral basis. The only way to implement SFAS 109 on a revenue-neutral basis was to retain flow-through tax accounting as modified by the amendments to the USOA. Without the USOA amendments, the adoption of SFAS 109 would result in a switch from flow-through tax accounting to normalized tax accounting. Such a switch could not be revenue neutral for all telephone companies, according to Overland, since it would cause a dramatic change in income tax expense.

Overland states that Pacific Bell's interpretation of Resolution F-634 as requiring normalized tax accounting is not consistent with Pacific's own accounting practices. During the audit period Pacific applied flow-through tax accounting to the following items:

- Depreciation expense for state income tax purposes.
- Vacation pay accrual.
- Uncollectible accounts accrual.
- Property tax accrual.
- Payroll tax (FICA) accrual.
- Interest During Construction - FCC versus Commission rate difference.

Overland believes that Pacific's use of flow-through tax accounting for the previously listed items contradicts its claim that Resolution F-634 required Pacific to use normalized tax accounting during the audit period.

2. Position of the Parties

a. ORA

ORA asserts that the Commission's long-standing policy has been to use flow-through tax accounting except in situations where federal tax laws require normalization for ratemaking purposes.[186] Although there are a few Commission decisions that adopted normalized tax accounting for a small number of items, ORA opines that these decisions involved narrow exceptions to the Commission's flow-through policy, none of which are applicable here.

ORA disputes Pacific's contention that the Commission determined in D.90-12-034 that flow-through tax accounting is not appropriate for NRF

[186] D.84-05-036, COL 6, and D.87-12-063, 26 CPUC 2d 349, 361.

companies.[187] According to ORA, the narrow issue that was addressed in D.90-12-034 was whether the calculation of federal income tax expense for ratemaking purposes should be based on the prior year's or the current year's tax deduction for the California Corporate Franchise tax (CCFT). Decision 90-12-034 did not consider the broader issue of whether the Commission's long-held policy of using flow-through tax accounting should be abandoned.

ORA also disputes Pacific's contention that Resolution F-634 adopted normalized tax accounting.[188] ORA argues that Resolution F-634 adopted only minor revisions to flow-through tax accounting for the purpose of implementing SFAS 109 on a revenue-neutral basis. In any event, ORA believes that Resolution F-634 could not have abandoned the Commission's flow-through policy, since doing so would have required notice and an opportunity to be heard pursuant to Pub. Util. Code Section 1708. Because there was no notice or opportunity to be heard, Resolution F-634 did not alter the Commission's flow-through policy.

b. TURN

TURN argues that the Commission has a long-standing policy of using flow-through tax accounting. TURN opines that Pacific's self-initiated conversion to normalized tax accounting violated the Commission's policy.

c. Pacific

Pacific states that several Commission decisions demonstrate that it was proper for Pacific to use normalized tax accounting during the audit period. In D.84-05-036, the Commission adopted normalized tax accounting for interest during construction.[189] In D.87-09-026, the Commission adopted normalized tax

[187] Pacific Exhibit Phase 2A: 318, p. 7.

[188] Pacific Exhibit Phase 2A: 318, p. 7.

[189] D.84-05-036, 15 CPUC 2d 42, 45-47.

accounting for contributions in aid of construction.[190] In D.88-01-061, the Commission adopted normalized tax accounting for vacation pay and allowance for funds used during construction.[191] In D.94-12-022, the Commission adopted a stipulation that used normalized tax accounting to set rates for Southwest Gas Corporation.[192] And in D.90-12-034, the Commission held that NRF "does not lend itself to adoption of the flow-through method for the ratemaking treatment of CCFT" and ordered Pacific to apply normalized tax accounting to CCFT.[193] While D.90-12-034 considered only one item, CCFT, Pacific posits that the Commission's observation was one of general applicability. Thus, when presented with a choice between flow-through and normalized tax accounting in the context of NRF, the Commission adopted normalization.

Pacific acknowledges that the Commission has sometimes employed flow-through tax accounting. Pacific believes, however, that the Commission's use of normalized tax accounting in the previously cited decisions shows that the Commission had, at most, a preference for flow-through accounting and not a policy mandating the use of flow-through accounting. To the extent the Commission did have a flow-through policy, Pacific believes it was a ratemaking policy that did not affect how Pacific should account for income taxes or report income taxes to the Commission.

Pacific maintains that D.84-05-036 demonstrates that flow-through was, at most, a ratemaking policy. The title of the docket was "Re Income Tax Expense for Ratemaking Purposes," which shows that the purpose of D.84-05-036 was to

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190 D.87-09-026, 25 CPUC 2d 299, 305-309.

191 D.88-01-061, 27 CPUC 2d 310, 317-318.

192 D.94-12-022, OP 1, 57 CPUC 2d 646, 651.

193 D.90-12-034, 1990 Cal. PUC LEXIS 1292, *7 and *13.

address the ratemaking treatment of income tax expense, not the accounting treatment. Moreover, D.84-05-036 did not require Pacific to use either normalization or flow-through for accounting purposes. The Commission only required Pacific to maintain records to track the effects of normalization and flow-through. Pacific says that it did so.

Pacific argues that the following passage from D.87-12-063 further demonstrates that the Commission's flow-through policy was, at most, a ratemaking policy and not an accounting policy:

> Therefore, the policy of flowing through tax benefits should continue as generic **ratemaking policy** and telephone utilities should continue, as they have in the past, to maintain **memorandum records** reflecting the accounting for **both flow-through and normalization of taxes.** (D.87-12-063, 26 CPUC 2d 349, 361. Emphasis added.)

Pacific asserts that the "ratemaking policy" articulated in D.87-12-063 applied only when rates were set. The fact that D.87-12-063 ordered telephone utilities to maintain memorandum records reflecting both flow-through and normalization indicates that the Commission knew that Pacific did not use flow-through tax accounting for every element of income tax expense. Indeed, requiring Pacific to keep separate memorandum records would be meaningless if the Commission had a consistent flow-through policy for its accounting requirements.

Pacific states that D.89-10-031 significantly expanded the use of normalized tax accounting for ratemaking purposes. In particular, D.89-10-031 determined that Pacific's Results of Intrastate Operations Report should be used to establish Pacific's startup revenue requirement under NRF.[194] Pacific had been

[194] D.89-10-031, 33 CPUC 2d 43, 192.

submitting this monthly report to the Commission since at least 1979, and the report contained a combination of flow-though and normalized tax accounting.[195] The Commission specifically found in D.89-10-031 and D.89-12-048 that it was reasonable to use this report for the NRF startup revenue requirement.[196] Furthermore, in the Workshop III report, which was adopted by the Commission in D.91-07-056, Commission staff stated as follows:

> In calculating that startup level, all the ratemaking adjustments then required by the Commission were included. What this means is that the rates presently being charged by [Pacific under NRF] reflect all Commission mandated adjustments from the old regulatory framework that were existing at the time. (Pacific Exhibit Phase 2A: 333, Tab 18, p. 4.)

Pacific claims that Commission staff would not have made such a bold assertion without determining that was true. In sum, the Commission determined in D.89-10-031, D.89-12-048, and D.91-07-056 that it was reasonable for Pacific to use a combination of flow-though and normalized tax accounting under NRF.

Pacific argues that because the Commission used Pacific's Results of Intrastate Operations Report to set Pacific's rates at the start of NRF, the normalized tax accounting reflected therein became the rule for Pacific. Any change at this time would be retroactive ratemaking. Moreover, if Pacific had used only flow-through at the start of NRF, Pacific's startup revenue requirement would have been higher by $94 million annually.[197] Hence, any suggestion that Pacific intentionally avoided flow-through accounting is specious.

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[195] Pacific Exhibit Phase 2A: 318, Attachment 1, lists all of the tax timing differences included in Pacific's startup revenue requirement and the tax treatment given to each item. As shown in the Exhibit, some items received normalized treatment and others flow-through treatment.

[196] D.89-12-031, FOF 175, 33 CPUC 2d 43, 224; D.89-12-048, FOF 10, 34 CPUC 2d 155, 184.

[197] Pacific Exhibit Phase 2A: 318, p. 9.

Pacific states that the establishment of its startup revenue requirement was not the only opportunity for the Commission to confirm the correctness of Pacific's accounting for income tax expense under NRF. For eight years after the institution of NRF, Pacific regularly filed its Intrastate Earnings Monitoring Report with the Commission. Pacific represents that no concerns were ever raised about Pacific's tax accounting.

Pacific avers that the Commission formalized its use of normalized tax accounting in Resolution F-634. In that Resolution, the Commission adopted normalized tax accounting consistent with SFAS 109 and the FCC's related amendments to its USOA. Section 32.22 of the USOA 32 states:

> Companies shall apply interperiod tax allocation (normalization) to all book/tax temporary differences.

Pacific states that Section 32.22 clearly requires normalized accounting for all income tax expense. This mandate was limited, however, by the requirement in Resolution F-634 that the adoption of SFAS 109 and the related amendments to the USOA be revenue neutral. The revenue neutrality requirement forced Pacific to continue to use flow-though accounting for those elements of income tax expense that were being flowed through prior to Resolution F-634. Otherwise, any change from flow-though to normalization would not have been revenue neutral. As a result, Resolution F-634 required Pacific to: (1) continue flow-through treatment of those items it was flowing-through prior the Resolution; (2) continue normalization treatment of those items it was normalizing prior to Resolution F-634; and (3) normalize all new book/tax temporary differences. Pacific says that is exactly what it did.

Pacific disagrees with Overland's and ORA's suggestion that Resolution F-634 adopted only "the amendments" to USOA Section 32.22.[198] If the Commission had done so, the adopted language would have read as follows:

> temporary . . . temporary . . . temporary . . . or . . . or . . . Subsidiary records . . . be used to reduce the deferred tax assets contained in . . . specified in paragraph (a) of . . . section when it is likely that some portion or all of the deferred tax asset will not be realized. The amount recorded in the subsidiary record should be sufficient to reduce the deferred tax asset to the amount that is likely to be realized . . . temporary . . . specified in this section . . . temporary. (Pacific Exhibit Phase 2A: 330.)

Pacific argues that it is unlikely the Commission adopted the above gibberish. Accordingly, the Commission must have adopted Section 32.22 in total, including the language requiring tax normalization. Otherwise, Resolution F-634 would have been pointless.

Pacific disputes ORA's assertion that the Commission did not provide notice and an opportunity to be heard prior to adopting normalized tax accounting in Resolution F-634. Pacific believes that the following excerpt from Resolution F-634 demonstrates that parties were properly notified of Pacific's advice letter that led to Resolution F-634:

> Public notice of]Pacific's] Advice Letter No. 17024 appeared in the . . . Commission's Daily Calendar of July 5, 1994 . . . In addition, copies of [Pacific's advice letter] were mailed in accordance with the Commission's General Order No. 96-A, Section III. G, to . . . interested parties having requested such notification. No protests to [Pacific's advice letter] have been received. (Resolution F-634, *mimeo.*, pp. 4 - 5.)

[198] Overland Exhibit Phase 2A: 402, p. 58; ORA Exhibit Phase 2A: 111, p. 7, footnote 2.

Pacific contends that because ORA had notice and an opportunity to be heard if it objected to the adoption of normalized tax accounting by Resolution F-634, ORA's belated attempt to enter an objection must be rejected.

3. Discussion

The issue before us is what method Pacific should have used to account for income taxes for regulatory purposes during the audit period. Overland, ORA, and TURN believe that long-standing Commission policy requires the use of flow-through tax accounting to the extent permitted by law. Pacific argues that there never was such a policy. To the contrary, the Commission's policy as set forth in Resolution F-634 required the use of normalized tax accounting.

This may seem like an arcane issue, but it is far from trivial. As shown in Appendix L of today's decision, applying flow-through tax accounting to Pacific's pension costs, PBOP costs, and CHCF-B revenues increases Pacific's net operating income (NOI) by $50.4 million during the audit period.

In order to resolve this issue, we must first determine the Commission's policy for tax accounting during the audit period. If we find that it was the Commission's policy to use flow-through tax accounting, we must next consider the various arguments raised by Pacific as to why the policy did not apply to Pacific during the audit period. We address each of these matters below.

a. The Commission's Policy for Income Taxes

In D.59926, issued in 1960, the Commission held that it was unlawful for a utility to record as an expense or recover in rates any costs for income taxes in excess of the taxes actually paid by the utility. The specific holding by the Commission was as follows:

> [W]e hold that a public utility is not lawfully entitled to charge to its operating expense any amount of income taxes in excess of the amount of such taxes which the

> taxing authority lawfully assesses and which the utility pays. It will be the order of this Commission that such treatment will be accorded income taxes for the purpose of ratefixing. (D.59926, 57 CPUC 1st 598, 602.)

Flow-through tax accounting complied with D.59926 in all respects. Thus, the practical effect of D.59926 was to establish a flow-through policy that prohibited utilities from either recording in their operating expense accounts or recovering in rates any costs for income taxes in excess of the taxes lawfully assessed and paid by the utility.[199] On the other hand, normalized tax accounting could, depending on circumstances, cause utilities to record as an expense and recover in rates an amount for income taxes that is higher or lower than the actual taxes paid by the utility during the relevant period. As explained in the next section, the Commission occasionally authorized the use of normalized tax accounting in situations where doing so either (1) complied with the Commission's general policy of excluding from operating expense accounts and rates any costs for taxes in excess of those paid by the utility, or (2) overriding policy considerations compelled the use of normalized tax accounting.

Subsequent to D.59926, the California Supreme Court issued several decisions that (1) upheld the Commission's flow-through policy of setting rates based on the actual taxes paid by the utility, and/or (2) annulled Commission decisions that applied normalized tax accounting in a way that resulted in more taxes being included in rates than the actual taxes paid by the utility.[200] The

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[199] In the following decisions, the Commission affirmed its policy of excluding from rates any costs for income taxes in excess of the taxes lawfully assessed and paid by the utility: D.61711, 58 CPUC 1st 564, 565; D.62585, 59 CPUC 1st 119; D.78329, 1971 Cal. PUC LEXIS 1206, *52; and D.80322, 1972 Cal. PUC LEXIS 1305, *29.

[200] Sometime after D.59926 was issued, the Commission began to apply normalized tax accounting to accelerated depreciation and the investment tax credit (ITC), which resulted in

Footnote continued on next page.

Court's decisions are perhaps best summarized in Southern California Gas Company v. Public Utilities Commission wherein the Court stated:

> [T]he commission [has] generally taken the position that rates . . . should reflect only actual costs incurred. As taxes are treated as part of a utility's cost of service, any tax savings should not be retained by the utility but should be immediately passed on to the utility's customers. Accordingly, since 1960 the commission has required utilities to charge as operating expenses only the amount of taxes actually paid. Any savings acquired through the use of accelerated depreciation or the investment tax credit is to be immediately flowed through to the ratepayers. (*Commission Investigation Regarding Rate Fixing Treatment for Accelerated Amortization and Depreciation for All Utilities* (1960) 57 Cal. P.U.C. 598 [hereafter *Commission Investigation*]; *Pac. Southwest Airlines* (1972) 73 Cal. P.U.C. 697, 708-710.)
>
> The difference between the commission's policy and the utilities' position is thus clear. From the utilities' standpoint, the investment tax credit for public utilities amounts to a federally subsidized source of interest-free capital over and above the return allowed by the state regulatory agency. The utility is expected to invest its tax savings in capital equipment and "repay" it, in the form of reduced rates, ratably over the life of the investment. From the commission's standpoint, however, the tax credit is like any other reduction in the cost of service, the benefit of which the commission is required by California law to pass on to the ratepayers as fully and immediately as possible. (*Commission Investigation, supra*, 57 Cal. P.U.C. at p. 602.) Insofar as present ratepayers are charged on the basis of taxes the utility does not actually pay, it is they and not the federal government who supply the additional

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more taxes being included in rates than the actual taxes paid by utilities. The basis for the Commission's action was its belief that federal tax law required the Commission to apply normalized tax accounting to accelerated depreciation and ITC. The California Supreme Court later held that federal tax law did not necessarily preempt all means at the Commission's disposal for flowing through the tax benefits associated with accelerated depreciation and ITC, and ordered the Commission to examine the means for doing so.

capital for utility expansion, even though the savings may be eventually flowed through ratably to future ratepayers.

This court has endorsed the commission's position: "'The basic principle [of ratemaking] is to establish a rate which will permit the utility to recover its cost and expenses *plus* a reasonable return on the value of property devoted to public use.' (Italics added.) (*City and County of San Francisco* v. *Public Utilities Com*. (1971) 6 Cal. 3d 119, 129 [98 Cal. Rptr. 286, 490 P.2d 798].) It is thus elementary regulatory law that the 'return' -- i.e., the profit -- of the utility is calculated solely on the rate base -- i.e., the capital contributed by its investors; the utility is not entitled to earn an additional profit on its expenses, but only to 'recover' them on a dollar-for-dollar basis as part of the rates." (*Southern Cal. Edison Co.* v. *Public Utilities Com*. (1978) 20 Cal. 3d 813, 818-819 [144 [*477] Cal. Rptr. 905, 576 P.2d 945].) Permitting rates to be set on the basis of taxes the utility has not actually paid, this court has reasoned, in effect forces the ratepayers to contribute capital to be used for utility expansion. (See *City of Los Angeles* v. *Public Utilities Commission, supra*, at pp. 685-687 [hereafter *City of Los Angeles*]; *City of San Francisco, supra*, 6 Cal. 3d at pp. 128-129.)

This court upheld the commission's policy of requiring immediate flow-through of tax benefits in *City of San Francisco, supra*, 6 Cal. 3d 119, annulling a commission decision that failed to consider available alternatives for passing tax savings realized through use of accelerated depreciation on to customers. Similarly, in *City of Los Angeles, supra*, 15 Cal. 3d 680, this court treated the tax savings realized through the investment credit in the same manner as the savings realized through use of accelerated depreciation (*Id.*, at p. 685, fn. 3), and directed the commission to use any means legally at its disposal, including adjustment of rate of return, to insure that the savings were passed to the customers. (*Id.*, at pp. 685 and 704-705, fn. 42.) (23 Cal. 3d 470, 475 - 77 (1979). Footnotes omitted, italics in original.)

In 1981, newly enacted federal tax laws[201] effectively mandated the use of normalized tax accounting for accelerated depreciation and ITC.[202] The effect of the new laws was that the Commission could no longer require utilities to flow through to ratepayers the substantial tax benefits associated with accelerated depreciation and ITC. As a result, ratepayers had to pay substantially more money in rates for income taxes than were actually paid by the utilities.

Although federal law had preempted the Commission's flow-through policy with respect to accelerated depreciation and ITC, in D.84-05-036 the Commission held that its flow-through policy should remain in effect to the extent allowed by law.[203] In D.87-12-063, the Commission affirmed its long-held policy of using flow-through tax accounting for regulatory purposes:

> The issue of comprehensive income tax normalization was initially raised . . . because the FCC's [USOA] requires [normalized tax accounting.]
>
> * * * *
>
> The issue of normalization versus flow-through was addressed by the Commission in D.84-05-036 (OII 24). Upon review of a comprehensive analysis of all California utilities, the decision affirmed that flow-through treatment of timing differences is to continue as Commission policy.
>
> * * * *
>
> A substantial amount of time and analysis went into our affirmation of a generic flow-through policy. The telephone utilities have not convinced us that the generic policy should be modified for telephone utilities. Therefore, the policy of flowing through tax benefits should continue as a generic ratemaking policy and the telephone utilities should continue, as they have in the past

[201] The Economic Recovery Tax Act of 1981.

[202] D.93848, 7 CPUC 2d 332, 333, 334 – 337, and 340.

[203] D.84-05-036, 15 CPUC 2d 42, 53 – 54, 60, and 61.

> to maintain memorandum records reflecting the accounting for both flow-through and normalization of taxes. (D.87-12-063, 26 CPUC 2d 349, 360 - 61.)

In sum, the Commission had an established policy, affirmed by the California Supreme Court, that prohibited, to the extent allowed by law, the inclusion in rates of any taxes in excess of those actually paid by the utility. To implement this policy the Commission employed flow-through tax accounting.

There is no merit to Pacific's claim that the Commission did not have a flow-through policy, but a mere preference. The Commission adopted flow-through tax accounting as its *de facto* policy in D.59926 and as its official policy in D.84-05-036 and D.87-12-063. Nor is there any merit to Pacific's claim that to the extent the Commission did have a flow-through policy, it was a ratemaking policy that did not affect how Pacific should account for income taxes or report income taxes to the Commission. Decision 87-12-063 expressly required Pacific to maintain accounting records reflecting flow-through tax accounting.[204] Moreover, it is a fundamental regulatory principle that ratemaking controls accounting.[205] Because it was the Commission's policy to use flow-through tax accounting for ratemaking purposes, Pacific was obligated to follow that policy for regulatory accounting and reporting purposes.[206]

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[204] D.87-12-063, 26 CPUC 2d 349, 360-61, 370, 371, 372.

[205] D.95-11-031, 62 CPUC 2d 391, 393; D.94-01-028, 53 CPUC 2d 45, 51; and D.90-11-031, 38 CPUC 2d 166, 191.

[206] Decision 59926 prohibited the use of normalized tax accounting for regulatory accounting purposes to the extent that doing so resulted in utilities' charging to their operating expense accounts any costs for income taxes in excess of the taxes actually paid. (57 CPUC 1st 598, 602.) The Commission subsequently allowed utilities to record income tax expenses in excess of the taxes actually paid to the extent required by federal law or warranted by other special circumstances.

Having concluded that the Commission did have a flow-through policy for both accounting and ratemaking purposes, we next consider the reasons given by Pacific as to why the policy did not apply to Pacific during the audit period.

b. Commission Decisions Requiring Normalization

Pacific states that the Commission authorized normalized tax accounting in the following decisions: D.84-05-036, D.87-09-026, D.87-12-063, D.88-01-061, D.90-12-034, and D.94-12-022. According to Pacific, these decisions demonstrate that the Commission did not have a policy that required the use of flow-through tax accounting during the audit period of 1997 - 1999.

In the D.84-05-036, the Commission determined that normalized tax accounting should be applied to interest during construction (IDC). The Commission's rationale for doing so was as follows:

> The current practice in the development of income taxes for rate fixing is to exclude as a tax deduction the interest expense associated with nonutility plant and investment. By far the greatest dollar amount of nonutility investment is represented by construction work in progress (CWIP). Such CWIP is classified as nonutility because it is plant that is not used and useful for utility operations.
>
> The utility recovers this interest expense by capitalizing the debt or interest cost via the debt component of the Allowance for Funds Used During Construction (AFUDC)**.** The amount to be capitalized is the net amount of the interest expense, after effect of income taxes, or approximately 50% of interest expense. This method is called the "net method," and is consistent with the [USOA.]
>
> Excluding such interest expense as a tax deduction in the income tax calculations for rate fixing in the test-year results in the test-year income taxes being greater than if calculated on an "as-paid" basis. However, because the tax effect of the AFUDC is credited to plant, rates for future ratepayers

> will be lower due to the lesser depreciation of, and return on, the net cost of borrowed funds in plant accounts.
>
> * * * *
>
> Our primary consideration is the matching of interest expense with the rate base treatment of the investment. We agree that the net method is consistent with the exclusion of CWIP from rate base. If the present ratepayers do not bear the burden of financing new plant, it follows that their rates should not be lower based on the tax consequences of that investment in new plant.
>
> * * * *
>
> We recognize that the use of the net method contributes to the disparity between taxes allowed and taxes paid. However, the purpose of this proceeding is not necessarily to eliminate such disparities. In this instance the disparity results from the consistent application of a principle that we have found to be in the public interest, the exclusion of CWIP from rate base. We are not persuaded that regulatory credibility is enhanced by a change in these well-founded policies. (D.84-05-036, 15 CPUC 2d 42, 45, 46, and 47.)

The previously quoted passages from D.84-05-036 demonstrate that the Commission's use of normalized tax accounting for IDC was a narrowly tailored exception to its flow-through policy. It is axiomatic that the only taxes a utility should be allowed to recover in rates are those that are incurred during the course of providing service to the public. The Commission applied this axiom in D.84-05-036 when it held that its flow-through policy did not apply to tax deductions for interest costs associated with assets that were excluded from rate base. By normalizing IDC, the Commission ensured that tax deductions for IDC

would be reflected in rates only when the assets financed by IDC were placed into utility service.[207]

Unlike Pacific, we do not interpret the application of normalized tax accounting to IDC in D.84-05-036 as evidence that the Commission did not have a flow-through policy. In fact, the Commission specifically held in D.84-05-036 that its flow-though policy should remain in effect to the extent allowed by law.[208] This holding eviscerates Pacific's claim that D.84-05-036 somehow shows that the Commission did not have a flow-though policy in effect during the audit period.

In D.87-09-026, the second decision cited by Pacific, the Commission considered the regulatory treatment of income taxes arising from contributions in aid of construction (CIAC). CIAC consists of assets, property, or money contributed to a public utility for the purpose of expanding, improving, or replacing the utility's facilities.[209] Public utilities are required by federal law to pay income taxes on CIAC in the year the contributions are received.[210]

Decision 87-09-026 required large utilities to pay the income taxes on CIAC, include such taxes in rate base, and amortize the taxes over the life of the CIAC assets. Although this practice accorded normalized tax accounting to

[207] Subsequent to D.84-05-036, federal tax laws were revised so that IDC had to be capitalized and deducted for federal tax purposes over the life of the asset. (D.88-01-061, 27 CPUC 2d 310, 317 – 18.)

[208] D.84-05-036, 15 CPUC 2d 42, 53-54, 60, and 61.

[209] D.87-09-026, 25 CPUC 2d 299, 305. CIAC often occurs when real estate developers construct utility facilities to serve a new development and then transfer the facilities to the public utilities serving the development.

[210] D.87-09-026, 25 CPUC 2d 299, 306.

CIAC,[211] it was consistent with Commission and Court precedent that prohibits utilities, to the extent allowed by law, from recovering more taxes in rates than are actually paid by utilities, since the normalized income taxes included in rates for CIAC under D.87-09-026 had already been paid by the utilities.

In D.87-12-063, the third decision cited by Pacific, the Commission considered whether to adopt the FCC's new USOA, known as Part 32, that included normalized tax accounting. In Conclusion of Law (COL) 30, the Commission rejected the normalized tax accounting embedded in Part 32 and required telephone utilities to continue to use flow-through tax accounting:

> Part 32 comprehensive normalization for income taxes should not be adopted. Flow-through of income taxes should continue. (D.87-12-063, COL 30, 26 CPUC 2d 349, 372.)

The Commission's reasons for rejecting normalized tax accounting and requiring the continued use of flow-through tax accounting were as follows:

> [T]he Federal tax law is volatile and . . . normalization would only benefit the ratepayers in the short-term. A substantial amount of time and analysis went into our affirmation of a generic flow-through policy [in D.84-05-036]. The telephone utilities have not convinced us that the generic policy should be modified for telephone utilities. **Therefore, the policy of flowing through tax benefits should continue as a generic**

[211] Under the so-called Method 5, the Commission required the party contributing the CIAC to pay to the utility an amount equal to the present value of the revenue requirement for the taxes included in rate base. The utility, in turn, was required to reduce its rate base by this amount. (D.87-09-026, 25 CPUC 2d 299, 309, 330, and 337.) The result was that the contributors paid much of the income taxes associated with CIAC. (Id., 303, 330, and 336.) The Commission also allowed large utilities the option of using the so-called "Maryland Method." Unlike Method 5, which allocated the income tax arising from CIAC between contributors and ratepayers, the Maryland Method allocated the income tax between contributors and shareholders. (Id., FOF 6, 25 CPUC 2d 299, 535.) Because the Maryland Method had no effect on rates, it is not relevant to resolving the issue of whether the Commission required normalized tax accounting or flow-through tax accounting.

> **ratemaking policy and the telephone utilities should continue, as they have in the past to maintain memorandum records reflecting the accounting for both flow-through and normalization of taxes**. (D.87-12-063, 26 CPUC 2d 349, 361. Emphasis added.)

The above excerpts from D.87-12-063 demonstrate that the Decision required telephone utilities, including Pacific, to use flow-through tax accounting.

Although D.87-12-063 directed telephone utilities to maintain memorandum records reflecting both flow-through and normalized tax accounting, this does not indicate, as Pacific claims, that the Commission was aware that Pacific did not use flow-through tax accounting for every component of income tax expense. Decision 87-12-063 was referring to all telephone utilities, not just Pacific, making it unlikely that D.87-12-063 was singling out the accounting practices employed by Pacific. It is far more likely that D.87-12-063 was referring to the separate accounting records that utilities had to maintain for tax, external financial reporting, and regulatory purposes.[212] For example, prior to D.87-12-063 utilities had to use flow-through tax accounting for Commission purposes and normalized tax accounting for external reporting purposes. Consequently, it was essential for utilities to maintain records reflecting both flow-through and normalized tax accounting. Decision 87-12-063 increased the need for telephone utilities to maintain records reflecting both flow-through and normalization because the Decision required the continued use of flow-through for Commission regulatory purposes even though the FCC had switched to normalization. In any event, D.87-12-063 expressly rejected normalized tax accounting,[213] retained flow-though tax accounting as the Commission's generic

[212] D.87-12-063, FOF 38, 26 CPUC 2d 349, 370.

[213] D.87-12-063, COL 30, 26 CPUC 2d 349, 372.

policy, and required utilities to maintain memorandum accounting records that reflected flow-through tax accounting. There is nothing in D.87-12-063 that exempted Pacific from this policy.[214]

In D.88-01-061, the fourth decision cited by Pacific, the Commission considered the ratemaking implications associated with a change in the federal tax treatment of IDC. Prior to 1986, utilities were allowed to deduct for tax purposes all the interest costs they incurred to finance construction. With the passage of the Tax Reform Act of 1986 ("TRA 86"), utilities were required to capitalize IDC for federal income tax purposes on 100% of construction costs beginning in 1987. The requirement to capitalize construction-related interest costs for tax purposes reduced the amount of interest available as a current tax deduction, resulting in higher taxable income.

For ratemaking purposes, the Commission required utilities to capitalize "allowance for funds used during construction" (AFUDC) on 100% of construction costs. AFUDC includes both an interest component (IDC) and an equity component. The Commission's use of AFUDC resulted in less interest costs (but more equity costs) being capitalized for regulatory purposes than for tax purposes.[215] Because utilities capitalized more of their interest costs for tax purposes than for regulatory purposes, there was less interest available as a current tax deduction for tax purposes than for regulatory purposes, resulting in higher taxable income for tax purposes than for regulatory purposes.

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[214] D.87-12-063, COL 26, COL 32, and OP 1, required Pacific to maintain previously established accounting requirements unless changes were authorized by the Decision. (26 CPUC 2d 349, 361, 372.) There is nothing in D.87-12-063 that authorized Pacific to deviate from the flow-through tax accounting requirements previously established by the Commission.

[215] Unlike interest costs, equity costs (including capitalized equity costs) cannot be deducted for federal tax purposes.

The Commission concluded in D.88-01-061 that utilities should normalize the income tax effects associated with IDC.[216] This had the effect of spreading the higher income taxes initially paid by the utilities over the depreciable lives of the assets financed by IDC.[217] The Commission's decision to normalize IDC was consistent with Commission and Court precedent that prohibits utilities, to the extent allowed by law, from recovering more taxes in rates than actually paid by utilities, since the normalized income taxes included in rates for IDC pursuant to D.88-01-026 had already been paid by the utilities.

Decision D.88-01-061 also allowed, but did not require, utilities to apply normalized tax accounting to vacation pay. The Commission's reason for doing so was that recent changes in federal tax law had made it beneficial to ratepayers to apply normalized tax accounting to vacation pay instead of flow-through accounting. However, the Commission made it unequivocally clear in D.88-01-061 that allowing utilities to apply normalized tax accounting to vacation pay was a limited exception to the Commission's generic flow-through policy.[218] Thus, Pacific's argument that D.88-01-061 demonstrates that Commission did not have a flow-through policy is without merit.[219]

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[216] D.88-01-061, 27 CPUC 2d 310, 317-318.

[217] The higher taxes initially paid by utilities were recouped for regulatory purposes over the tax lives of the assets, since utilities were able to deduct more depreciation costs (i.e., deduct more capitalized interest costs) for tax purposes than for regulatory purposes, resulting in lower taxable income (and lower taxes) for tax purposes than for regulatory purposes.

[218] D.88-01-061, 27 CPUC 2d 310, 323.

[219] Pacific applied flow-through tax accounting to its vacation pay accruals during the audit period of 1997 – 1999. (Overland Exhibits Phase 2A: 402, Part 1, pp. 58 – 59, and 404, Vol. 2, p. 9-10; Pacific Exhibit Phase 2A: 318, pp. 16-17.) This is ironic given that (i) Pacific argues that it was required to use normalized tax accounting during the audit period, and (ii) D.88-01-061 authorized the use of normalized tax accounting for vacation pay accruals.

In D.90-12-034, the fifth decision cited by Pacific, the Commission modified the provision in D.89-11-058 concerning when the California Corporation Franchise Tax (CCFT) should be recognized as a deduction for computing federal income tax (FIT) expense for regulatory purposes. Under the particular method of flow-through accounting for CCFT adopted by D.89-11-058, the prior year's CCFT was to be used as a deduction for computing the current year's FIT.[220] The amount of the prior year's CCFT was to be either the adopted test-year estimate of CCFT or the attrition-year estimate of CCFT.

There are no test years or attrition years under NRF. Hence, it was not possible under NRF to use the particular method of flow-through accounting for CCFT adopted by D.89-11-058. Consequently, D.90-12-034 authorized Pacific to use the current year's CCFT to calculate the current year's FIT, which had the effect of applying normalized tax accounting to CCFT. However, D.90-12-034 did not represent a repudiation of flow-through tax accounting under NRF as Pacific contends. Rather, it was a pragmatic response by the Commission to the inability under NRF to use the particular method of flow-through accounting for CCFT adopted by D.89-11-058.[221]

In D.94-12-022, the final decision cited by Pacific, the Commission adopted a stipulation that used "full normalization" to set rates for Southwest Gas Corporation.[222] As Pacific is well aware, Rule 51.8 provides that the

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[220] At the time D.90-12-034 was issued, federal tax laws required the prior year's CCFT to be used as a deduction in computing the current year's FIT. Federal tax laws have since been revised so that the current year's CCFT may be used to compute the current year's FIT.

[221] As noted in the previous footnote, tax laws have been revised since the issuance of D.90-12-034 so that the current year's CCFT may be used to compute the current year's FIT. As a result, the method of tax accounting for CCFT adopted by D.90-12-034 is now consistent with flow-through tax accounting.

[222] D.94-12-022, 57 CPUC 2d 646, 651, and 657.

Commission's adoption of a stipulation does not constitute approval of, or precedent for, any principle or issue unless the Commission expressly provides otherwise. There is nothing in D.94-12-022 that remotely indicates the stipulation adopted therein constitutes precedent for tax-accounting issues. Consequently, D.94-12-022 is not relevant to any tax-accounting issue in the instant proceeding.

Assuming, *arguendo*, that D.94-12-022 did constitute precedent on the issue of normalization versus flow-through, it would be necessary to examine the Commission's reasons for adopting normalization in D.94-12-022 to determine if those reasons are pertinent here. The stipulation adopted by D.94-12-022 provided the following reasons for using normalization:

> For purposes of this Stipulation, it is agreed that Southwest shall utilize full normalization along with amortization of the unfunded future tax liability . . . **It is agreed that full normalization and amortization of the unfunded future tax liability yields a lower revenue requirement than flow through**. (D.94-12-022, 57 CPUC 2d 646, 657. Emphasis added.)

The above excerpt from D.94-12-022 demonstrates that the Commission's decision to allow a single utility to use "full normalization" instead of flow-through tax accounting resulted in a lower revenue requirement and thus benefited ratepayers. In complete contrast, Pacific's use of normalized tax accounting during the audit period of 1997 – 1999 reduced its earnings by $50.4 million with respect to Phase 2A issues.[223] Accordingly, D.94-12-022 does not support Pacific's claim that it was proper for Pacific to use normalized tax accounting during the audit period.

[223] Appendix L of today's decision, Column D, Line 4.

c. Resolution F-634

In Resolution F-634, issued on January 5, 1995, the Commission adopted SFAS 109 for regulatory accounting purposes and the FCC's related amendments to the USOA. Pacific contends that because SFAS 109 and the FCC's USOA require normalized tax accounting, Resolution F-634 must have adopted normalized tax accounting.

Pacific reads too much into Resolution F-634. Pacific has been required to use normalized tax accounting for external reporting purposes since 1967 [224] and for FCC purposes since 1988.[225] SFAS 109 and the related amendments to the FCC's USOA merely refined how companies should account for income taxes. For items that receive flow-through treatment, SFAS 109 requires regulated utilities to present a deferred income tax liability and an associated regulatory asset or liability as separate items on the balance sheet.[226] Prior to SFAS 109, the deferred income tax liability and the associated regulatory asset/liability were offset against each other. As a result, there was no recognition of either on the balance sheet. The change in balance sheet presentation adopted by SFAS 109 did not have any effect on net income.

SFAS 109 does not require utilities to use normalized tax accounting for regulatory purposes. To the contrary, SFAS 109 contemplated that utilities would use flow-through tax accounting for regulatory purposes, as evidenced by the requirement in SFAS 109 for regulated utilities to report on their balance

[224] Resolution F-634, *mimeo.*, p. 2; Pacific Exhibit Phase 2A: 333, Binder 2, Tab 17.

[225] D.87-12-063, 26 CPUC 2d 349, 353, 360-61, 368.

[226] SFAS 109, Para. 29, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 26.

sheets a deferred tax liability and an offsetting regulatory asset or regulatory liability "for the tax benefits that are flowed through to customers.[227]"

To implement the new balance sheet presentation required by SFAS 109, the FCC added the following three new accounts to the USOA[228]:

Account 1437 – Deferred Tax Regulatory Asset.

Account 4341 – Net Deferred Tax Liability.

Account 4361 – Deferred Tax Regulatory Liability.

The three new accounts were specifically intended to put into practice the deferred tax liability and the regulatory asset/liability contemplated by SFAS 109 for the "tax effects of temporary differences accounted for under the flow-through method."[229]

It is noteworthy that Resolution F-634 never states that it is adopting normalized tax accounting. Presumably, if the Commission had intended to adopt normalized tax accounting, it would have said so. Instead, the Resolution states that it is adopting SFAS 109 and the FCC's related amendments to the USOA, and it explicitly acknowledges that SFAS 109 and the FCC's related amendments to the USOA establish new accounting requirements with respect to flow-through ratemaking.[230]

The fact that Resolution F-634 did not expressly adopt normalized tax accounting takes added significance given that (1) the Commission had previously adopted flow-through tax accounting as its generic policy, (2) the

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[227] SFAS 109, Para. 29, Pacific Exhibit Phase 2A: 333, Index Tab 26. Emphasis added.

[228] FCC Order 94-28, Paras. 10-13 and Appendix B, Pacific Exhibit Phase 2A: 333, Binder 3, Tab 30.

[229] FCC Order 94-28, Para. 10 and Appendix B, Section 32.4341, Pacific Exhibit Phase 2A: 333, Binder 3, Tab 30. Emphasis added

[230] Resolution F-634, *mimeo.*, pp. 3 and 4.

Commission had previously rejected normalized tax accounting and held that the use of normalized tax accounting for ratemaking was unlawful in many circumstances, and (3) the adoption of normalized tax accounting would have had significant implications for ratemaking.[231] If the Resolution had intended to adopt normalized tax accounting, it should have addressed why it was necessary to abandon the Commission's flow-through policy, why the use of normalized tax accounting was no longer unlawful in many circumstances, and why it was appropriate to adopt normalized tax accounting given the significant ratemaking implications of doing so. Tellingly, the Resolution did not address these matters. In addition, the Resolution did not consider if the abandonment of the Commission's long-established flow-though policy was subject to Pub. Util. Code Section 1708.[232] The aforementioned circumstances strongly suggest that the Commission did not intend to abandon its flow-through policy in Resolution F-634.[233]

We are not persuaded by Pacific's argument that the provisions in Section 1708 that require notice and an opportunity for hearing prior to changing a Commission decision were satisfied because, as stated in Resolution F-634, Pacific's Advice Letter (AL) 17024 in which Pacific requested authority to adopt

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[231] For example, Pacific's use of normalized tax accounting with respect to Phase 2A issues increased Pacific's net income during 1997 and 1998, when the earnings-sharing mechanism was in effect, by $115.3 million compared to flow-through tax accounting. (Appendix L of today's decision, Column D, Lines 1 and 2.)

[232] Section 1708 states, in relevant part, as follows: "The commission may at any time, upon notice to the parties, and with opportunity to be heard…rescind, alter, or amend any order or decision made by it."

[233] It is the Commission's general practice to issue decisions, and not resolutions, to promulgate major changes in policy. Thus, it is unlikely that the Commission intended in Resolution F-634 to adopt a major change in policy by replacing flow-through tax accounting with normalized tax accounting.

SFAS 109 and the FCC's related amendments to the USOA was noticed in the Commission's Daily Calendar and mailed to interested parties.[234] Pacific's advice letter did not state that Pacific sought to replace the Commission's flow-through policy with normalized tax accounting. Rather, the advice letter stated that SFAS 109 and the related amendments to the USOA established new accounting requirements for "items accounted for under the flow through method.[235]" The advice letter also stated that "the adoption of SFAS 109 will have no impact on future income statement related accounts.[236]" As explained below, it is highly likely and easily foreseeable that any switch from flow-through accounting to normalized tax accounting would have impacted income statement related accounts.[237] In sum, AL 17024 cannot be reasonably construed as having provided notice that Pacific sought to replace the Commission's flow-through policy with normalized tax accounting.

Additional evidence that Resolution F-634 did not alter the Commission's flow-through policy is found in the Resolution's requirement that SFAS 109 and

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[234] We take official notice of AL 17024 pursuant to Rule 73 of the Commission's Rules of Practice and Procedure. Rule 73 provides that "official notice may be taken of such matters as may be judicially noticed by the courts of the State of California." Evidence Code § 452(d) authorizes trial courts to take judicial notice of the records of any state or federal court. Additionally, courts may take judicial notice of the records and files of state agencies, including those of the Commission. (Pratt v. Coast Trucking, Inc. (1964) 228 Cal. App. 2d 139, 143-44.) AL 17024 constitutes an official record of the Commission, and the Commission may take official notice of its own records.

[235] AL 17024, p. 2.

[236] AL 17024, p. 3. Emphasis added.

[237] As shown in Appendix L, Pacific's use of normalized tax accounting with respect to Phase 2A issues increased Pacific's income tax expense by $50.4 million during the audit period. Therefore, even though Pacific's AL 17024 stated that "the adoption of SFAS 109 will have no impact on future income statement related accounts," Pacific's decision to use normalized tax accounting under the guise of implementing SFAS 109 had an impact of at least $50.4 million on income statement related accounts.

the companion amendments to the USOA be implemented on a revenue-neutral basis.[238] Because utility revenues were unaffected by the accounting changes adopted by Resolution F-634, the Resolution waived the requirement established by D.87-12-063 for utilities to submit studies showing the impact that changes in GAAP, if adopted for regulatory purposes, would have on utility revenues.[239]

It is unlikely that switching from flow-through to normalized tax accounting would be revenue neutral. This is especially true for telephone utilities that continued to be subject to cost-of-service regulation.[240] Pacific's own implementation of normalized tax accounting shows why switching from flow-through to normalized tax accounting may not be revenue neutral. In particular, Pacific's use of normalized tax accounting with respect to Phase 2A issues increased Pacific's net income during 1997 and 1998, when the earnings-sharing mechanism was in effect, by $115.3 million compared to flow-through tax accounting.[241] Any change in Pacific's earnings could potentially affect its revenues via the earnings-sharing mechanism. In short, the only way for Resolution F-634 to ensure the mandated revenue neutrality was to retain the existing flow-through policy.[242]

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[238] Resolution F-634, *mimeo.*, pp. 1, 4, 5, and 6.

[239] D.87-12-063, OP 12.b, 26 CPUC 2d 349, 373; Resolution F-634, OP 3, *mimeo.*, p. 6.

[240] Resolution F-634 applied to all telephone utilities subject to the FCC's Part 32 and the Commission's jurisdiction. (Resolution F-634, OPs 1 and 2, *mimeo.*, p. 6.) The FCC's Part 32 applies to all California local exchange telephone utilities. (Id., p. 4 and FOF 1, p. 5.)

[241] Appendix L of today's decision, Column D, Lines 1 and 2.

[242] To ensure revenue neutrality, Resolution F-634 required telephone utilities to record deferred tax liabilities for items that receive flow-through treatment and to also record regulatory assets/liabilities (instead of deferred income tax expenses) to offset the deferred tax liabilities. Following the issuance of Resolution F-634, Pacific recorded the deferred tax liabilities, but also recorded deferred income tax expenses in many instances instead of the offsetting regulatory assets/liabilities. As a result, Pacific implemented Resolution F-634 in a

Footnote continued on next page.

Finally, Pacific's claim that it was required by Resolution F-634 to use normalized tax accounting is inconsistent with Pacific's own accounting practices. During the audit period Pacific applied flow-through tax accounting to the following items[243]:

- Depreciation expense for state income tax purposes.
- Vacation pay accrual.
- Uncollectible accounts accrual.
- Property tax accrual.
- Payroll tax (FICA) accrual.
- IDC - - FCC versus Commission rate difference.

Pacific's use of flow-through tax accounting for the above items contradicts its claim that it was required by Resolution F-634 to use normalized tax accounting.

For the preceding reasons, we conclude that Resolution F-634 did not adopt normalized tax accounting, but additional accounting requirements pertaining to flow-through tax accounting. Prior to Resolution F-634, deferred income tax liabilities were not recognized for items that received flow-through treatment. Under SFAS 109 and the related amendments to the USOA adopted by Resolution F-634, deferred tax liabilities are recorded for items that receive flow-through treatment and an offsetting regulatory asset or regulatory liability is also recorded. That change "grossed-up" the balance sheet by increasing assets and liabilities by equal amounts with no impact on net income. Thus, Resolution F-634 represented a relatively minor technical refinement to flow-through tax accounting and did not alter the Commission's flow-through policy.

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way that increased the amount of deferred income tax expense it reported, which had the potential for affecting Pacific's revenues via the earnings-sharing mechanism.

[243] Overland Exhibit Phase 2A: 402, Part 1, pp. 58 – 59; Overland Exhibit Phase 2A: 404, Volume 2, p. 9-10; Pacific Exhibit Phase 2A: 318, pp. 16-17.

d. NRF Startup Revenue Requirement

The Commission adopted Pacific's startup revenue requirement under NRF in D.89-12-048. The startup revenue requirement was based on the financial information contained in Pacific's monthly Results of Intrastate Operations Reports for the first eight months of 1989.[244] Pacific testified that the income tax expense shown in these reports included items that received normalized tax treatment.[245] To primary support for Pacific's testimony is Attachment 1 of Exhibit Phase 2A: 318 (referred to hereafter as "Attachment 1"), which lists every item of normalized tax expense that was included in Pacific's startup revenue requirement and the amount of deferred income tax expense for each item.[246]

Attachment 1 shows convincingly that Pacific's startup revenue requirement included items that received normalized tax treatment in contravention of the Commission's flow-though policy. However, there is no evidence that the Commission in D.89-12-048 knew that Pacific's startup revenue requirement did not comply with the Commission's flow-through policy.[247] In particular, the reports that Pacific submitted to establish its startup revenue requirement were not usually used for ratemaking purposes,[248] and there was apparently no indication in the reports that the tax expenses reflected therein did

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[244] D.89-10-031, OP 14, 33 CPUC 2d 43, 192.

[245] Pacific Exhibit Phase 2A: 318, pp. 15 – 16.

[246] Deferred income tax expense only occurs with normalized tax accounting; there is no deferred income tax expense with flow-through accounting.

[247] Attachment 1 lists SFAS 87 as an item that received normalized tax treatment in Pacific's startup revenue requirement. The Commission rejected SFAS 87 for intrastate regulatory purposes in D.87-03-072. Therefore, if Attachment 1 demonstrates that the Commission knowingly adopted normalized tax accounting, which it does not, then it also demonstrates that the Commission knowingly adopted SFAS 87 for regulatory purposes. As described previously in today's decision, Pacific incurred hundreds-of-millions of dollars of negative pension costs under SFAS 87 during the audit period.

[248] D.91-11-023, 41 CPUC 2d 647, 657.

not conform to the Commission's flow-through policy.[249] It also appears that Pacific did not inform the Commission that the reports did not conform to the Commission's flow-through policy.[250] In addition, the Commission did not audit the reports that Pacific submitted to establish its startup revenue requirement.

The parties' review of Pacific's reports took place during a two-week period between October 26, 1989, when the reports were submitted, and November 9, 1989, when responses were filed.[251] No evidentiary hearings were held but workshops took place on November 17 and 28.[252] Final pleadings were filed three days later on December 1, 1989. The Commission's own review ended December 18, 1989, when it issued D.89-12-048, the decision adopting Pacific's startup revenue requirement. Decision 89-12-048 did not address, let alone approve, Pacific's use of normalized tax accounting for certain items in its startup revenue requirement.

Given the impressive list of Commission and Court decisions that require flow-through tax accounting for regulatory purposes, it is unreasonable to conclude that the Commission in D.89-12-048 abandoned its decades-old policy of using flow-through tax accounting without uttering a single word that it was

[249] Pacific Exhibit Phase 2A: 318, Attachment 2, contains parts of the reports that Pacific filed to establish its startup revenue requirement. There is nothing in Attachment 2 that indicates the tax expenses reflected therein did not conform to the Commission's flow-through policy.

[250] There is no indication in the record of this proceeding that (i) Pacific submitted Attachment 1 to the Commission in the proceeding leading to the adoption of Pacific's startup revenue requirement in D.89-12-048, or (ii) Pacific informed the Commission prior to D.89-12-048 that the reports Pacific had submitted to establish its startup revenue requirement did not conform to the Commission's flow-through policy.

[251] D.89-10-031, OP 14, 33 CPUC 2d 43, 234.

[252] D.89-12-048, 34 CPUC 2d 155, 165.

doing so.[253] A far more plausible explanation is that the Commission, in its hurried adoption of Pacific's multi-billion dollar startup revenue requirement, presumed the reports that Pacific had submitted to establish its startup revenue requirement complied with the Commission's flow-through policy.

Pacific, like the Commission, apparently did not realize that its startup revenue requirement contained many items of normalized tax expense in contravention of the Commission's flow-through policy. More specifically, in D.89-11-058 the Commission ordered Pacific to apply flow-though tax accounting to CCFT.[254] However, contrary to D.89-11-058, Attachment 1 shows that CCFT was normalized in Pacific's startup revenue requirement adopted in D.89-12-048. Following the issuance of D.89-12-048 in December 1989, Pacific filed a petition to modify D.89-11-058 in September 1990 to allow Pacific to use normalized tax accounting for CCFT in lieu of the flow-through method adopted in D.89-11-058.[255] If the Commission had adopted normalized tax accounting for CCFT in D.89-12-048 as Pacific now claims, it would have superseded the flow-though accounting for CCFT adopted in D.89-11-058 and Pacific would not have had to file a petition to modify D.89-11-058. The fact that Pacific filed such a petition demonstrates that Pacific believed at the time that flow-through

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[253] There is no evidence in this proceeding that the Commission provided notice prior to D.89-12-048 that the Commission was contemplating the abandonment of its flow-through policy as would have been required by Pub. Util. Code Section 1708. The lack of such notice, as well as the lack of any findings of fact or conclusions of law regarding the abandonment of the flow-through policy as would have been required by Section 1705, strongly suggests that the Commission did not intend to abandon its flow-through policy in D.89-10-048.

[254] D.89-11-058, 33 CPUC 2d 495, 506.

[255] D.90-12-034, 1990 Cal. PUC LEXIS 1292, *1 - *2. The Commission granted Pacific's petition in D.90-12-034. (Id.) For the reasons described previously, the Commission's decision in D.90-12-034 to allow Pacific to apply normalized tax accounting to CCFT was a narrowly tailored exception to the Commission's general policy of using flow-through tax accounting.

accounting continued to apply to CCFT after the adoption of Pacific's startup revenue requirement in D.89-12-048, even though CCFT had been normalized in Pacific's startup revenue requirement.

Two Commission decisions issued after the adoption of Pacific's startup revenue requirement in D.89-12-048 indicate that the Commission's flow-through policy remained in effect under NRF. First, in Resolution F-627, issued on September 12, 1990, the Commission considered an advice letter filed by Pacific on April 23, 1990, wherein Pacific requested, among other things, authority to recover costs associated with the application of flow-through to compensated absences (e.g., vacation pay). Resolution F-627 contains the following description of Pacific's request:

> Pacific states that since California is a "flow through" jurisdiction for ratemaking purposes, tax benefits received by utilities are passed on to ratepayers. "For tax purposes, Pacific took a deduction each year for compensated absences that were earned in that year and expected to be paid the next year (i.e., using accrual accounting)." This tax benefit was flowed-through in the ratemaking process. (Resolution F-627, *mimeo.*, p. 6. Quotation marks in original.)

Resolution F-627 granted Pacific's request to apply flow-through tax accounting to compensated absences, stating: "Pacific should apply the net-to-gross multiplier [i.e., flow-through tax accounting][256] to calculate the revenue requirement associated with embedded compensated absences.[257]"

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[256] The purpose of the net-to-gross multiplier is to "gross up" the revenue requirement for items that are not tax deductible. For example, if a utility incurs $100 of expenses that are not tax deductible, and the utility has a tax rate of 50%, the utility would have to recover $200 in rates in order to receive $100 after taxes to pay for $100 of non-deductible expenses.

[257] Resolution F-627, *mimeo.*, p. 6. In Resolution F-627, the Commission authorized Pacific to recover additional costs for compensated absences as a Z-Factor. Pacific told the

Footnote continued on next page.

Second, in D.92-12-015, the Commission determined that utilities should not be allowed to recover in rates any SFAS 106 costs in excess of tax-deductible contributions because:

> [T]o authorize . . . full recovery [of SFAS 106 costs] would place an unnecessary financial burden on ratepayers. This is because [allowing utilities to recover SFAS 106 costs in excess of tax-deductible contributions] would require ratepayers to compensate utilities for income taxes applicable to non-taxable contributions. In other words, ratepayers would be required to pay an additional $670,000 for every $1 million that utilities contribute to [a PBOP trust fund], according to . . . net-to-gross calculations, with no additional benefit going to ratepayers. (D.92-12-015, 46 CPUC 2d 499, 520.)

Under normalized tax accounting, there is no need to gross-up SFAS 106 costs that are not currently deductible because the SFAS 106 costs and the associated tax deduction are recognized simultaneously for regulatory accounting purposes, regardless of when the tax deduction is actually taken. Only under flow-through tax accounting would there be a need to gross-up SFAS 106 costs that are not currently tax-deductible. The fact that D.92-12-015 concluded that there would be a need to gross-up SFAS 106 costs that are not currently deductible demonstrates that the Decision was viewing such costs through the lens of flow-through tax accounting.

We disagree with Pacific's claim that D.91-07-056 affirmed the use of normalized tax accounting in Pacific's startup revenue requirement. In

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Commission that it had previously deducted these costs for tax purposes and had flowed through the tax benefits to ratepayers. Thus, when Resolution F-627 authorized Pacific to recover these additional costs in rates, there was no offsetting tax deduction (which had previously been taken, according to Pacific), and it was necessary to use the net-to-gross multiplier to calculate the after-tax revenue requirement under flow-through tax accounting.

D.91-07-056, the Commission considered if certain ratemaking adjustments listed in a staff report should be excluded from the calculation of sharable earnings.[258] Noticeably absent from the list was any mention of income taxes.[259] Accordingly, D.91-07-056 did not consider, let alone affirm, the regulatory treatment of income taxes in Pacific's startup revenue requirement.[260]

Pacific argues that the Commission had ample opportunity to discover Pacific's use of normalized tax accounting in the proceeding that led to the establishment of Pacific's startup revenue requirement in D.89-12-048 and in the reports that Pacific has submitted to the Commission ever since. According to Pacific, it is simply too late to raise the issue now. We disagree. The burden was on Pacific to disclose its deviation from the Commission's well-established flow-through policy, not on the Commission to discover the deviation. Pacific's startup revenue requirement was not audited, and this proceeding marks the first comprehensive audit of Pacific since the inception of NRF. Pacific's

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[258] D.89-10-031, 33 CPUC 2d 43, 186, 230-31, and 235; D.91-07-056, 41 CPUC 2d 89, 125; and the Workshop III Report, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 18 pp. 1, 4, and 5.

[259] It is not surprising that the Workshop III Report did not list income taxes as a "ratemaking adjustment." As stated in the Report, the ratemaking adjustments addressed by the Report did "not include the modifications that [Pacific was] required to make to [its] books . . . to reflect operations in accordance with Commission-mandated exceptions to the FCC Part 32 rules." (Pacific Exhibit Phase 2A: 333, Binder 2, Tab 18, p. 5.) In D.87-12-063, the Commission explicitly rejected those portions of the FCC's Part 32 rules that required the use of normalized tax accounting and ordered Pacific to maintain memorandum records reflecting flow-through tax accounting. (26 CPUC 2d 349, 361.) Consequently, the Commission's policy regarding flow-through tax accounting did not constitute a "ratemaking adjustment" as defined by the Workshop III Report.

[260] Although the Workshop III Report adopted by D.91-07-056 states that the NRF startup revenue requirement included all Commission-mandated ratemaking adjustments, the scope of this statement did not encompass the Commission's policy regarding flow-through tax accounting because (i) of the reasons set forth in the previous footnote, and (ii) the Report listed all ratemaking adjustments included in the NRF startup revenue requirement and Commission's policy regarding flow-through tax accounting was not on the list. (Workshop III Report, Verizon Exhibit Phase 1: 207, p. 5 and Appendix A.

suggestion that the Commission should have discovered and corrected Pacific's improper use of normalized tax accounting before now is baseless.

We are concerned by our discovery in this proceeding that Pacific's startup revenue requirement did not reflect the Commission's long-established policy regarding the proper regulatory treatment of income taxes. The Commission has believed since the inception of NRF that Pacific's startup revenue requirement reflected all of the Commission's regulatory policies and ratemaking adjustments.[261] Unfortunately, today's decision is not the first time the Commission has discovered that specific types of costs were not properly reflected in Pacific's startup revenue requirement. In D.91-11-023, the Commission found that costs associated with three below-the-line services (voice mail, electronic messaging, and voice store and forward) had been improperly included in Pacific's startup revenue requirement.[262] The Commission removed these costs from Pacific's rates in D.92-07-076.[263]

In the future, we will no longer assume that Pacific's startup rates reflected all of the Commission's regulatory policies and ratemaking adjustments. Henceforth, we may require any party that claims a particular regulatory policy or ratemaking adjustment has been reflected in Pacific's rates since the inception of NRF to demonstrate that its claim is true. Depending on circumstances, it might not be enough for a party to simply cite D.89-10-031, D.89-12-048, D.91-07-056, or the Workshop III Report. If appropriate, we may require a party to substantiate its claim by, for example, providing accounting records and/or

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[261] D.89-10-031, 33 CPUC 2d 43, 186; Workshop III Report, Pacific Exhibit Phase 2A: 333, Tab 18, p. 4.

[262] D.91-11-023, 41 CPUC 2d 647, 658-659, and 661.

[263] D.92-07-076, 45 CPUC 2d 158, 166-167 and 169-170.

exhibits submitted in the proceeding leading to the adoption of Pacific's startup revenue requirement in D.89-12-048.

B. Regulatory Treatment of Income Taxes on Revenues Received from the California High Cost Fund-B

1. Audit Findings

The Commission established the California High Cost Fund-B (CHCF-B) in D.96-10-066. The purpose of the CHCF-B is to subsidize the provision of affordable basic telephone service in high-cost areas of California served by the State's largest local exchange carriers. Funding for the CHCF-B is provided by a surcharge levied on all end-users of intrastate telecommunications services.

For tax purposes, Pacific reported the revenues it received from the CHCF-B in 1998 and 1999 as a reduction in construction costs. Consequently, Pacific paid no income taxes on the revenues.[264] For regulatory purposes, Pacific reported the CHCF-B revenues as income and, in accordance with normalized tax accounting, accrued income tax expense on its CHCF-B revenues even though Pacific did not actually pay any income taxes on the revenues.

Overland states that Pacific should have applied flow-through tax accounting to its CHCF-B revenues as required by the Commission's long-standing policy. If Pacific had done so, it would have reported no income tax expense on its CHCF-B revenues because it paid no taxes on the revenues. As shown in the following table, Pacific's income tax expense for intrastate regulatory purposes would have been lower by $203.6 million during 1998 and

[264] Pacific used the revenues it received from the CHCF-B to reduce the tax basis of its assets, which had the effect of reducing the depreciation expense that Pacific could deduct for tax purposes. As a result, the initial tax benefit that Pacific realized by not reporting the CHCF-B revenues as taxable income reverses over the tax life of the assets by reducing the depreciation expense that Pacific can deduct for tax purposes.

1999 if it had applied flow-through tax accounting to its CHCF-B revenues instead of normalized tax accounting.[265]

Reduction of Pacific's Reported Intrastate Income Tax Expense by Applying Flow-Through Tax Accounting to CHCF-B Revenues		
1998	**1999**	**Total**
($98,999,000)	($104,619,000)	($203,618,000)
Source: (1) Overland Exhibit Phase 2A: 404, Volume 2, p. 9-19, Table 9-4, and (2) Attachment J of today's decision, pp. J-2 and J-3, Column L, Row 3.		

2. Position of the Parties

a. ORA

ORA states that the Commission's policy required Pacific to apply flow-through tax accounting to its CHCF-B revenues. Pacific ignored that policy, according to ORA, in an effort to record additional income tax expense to reduce its sharable earnings and conceal its excessive profits.

b. Pacific

Pacific asserts that it was required by Resolution F-634 to apply normalized tax accounting to its CHCF-B revenues. Pacific is also concerned that recognizing zero tax expense on its CHCF-B revenues under flow-through accounting as recommended by Overland will adversely affect Pacific's cash position via the earnings-sharing mechanism that was in effect during 1998.

Pacific argues that its tax accounting for CHCF-B revenues is analogous to the tax accounting that the Commission adopted for contributions in aid of

[265] Pacific is not required by federal law to normalize CHCF-B revenues. Thus, applying flow-through accounting to this item for regulatory purposes would not cause a change in the tax treatment of CHCF-B revenues. (Overland Exhibit Phase 2A: 402, Part 2, p. S9-2.)

construction (CIAC) in D.87-09-026. Pacific contends that there is no reason to treat CHCF-B revenues differently than CIAC revenues.

Pacific represents that its treatment of CHCF-B revenues for tax purposes (i.e., treating its CHCF-B revenues as a reduction in construction costs instead of taxable income) is somewhat controversial and that the IRS might contest Pacific's position. Pacific states that because the IRS tax treatment is unresolved, the flow-through of CHCF-B tax benefits, rather than normalization, assumes the existence of tax benefits that may never materialize. Normalization avoids this problem, according to Pacific, and thereby encourages utilities to develop innovative tax positions that benefit ratepayers in the long run.

3. Discussion

As described previously in today's decision, the Commission's long-held policy has been to use flow-through tax accounting to the extent permitted by law. Pacific's use of normalized tax accounting for CHCF-B revenues failed to comply with the Commission's policy and caused Pacific to report federal income tax expenses for its CHCF-B revenues that had not been paid by Pacific.

We disagree with Pacific's position that it should not have to flow through the substantial tax benefits associated with CHCF-B revenues because doing so would negatively affect Pacific's cash position. Pacific's position is true only if there are sharable earnings. Assuming there are, adopting Pacific's position would result in ratepayers' cash position being negatively affected instead of Pacific's. We conclude that it is unfair for California's ratepayers to provide Pacific with the CHCF-B revenues and for Pacific to reap all of the tax benefits associated with the CHCF-B revenues. It is far more equitable for Pacific and its ratepayers to share the tax benefits in accordance with the earnings-sharing

mechanism that was in effect during 1998. There was no sharing mechanism in 1999, thereby allowing Pacific to keep all the tax benefits for that year.

Pacific does not persuade us that CHCF-B revenues are analogous to CIAC revenues and, therefore, the income taxes on CHCF-B revenues should receive the same regulatory treatment as the taxes on CIAC. Utilities pay income taxes on CIAC revenues in the year they receive the revenues and then amortize the income taxes for regulatory purposes over the life of the assets funded by the CIAC revenues.[266] The situation with CHCF-B revenues is the exact opposite. Pacific does not pay income taxes on CHCF-B revenues when it receives the revenues, but over the life of the assets funded by the CHCF-B revenues. We fail to see how the regulatory treatment of the income taxes on CIAC revenues justifies Pacific's decision to recognize all income tax expense on CHCF-B revenues up front for regulatory purposes even though Pacific has not yet paid the taxes. Moreover, the regulatory treatment of the income taxes on CIAC revenues comports with the Commission's flow-through policy for the reasons described previously, while Pacific's accounting for the income taxes on CHCF-B revenues does not.

For the foregoing reasons, we conclude that Pacific should have used flow-through tax accounting during the audit period to record and report the income taxes associated with CHCF-B revenues.

VII. Summary of Adopted Audit Adjustments and Refund

The following table summarizes the revisions to Pacific's net operating income (NOI) and rate base adopted in Phases 2A and 2B of this proceeding

[266] D.87-09-026, 25 CPUC 2d 299, 305-309.

(referred to hereafter as "the revisions") and the refund that Pacific owes to its ratepayers as a result of the revisions.

Summary of (1) the Adopted Revisions to Pacific's Recorded NOI and Rate Base, and (2) the Refund Owed to Pacific's Ratepayers Phases 2A and 2B			
	1997 ($000)	**1998 ($000)**	**1999 ($000)**
Net Operating Income Reported by Pacific	652,499	922,472	962,198
Adopted Audit Adjustments: Phase 2A	(7,924)	285,319	241,699
Adopted Audit Adjustments: Phase 2B	293,472	222,474	114,638
Adopted Net Operating Income	$938,047	$1,430,265	$1,318,535
Rate Base Reported by Pacific Bell	10,057,145	10,170,675	9,963,603
Adopted Audit Adjustments: Phase 2A	0	43,446	132,372
Adopted Audit Adjustments: Phase 2B	(787,018)	(823,685)	(639,172)
Adopted Rate Base	$9,270,127	$9,390,436	$9,456,803
Rate of Return (ROR) Reported by Pacific	6.49%	9.07%	9.66%
Adopted Audit Adjustments: Phase 2A	-0.08%	2.86%	2.34%
Adopted Audit Adjustments: Phase 2B	3.71%	3.30%	1.95%
Adopted ROR	10.12%	15.23%	13.94%
Sharing Trigger ROR	11.50%	11.50%	N/A
Refund - Sharable Earnings	None	$288,322	N/A
Refund – VEBA 1 PBOP Trust Withdrawal	N/A	N/A	$136,218
10% Interest: 1/1/99 through 7/31/03	N/A	$178,153	- -
10% Interest: 1/1/00 through 7/31/03	N/A	- -	$58,413
Refund Owed to Ratepayers	None	$466,475	$194,631
Total Refund Owed to Ratepayers Through 7/31/03: $661,106,000			

The Appendices attached to today's decision provide a detailed summary of the adopted revisions and their impact on Pacific Bell's NOI, rate base,

sharable earnings, and the refund owed to Pacific's ratepayers.[267] The Commission's Phase 2B audit decision addresses (1) the appropriate rate of interest on the refund owed to ratepayers, and (2) the procedures for implementing the refund.

Within 60 days from the effective date of today's decision, Pacific shall file an advice letter that contains the following: (1) amended financial monitoring reports for every year since 1997 that reflect all of the revisions, and (2) work papers that demonstrate Pacific has properly reflected the revisions in its amended financial monitoring reports. Pacific shall continue to reflect the revisions, as appropriate, in all future financial monitoring reports that it submits to the Commission. To this end, we will require Pacific to include documentation in the advice letter that demonstrates Pacific's accounting and reporting practices will henceforth comply with today's decision. This documentation shall include a sworn declaration by an officer of Pacific Bell which states that (i) Pacific no longer engages in the proscribed accounting and reporting practices, and (ii) Pacific has implemented procedures to ensure that its accounting and reporting practices will henceforth comply with today's decision.

The adopted revisions might affect various matters that have come before the Commission. To determine if this is the case, Pacific shall include within the previously described advice letter a compliance report that states what rates, charges, price ceilings, or price floors previously adopted by the Commission or currently being considered by the Commission would change based on the revisions to Pacific's revenues, expenses, NOI, rate base, and accounting and

[267] The numbers shown in the above table differ slightly from those shown in the Appendices of today's decision due to rounding. Today's decision adopts the revisions and refund shown in the Appendices.

reporting practices adopted by the Commission in Phases 2A and 2B of this proceeding. Pacific should identify the amount of any such change and provide work papers that show the derivation of the amount. Parties may file and serve comments and reply comments on Pacific's compliance report. The comments may suggest remedies and identify other possible effects stemming from the adopted revisions.[268] The comments and reply comments shall be due 30 and 45 days, respectively, after Pacific's compliance report is filed.

VIII. Allocation of Refund to Carrier Access Services

In the following section, we address the narrow issue of whether Pacific Bell's access services should receive a pro rata share of any refunds that result from the Commission's decisions issued in Phases 2A and 2B of this proceeding.

A. Position of the Parties

1. AT&T

AT&T states that the Commission determined in D.89-10-031 and D.94-06-011 that any refund of sharable earnings should go to end-users. To accomplish this objective, the Commission required the refund to be effected via a surcredit applied to all Category I services except for access services and certain other services.[269] The Commission excluded access services from the surcredit because there was no way to ensure that the telephone companies purchasing access services (a.k.a. "carriers") would pass through the surcredit to their customers (i.e., end-users). However, D.94-06-011 held out the possibility that

[268] If the revisions affect previously adopted rates, charges, price ceilings, or price floors (referred to collectively hereafter as "rates"), one possible remedy would be for Pacific to file advice letters in accordance with Pub. Util. Code Section 454 to correct the rates. Similarly, if the revisions affect proposals to changes rates that are currently pending before the Commission, one possible remedy would be for Pacific to submit amended filings in those proceedings to correct the proposed rates.

[269] D.89-10-031, 33 CPUC 2d 43, 188.

access services might receive a pro rata portion of sharable earnings in the future if carriers could ensure that the sharable earnings would be passed through to their customers.[270] AT&T states that in light of D.94-06-011, the Commission should allow carriers that purchase switched access services from Pacific Bell to participate in any refunds that result from Phases 2A and 2B provided the carriers are willing to pass through the refunds to their customers.

AT&T asserts that Pacific has earned excessive profits from intrastate access charges, which has stifled competition for interLATA services. By allowing carriers to receive and pass through refunds on switched access, the Commission would help to (1) level the playing field as Pacific enters the California interLATA market, and (2) return to the end-users of access services the excessive profits that Pacific has extracted from these customers.

AT&T avers that D.94-06-011 authorized carriers to receive refunds on all Category I services they purchase apart from access services. Category I currently includes unbundled network elements (UNEs) and wholesale services available for resale. AT&T urges the Commission to reiterate in this proceeding that carriers are entitled to receive refunds on Category I services.

AT&T opposes ORA's proposal to allow residential intraLATA toll services to receive a pro rata share of any refund. AT&T states that one of the main goals of NRF is to provide a check on monopoly power and to promote competition. Because the intraLATA toll market is competitive, there is no need for such services to receive a refund. In contrast, Pacific continues to have monopoly power in the market for switched access services.

[270] D.94-06-011, 55 CPUC 2d 1, 34.

2. ORA

ORA states that D.89-10-031 required any refund of sharable earnings to go to end-users via a surcredit applied to all Category I services except for access services and other services normally excluded from surcredits.[271] Since then, the Commission has moved most end-user services to Category II.[272] Thus, if the Commission's original mandate stands only a small subset of end-users would receive large refunds. ORA believes the public interest would be better served if the refund were extended to local exchange services and residential intraLATA toll services. These services include the end-users identified in D.89-10-031 and services for which Pacific still holds a dominant market share. ORA states that its proposal would ensure that the benefits of sharing are passed through to the end-users identified in D.89-10-031.

3. Pacific

Pacific's opposes AT&T's proposal to include access services in any refund. Pacific states that the Commission has twice determined that access services should be excluded from the sharing mechanism – once in D.89-10-031 and again in D.94-06-011. Additionally, the Commission in D.94-06-011 specifically rejected AT&T's argument that the exclusion of access services from the sharing mechanism discriminated against carriers.[273]

B. Discussion

In our Phase 2B audit decision, we conclude that any refund that results from the audit adjustments adopted in Phases 2A and 2B should be implemented via a surcredit and we specify the particular rates and charges (i.e., "services") to

[271] D.89-10-031, 33 CPUC 2d 43, 188.

[272] D.96-03-020, 65 CPUC 2d 156, 189-190.

[273] D.94-06-011, 55 CPUC 2d 1, 34.

which the surcredit should apply. AT&T and other carriers will benefit from the surcredit to the extent they purchase these services.

AT&T recommends that access services receive a pro rata share of any refund that results from Phases 2A and 2B. Our policy on this matter is well established. We previously concluded, and affirm here, that end-users are the appropriate recipients of any refund of sharable earnings that may occur under NRF since they create the underlying demand and pay for all communications services, either directly or indirectly.[274] We deliberately excluded access services from any refund of sharable earnings because such services are purchased by intermediaries – the carriers – and not by end-users, and there was no way to ensure that the carriers would pass along any refund to their customers.

In general, we are favorably disposed towards AT&T's proposal to allow carriers that purchase access services to receive refunds if they commit to pass through the refunds to their end users. However, in order to implement AT&T's proposal there must be a mechanism in place to ensure that the carriers do, in fact, pass through any refunds to their end users. Unfortunately, AT&T offered no details on what type of mechanism should be established, how it would be implemented, or when it would go into effect. Without more information, we are left with the same situation faced by the Commission in D.94-06-011. There, the Commission stated:

> Since the evidence in this proceeding does not present an assurance to the Commission that the [carriers] would pass through any shared earnings to their end-users, we will not include access services in the sharing mechanism.
> (D.94-06-011, 55 CPUC 2d 1, 34.)

[274] D.89-10-031, 33 CPUC 2d 43, 187-188; D.94-06-011, 55 CPUC 2d 1, 34.

Nothing in the record of Phase 2A of this proceeding warrants a different outcome from D.94-06-011. AT&T may raise this matter again in Phase 3B where we will consider whether to reinstate the currently suspended earnings-sharing mechanism. If we decide to reinstate the mechanism, we will also consider whether and how the mechanism should be revised. We encourage AT&T and other parties to present fully developed proposals in Phase 3B for ensuring that refunds of sharable earnings are passed through to end-users, including refunds allocated to flexibly priced services and/or intermediary services such as access services and UNEs.[275]

IX. Phase 3B Review Considerations

The record developed in Phase 2 of this proceeding may be used by the Commission in Phase 3 to determine whether and how NRF should be revised. Today's decision finds that Pacific significantly underreported its earnings during the audit period, resulting in millions of dollars of sharable earnings being improperly withheld from ratepayers. The substantial harm to ratepayers calls into question whether NRF in its current form adequately serves and protects the public interest. Parties are invited to address in Phase 3B whether and how NRF should be modified based on this finding.

X. Comments on the Proposed Decision

The proposed decision of the Administrative Law Judge (ALJ) was mailed to the parties in accordance with Pub. Util. Code Section 311(d) and Rule 77.1 of the Commission's Rules of Practice and Procedure. The following parties submitted comments and/or reply comments on the ALJ's proposed decision:

[275] UNEs are similar to access services in that both are inputs used by carriers to provide services to end-users rather than being services purchased by end-users directly.

_____. The parties' comments have been reflected, as appropriate, in the final decision adopted by the Commission.

XI. Assignment of Proceeding

The assigned Commissioner for this proceeding is Susan P. Kennedy. The assigned ALJ for Phase 2A of this proceeding is Timothy Kenney.

Findings of Fact

1. In D.88-03-072, the Commission determined that the Aggregate Cost Method (ACM) should be used to determine pension costs for regulatory accounting and ratemaking purposes.

2. During the audit period of 1997 - 1999, the value of Pacific's pension assets significantly exceeded the present value of all pension benefits that Pacific expected to pay to its then current employees, retirees, and other beneficiaries.

3. When pension assets exceed pension obligations, the mechanical application of the ACM formula produces negative pension costs.

4. Pacific recorded and reported zero pension costs for intrastate regulatory purposes during the audit period of 1997 through 1999. During that period, Pacific made no contributions to its pension funds.

5. Failure to recognize negative pension costs under the ACM when pension assets exceed pension obligations results in more pension costs being recognized than is necessary to provide pension benefits to all current employees, retirees, and other beneficiaries.

6. Decision 88-03-072 repeatedly states that the purpose of the ACM as used for regulatory purposes is to evenly spread the costs incurred by utilities to provide pension benefits over the service lives of active utility employees.

7. It is a well-established accounting practice to record and report negative pension costs and prepaid pension assets under appropriate circumstances.

8. In the financial reports that Pacific submitted to the SEC, FCC, and its shareholders during 1997 - 1999, Pacific reported negative pension costs and a prepaid pension asset pursuant to SFAS 87. Pacific's recognition of negative pension costs did not cause Pacific to withdraw funds from its pension trusts.

9. The recognition of negative pension costs for intrastate regulatory purposes does not mean that Pacific has received money by, for example, withdrawing assets from its pension trusts.

10. To the extent that recognizing negative pension costs results in lower rates, Pacific must finance the negative pension costs reflected in rates.

11. In 1999, Pacific withdrew surplus assets from one if its pension trust funds to reimburse itself for $41 million of intrastate regulated PBOP costs that Pacific had paid earlier in the year.

12. Pacific recorded the withdrawal described in the previous Finding of Fact as a negative contribution to the affected pension trust fund. Pacific did not (i) reduce the pension costs that it reported for intrastate regulatory purposes by the amount of withdrawal, or (ii) reduce the PBOP costs that it reported for intrastate regulatory purposes by the amount of PBOP costs that were reimbursed with surplus pension assets.

13. The discussion in the body of this decision provides several reasons why Pacific should have reduced the PBOP costs it recorded and reported in 1999 by the amount of such costs that were reimbursed with surplus pension assets.

14. Pacific Bell does not have stand-alone actuarial reports for its pension and PBOP plans. Instead, information concerning Pacific's pension and PBOP plans is aggregated with those of its affiliates, which hindered the auditors' ability to precisely determine the funded status of Pacific's pension plans.

15. Decision 92-12-015 limited the amount of SFAS 106 costs that Pacific could report as an expense and recover in any given year to the amount of its tax-deductible contributions. Any SFAS 106 costs in excess of tax-deductible contributions were to be recorded as a regulatory asset. The regulatory asset was to be amortized (i.e., recorded and reported as an expense) and recovered if, when, and to the extent that future tax-deductible contributions exceeded SFAS 106 costs.

16. SFAS 71 provides that (i) in order to establish a regulatory asset there must exist reasonable assurance that the asset will be recovered in future rates, and (ii) a regulatory asset must be written off to the extent that the assurance of recovery of the regulatory asset in future rates is lost.

17. Pacific never recorded a PBOP regulatory asset for external financial reporting purposes pursuant to SFAS 71 because Pacific believed that its PBOP regulatory asset did not meet the requirements of SFAS 71.

18. Pacific's PBOP regulatory asset did not meet the requirements of SFAS 71.

19. Decision 92-12-015 limited the SFAS 106 costs that Pacific could recover via the SFAS 106 Z-Factor to the lesser of (i) Pacific's tax-deductible contributions to external PBOP trusts, or (ii) Pacific's SFAS 106 costs less its PAYGO costs.

20. Pacific's SFAS 106 Z-Factor could not, by itself, provide Pacific with sufficient revenues to recover the entire PBOP regulatory asset that Pacific had recorded for regulatory accounting purposes pursuant to D.92-12-015.

21. Decision 92-12-015 provided Pacific with two sources of revenues to recover all of its SFAS 106 costs, including the PBOP regulatory asset. One source was the revenues for PAYGO costs built into Pacific's initial rates under NRF. The second source was the SFAS 106 Z-Factor.

22. When the Commission eliminated the SFAS 106 Z-Factor in D.98-10-026, Pacific still had PAYGO revenues to recover at some of its SFAS 106 costs, including, perhaps, some of the PBOP regulatory asset.

23. Decision 92-12-015 anticipated that Pacific's PAYGO costs would rise over time relative to its SFAS 106 costs and eventually exceed its SFAS 106 costs.

24. To prevent Pacific from realizing a windfall, D.92-12-015 required Pacific to adjust its SFAS 106 Z-Factor annually to reflect anticipated reductions in the difference between Pacific's SFAS 106 costs and its PAYGO costs.

25. The elimination of the SFAS 106 Z-Factor by D.98-10-026 potentially increased Pacific's recovery of SFAS 106 costs in the future, since Pacific would no longer have to implement a negative Z-Factor (i.e., reduce its rates) if its PAYGO costs ever exceeded its SFAS 106 costs.

26. The record in Phase 2A is not sufficient to determine (i) the total amount of future SFAS 106 Z-Factor revenues that were lost by Pacific when the Z-Factor was eliminated by D.98-10-026, (ii) the portion of the PBOP regulatory asset that was destined to be recovered via future Z-Factor revenues, and (iii) the portion of the PBOP regulatory asset that should have been written off when the SFAS 106 Z-Factor was eliminated by D.98-10-026.

27. In 1998, Pacific wrote off its $400 million PBOP regulatory asset. Pacific recorded the write-off above the line.

28. As shown in Appendix F, Pacific's intrastate regulated SFAS 106 costs in 1998, including the write-off of its PBOP regulatory asset, exceeded its tax-deductible contributions to external PBOP trusts by $165.6 million.

29. The write-off of Pacific's PBOP regulatory asset above the line in 1998 could affect rates to the extent the write-off reduced the amount of earnings that

Pacific might otherwise have had to refund to its ratepayers under the earnings-sharing mechanism.

30. SFAS 71 does not (i) require the write-off of Pacific's PBOP regulatory asset in 1998 to be recorded above the line, or (ii) govern the Commission's authority to determine regulatory accounting requirements.

31. Decision 92-12-015 limited the amount of SFAS 106 costs that utilities could recover in rates to only those costs that are deemed "reasonable." The Decision defines "reasonable" SFAS 106 costs as, in part, tax-deductible contributions to external PBOP trusts.

32. When the Commission terminated the SFAS 106 Z-Factor in D.98-10-026, the Z-Factor was providing Pacific with $99.5 million per year in revenues.

33. As shown in Appendix G, the record in Phase 2A suggests that Pacific's SFAS 106 Z-Factor in 1997 and 1998 should have been $52.1 million and $29.0 million, respectively, not $99.5 million that was actually in effect during each of those years.

34. Decision 98-10-026 and Resolution T-16102 indicate that the Commission intended to consider if Pacific had recovered more SFAS 106 costs via the Z-Factor than authorized by D.92-12-015, but set no timetable for doing so. To date the Commission has not considered this matter in any proceeding.

35. Decision 92-12-015 adopted SFAS 106 for both ratemaking and regulatory accounting purposes.

36. If the Commission ever reinstates an earnings-sharing mechanism, the amount of SFAS 106 cost reported by Pacific could have a significant effect on the amount of earnings that Pacific might have to share with its ratepayers.

37. Pacific's intrastate regulated contributions to its PBOP trusts declined from $179 million in 1998 to $80 million in 1999, even though Pacific's intrastate

regulated SFAS 106 costs increased from $155 million in 1998 to $171 million in 1999. Pacific also withdrew $180 million from one of its PBOP trusts in 1999 to pay for non-PBOP costs. The intrastate regulated amount of the withdrawal was $136 million. The effect of Pacific's actions in 1999 was to increase its unfunded PBOP liability by (i) not funding all of the PBOP liabilities that were accrued in 1999 under SFAS 106, and (ii) diverting PBOP trust assets to non-PBOP purposes.

38. Pacific established its VEBA 1 PBOP trust to provide life insurance benefits to retirees. Pacific's contributions to its VEBA 1 trust were (i) made prior to the adoption of SFAS 106 for regulatory purposes in D.92-12-015, and (ii) charged to regulated operating expense accounts and included in rates.

39. Sometime after D.92-12-015 was issued, Pacific amended the VEBA 1 trust agreement so that trust assets could be used to pay for healthcare benefits provided to active employees.

40. Pacific withdrew $180 million from the VEBA 1 trust in December 1999. The intrastate regulated amount of the withdrawal was $136 million. Pacific used the withdrawal to reimburse itself for healthcare costs associated with Pacific's active employees that Pacific had paid earlier in the year.

41. Pacific incurred substantial new unfunded PBOP liabilities in 1999.

42. Pacific's withdrawal of $136 million from the VEBA 1 trust in 1999 to pay for non-PBOP costs (i) increased Pacific's aggregate unfunded PBOP liability under SFAS 106, (ii) increased Pacific's future PBOP costs under SFAS 106, (iii) resulted in fewer PBOP assets available to pay for Pacific's PBOP obligations, and (iv) enriched Pacific because Pacific did not have to use its own cash to pay for the reimbursed healthcare costs.

43. The VEBA 1 refund ordered by today's decision might be subject to taxes.

44. The record suggests that Pacific may have withdrawn additional funds from the VEBA 1 trust subsequent to 1999 for non-PBOP purposes.

45. The economic incentives embedded in the current NRF structure might have played a role in Pacific's decision to divert VEBA 1 PBOP trust assets to non-PBOP purposes. Lax Commission oversight of Pacific's PBOP trusts might have been a factor as well.

46. The VEBA 3 is a PBOP trust. In 1989 and 1990, Pacific Bell contributed a total of $208 million to its VEBA 3 trust for the purpose of pre-funding PBOP obligations. Pacific made no contributions to its VEBA 3 trust after 1990.

47. In 1993, Pacific established the VEBA 5 PBOP trust to fund retiree medical and dental benefits. In 1997, 1998, and 1999, Pacific transferred funds from the VEBA 3 trust to the VEBA 5 trust. As shown in Appendix H, the normalized after-tax intrastate regulated amount of the transfers in 1997, 1998, and 1999 was $5.83 million, $35.56 million, and $40.31 million, respectively.

48. In 1997 and 1998, Pacific classified the transfers of funds from the VEBA 3 trust to the VEBA 5 trust as tax-deductible contributions to a PBOP trust for the purpose of determining the amount of SFAS 106 costs that Pacific was allowed to record and report for regulatory purposes under D.92-12-015.

49. The transfers of funds from the VEBA 3 trust to the VEBA 5 trust in 1997 and 1998 were not (i) tax deductible, or (ii) contributions to a PBOP trust.

50. In 1989 and 1990, Pacific Bell recorded the contributions to its VEBA 3 trust as a prepaid PBOP asset. The prepaid PBOP asset increased Pacific's transition benefit obligation (TBO) when SFAS 106 was adopted for Commission purposes effective January 1, 1993.

51. Decision 92-12-015 required Pacific's PBOP TBO to be amortized over 20 years. The amortization of the TBO increases PBOP costs under SFAS 106.

52. If Pacific had expensed the contributions to its VEBA 3 trust in 1989 and 1990, its PBOP TBO would have been smaller by $208 million, the amount of amortized intrastate regulated TBO costs included in Pacific's annual accrual of SFAS 106 costs would have been reduced by $4.3 million, and Pacific's PBOP regulatory asset in 1998 would have been smaller by $25.7 million.

53. The discussion in the body of this decision provides several reasons why Pacific should have recorded the contributions to its VEBA 3 trust in 1989 and 1990 as an expense for regulatory purposes.

54. Pacific Bell recorded a $4.8 billion write-down of its net plant in 1995 for external financial reporting purposes. The intrastate regulated portion of the write-down was $3.7 billion.

55. Pacific Bell initiated a plan in 1999 to amortize over a six-year period what Pacific termed a "depreciation reserve deficiency" (DRD), which consisted of the intrastate portion of the write-down described in the previous Finding of Fact.

56. The six-year amortization of the DRD increased Pacific's pre-tax intrastate regulated expense by $612 million annually in 1999 through 2004.

57. Under the flow-through method of tax accounting, the amount of income tax expense recognized for a given period is equal to the taxes lawfully assessed and actually paid for the period. Under the normalization method, the amount of income tax expense recognized for a given period is based on the accounting income and expenses recognized during the period, regardless of the amount of taxes actually paid during the period.

58. Normalized tax accounting can, depending on circumstances, result in utilities recording, reporting, and recovering in rates for a given period an amount for income taxes that is higher or lower than the actual taxes paid by the utility during that period.

59. During 1997 through 1999, Pacific's income tax expense under flow-through tax accounting was $50.4 million less with respect to Phase 2A issues compared to the normalized tax accounting actually used by Pacific.

60. Interest during construction (IDC) is a cost incurred by utilities to finance construction work in progress (CWIP). Costs associated with CWIP are not included in rate base or recovered in rates until the construction is complete and the assets financed by IDC are placed into utility service.

61. In 1984, IDC was deductible for tax purposes in the year incurred. Decision 84-05-036 adopted normalized tax accounting for IDC, which had the effect of spreading the tax benefits of IDC over the depreciable lives of the assets financed by IDC.

62. Contributions in aid of construction (CIAC) consist of assets, property, or money contributed to a public utility for the purpose of expanding, improving, or replacing the utility's facilities. Public utilities are required by federal tax law to treat CIAC as taxable income and pay income taxes on CIAC in the year the contributions are received.

63. Decision D.87-09-026 required Pacific to (i) pay the income taxes on CIAC, (ii) include such taxes in rate base, and (iii) amortize such taxes in rates over the lives of the CIAC assets. This practice accorded normalized tax accounting to CIAC, which had the effect of spreading the higher income taxes initially paid by the utilities over the depreciable lives of the CIAC assets.

64. The Tax Reform Act of 1986 required utilities to capitalize IDC on 100% of construction costs for federal tax purposes beginning in 1987. For ratemaking purposes, the Commission required utilizes to capitalize allowance for funds used during construction (AFUDC) on 100% of construction costs. AFUDC includes both an interest component (i.e., IDC) and an equity component. The

result was that utilities had to capitalize more IDC for tax purposes than for ratemaking purposes.

65. Because utilities were required to capitalize more IDC for tax purposes than for ratemaking purposes, there was less interest available as a tax deduction for tax purposes than for ratemaking purposes. This caused the income taxes paid by utilities to be higher than the taxes included in rates, all else being equal.

66. Decision 88-01-026 required utilities to apply normalized tax accounting to IDC, which had the effect of spreading the higher income taxes initially paid by the utilities over the depreciable lives of the assets financed by IDC.

67. Decision 88-01-061 allowed, but did not require, utilities to apply normalized tax accounting to vacation pay. The reason for doing so was that recent changes to federal tax law had made it beneficial to ratepayers to apply normalized tax accounting to vacation pay instead of flow-through accounting. However, the Commission made it clear in D.88-01-061 that allowing utilities to apply normalized tax accounting to vacation pay was a limited exception to its flow-through policy.

68. Under the flow-through method for CCFT adopted by D.89-11-058, the prior year's CCFT was to be (i) used as a deduction for computing the current year's federal income tax (FIT), and (ii) based on the test-year estimate or the attrition-year estimate of CCFT.

69. Because there is no test year or attrition year estimate of CCFT under NRF, D.90-12-034 modified D.89-11-058 to allow Pacific to use the current year's booked CCFT to compute the current year's FIT for regulatory purposes.

70. Decision 94-12-022 adopted a stipulation that used normalized tax accounting to set rates for Southwest Gas Corporation, which resulted in a lower revenue requirement than flow-through accounting and thus benefited

ratepayers. Conversely, Pacific's use of normalized tax accounting during 1997 – 1999 reduced its earnings by $50.4 million with respect to Phase 2A issues.

71. In AL 17024, Pacific requested authority to adopt SFAS 109 and the FCC's related amendments to the USOA. Importantly, the advice letter did not explicitly request authority to replace flow-through tax accounting with normalized tax accounting. The advice letter also stated that the adoption of SFAS 109 would have no impact on income-statement related accounts.

72. By adopting normalized tax accounting, Pacific implemented SFAS 109 in a way that (i) had a substantial impact on income-statement related accounts, and (ii) was contrary to AL 17024.

73. Both SFAS 109 and the FCC's related amendments to the USOA provide for the accounting recognition of the economic effects associated with the flow-through of tax benefits to customers.

74. For items that receive flow-through treatment, SFAS 109 and the FCC's related amendments to the USOA require utilities to report a deferred income tax liability and an associated regulatory asset or liability as separate items on the balance sheet. Prior to SFAS 109, the deferred income tax liability and the associated regulatory asset/liability were offset against each other. As a result, there was no recognition of either on the balance sheet. The change in balance sheet presentation adopted by SFAS 109 and the FCC's related amendments to the USOA did not have any impact on net income.

75. SFAS 109 and the FCC's amended USOA contemplated that utilities might use flow-through tax accounting for regulatory purposes.

76. Commission Resolution F-634, issued on January 5, 1995, adopted SFAS 109 for regulatory accounting purposes and the related amendments to the USOA that the FCC had adopted to implement SFAS 109.

77. Resolution F-634 does not state that it is adopting normalized tax accounting; it states that it is adopting SFAS 109 and the FCC's related amendments to the USOA.

78. Resolution F-634 required the implementation of SFAS 109 to be revenue neutral. In order to do so, Resolution F-634 adopted the three new USOA accounts. The purpose of the three new accounts was to (i) implement the new balance sheet reporting requirements adopted by SFAS 109, (ii) recognize the economic effects of flow-through ratemaking, and (iii) implement SFAS 109 on a revenue-neutral basis.

79. Pacific Exhibit Phase 2A: 318, Attachment 1, lists every item that received normalized tax treatment in Pacific's NRF startup revenue requirement.

80. Decision 89-10-031, OP 14, required Pacific to submit a compliance filing to establish Pacific's startup revenue requirement under NRF. Pacific did not adjust its compliance filing to conform to the Commission's flow-through policy regarding income tax expense.

81. There is no indication in the record of this proceeding that Pacific ever informed the Commission during the course of the proceeding leading to the adoption of Pacific's startup revenue requirement in D.89-12-048 that the compliance filing that Pacific had submitted to establish its startup revenue requirement did not conform to the Commission's flow-through policy.

82. There was no reason for the Commission to expect or suspect that the compliance filing that Pacific had submitted to establish its NRF startup revenue requirement did not comply with the Commission's flow-through policy.

83. The Commission's review of Pacific's compliance filing containing its multi-billion dollar startup revenue requirement was brief and hurried.

84. Decision 91-07-056 adopted a staff report that stated Pacific's NRF startup revenue requirement included all Commission-mandated ratemaking adjustments. The scope of the staff's statement did not extend to whether Pacific's startup revenue requirement conformed to the Commission's flow-through policy.

85. For the reasons set forth in the body of today's Decision, Pacific's petition to modify D.89-11-058, which Pacific filed in September 1990, demonstrates that Pacific believed in 1990 that the Commission's flow-through policy remained in effect under NRF, even with respect to items that had been normalized in Pacific's startup revenue requirement.

86. In Resolution F-627, issued on September 12, 1990, the Commission applied flow-through tax accounting to a particular type of cost for compensated absences incurred by Pacific Bell.

87. In D.92-12-015, the Commission determined that utilities, including Pacific, should not be allowed to recover in rates any costs for SFAS 106 in excess of tax-deductible contributions because of the unacceptable financial burden it would impose on ratepayers under flow-through tax accounting.

88. The purpose of the CHCF-B is to subsidize the provision of affordable basic telephone service in high-cost areas of California served by the State's largest local exchange carriers. Funds for the CHCF-B are provided by a surcharge levied on all end-users of intrastate telecommunications services.

89. For tax purposes, Pacific reported the revenues it received from the CHCF-B in 1998 and 1999 as a reduction in construction costs. Consequently, Pacific paid no income taxes on the revenues. For regulatory purposes, Pacific reported the CHCF-B revenues as income and, in accordance with normalized

tax accounting, accrued income tax expense on its CHCF-B revenues even though Pacific did not actually pay any income taxes on the revenues.

90. The application of flow-through tax accounting to CHCF-B revenues instead of the normalized tax accounting actually used by Pacific would have reduced Pacific's federal and state income tax expense for intrastate regulatory purposes by $99.0 million in 1998 and $104.6 million in 1999.

91. The Commission has believed since the inception of NRF that all of the Commission's ratemaking policies and ratemaking adjustments that existed prior to NRF were reflected in Pacific's startup revenue requirement. The record in this proceeding shows the Commission's belief to have been unfounded.

92. The Commission's decision on Phase 2B audit issues (i) identifies the rate of interest that should apply to any refund of sharable earnings that results from the Commission's decisions issued in Phases 2A and 2B, and (ii) specifies the methods and procedures that should be used to implement any such refund.

93. The revisions to Pacific's revenues, expenses, NOI, rate base, and accounting and reporting practices adopted by the Commission in Phases 2A and 2B might effect other matters that have come before the Commission.

94. Telephone carriers will receive a pro rata share of any refunds that result from decisions issued in Phase 2 of this proceeding to the extent that carriers purchase the services to which the refunds apply.

95. Decisions 89-10-031 and 94-06-011 excluded access services from the refund of sharable earnings because such services are purchased by carriers, not end-users, and there was no way to ensure that the carriers would pass through any such refunds to their customers.

96. There is currently no mechanism in place to ensure that the end users of access services will receive their pro rata share of any refunds that result from Commission decisions issued in Phases 2A and 2B.

Conclusions of Law

1. The fundamental purpose of regulatory accounting for pensions is to accurately report the actual costs incurred by utilities to provide pension benefits to their employees. To achieve this purpose, Pacific should record and report negative pension costs under the ACM when its pension assets exceed the present value of its pension liabilities. This requirement should become effective in the first full calendar year after the effective date of today's decision.

2. Decision 88-03-072 contemplated that the amount of pension costs recognized for regulatory purposes should equal the actual costs that utilities reasonably incur to provide pension benefits.

3. Decision 88-03-072 did not authorize utilities to record and report higher costs to provide pension benefits than the actual cost of providing such benefits.

4. The proper application of the ACM for regulatory purposes will amortize surplus pension assets by recognizing negative pension expense over the average remaining service lives of active utility employees.

5. The requirement in today's decision for Pacific to recognize negative pension costs for intrastate regulatory purposes does not violate federal law or require Pacific to withdraw assets from its pension trusts.

6. The recognition of negative pension costs is consistent with NRF.

7. Pacific should record a prepaid pension asset (PPA) equal to the cumulative amount of negative pension costs recognized for regulatory purposes. The PPA should be included in rate base to the extent that negative

pension costs are actually included in rates via the earnings-sharing mechanism or other regulatory procedure.

8. The PPA, if any, should be amortized if and when there are positive pension costs. The PPA included in rate base should be amortized if and when there are positive pension costs reflected in rates via an earnings-sharing mechanism or other regulatory procedure.

9. Decision 92-12-015 ordered Pacific to use surplus pension assets to pay for PBOP costs to the extent allowed by the IRC and employee unions. The purpose of the Commission's order was to reduce the PBOP costs that Pacific incurred for regulatory purposes by the amount of such costs that are paid with surplus pension assets. Pacific frustrated the intent of the Commission's order when it reported in 1999 that it had incurred $41 million in after-tax intrastate regulated PBOP costs that were, in fact, paid with surplus pension assets.

10. The PBOP costs that Pacific recorded and reported for regulatory purposes in 1999 should be reduced by $41 million for the reasons set forth in the body of this decision and the previous Conclusion of Law (COL).

11. Pacific should use its pension assets for the sole purpose of providing pension benefits and, to the extent authorized by D.92-12-015, PBOPs to Pacific's retirees and their qualified beneficiaries. Any pension assets not used for this purpose should be refunded to ratepayers.

12. The withdrawal of assets from Pacific's pension plans for non-pension purposes should be recorded and reported as a reduction in Pacific's expenses for regulatory accounting purposes.

13. Pacific should (i) establish procedures to segregate its pension costs, assets, and obligations from those of its affiliates for actuarial, accounting, and reporting purposes, and (ii) prepare an annual actuarial report, certified by an

enrolled actuary, that shows Pacific's pension costs, assets, and obligations on a stand-alone basis. Pacific should establish the aforementioned procedures within 60 days from today's decision. Pacific should commence the preparation of the stand-alone actuarial report beginning with calendar year 2004.

14. ORA's proposal to true-up Pacific's pension assets in Phase 3 of this proceeding should not be adopted.

15. Decision 92-12-015 required Pacific to record a PBOP regulatory asset, even if the regulatory asset did not meet the requirements of SFAS 71.

16. It is not necessary to decide whether, and to what extent, Pacific should have written off its PBOP regulatory asset in 1998 following the termination of the SFAS 106 Z-Factor. This is because today's decision concludes that any such write-off should have been recorded below the line to the extent the write-off, together with Pacific's other SFAS 106 costs in 1998, exceeded Pacific's tax-deductible contributions to external PBOP trusts in 1998.

17. Pacific is prohibited by D.92-12-015 from recovering in rates any SFAS 106 costs that exceeded Pacific's tax-deductible contributions during 1998. This policy would be thwarted if Pacific could recover via the earnings-sharing mechanism any SFAS 106 costs in 1998, including any of the PBOP regulatory asset write-off in 1998, that exceeded Pacific's tax-deductible contributions.

18. Pacific should record below the line that portion of its SFAS 106 costs in 1998, including the write-off of its PBOP regulatory asset, that exceeded its tax-deductible contributions to external PBOP trust funds in 1998 in order to ensure that Pacific does not recover via the earnings-sharing mechanism any SFAS 106 costs in excess of its tax-deductible contributions.

19. Although Pacific's ROR consists of many separate items, the Commission may examine how any one of these items might affect Pacific's ROR.

20. The SFAS 106 costs that Pacific reported for regulatory purposes in 1998 in excess of its tax-deductible contributions to external PBOP trust funds were not "reasonable costs" as defined by D.92-12-015 and, therefore, should not have been recognized above the line for regulatory purposes.

21. Requiring Pacific to record below the line those SFAS 106 costs in 1998 that exceeded its tax-deductible contributions does not constitute an impermissible ratemaking adjustment under NRF, since D.92-12-015 explicitly limited the amount of SFAS 106 costs that Pacific could recover in 1998 to the amount of its tax-deductible contributions.

22. Decision 98-10-026 effectively terminated the use of SFAS 106 for ratemaking purposes in 1999 with respect to Pacific by abolishing the SFAS 106 Z-Factor and suspending the earnings-sharing mechanism. The Decision did not affect the use of SFAS 106 for regulatory accounting purposes.

23. Because D.98-10-026 ended the use of SFAS 106 for ratemaking purposes, but not for accounting purposes, it was proper for Pacific to report its full SFAS 106 accrual in 1999, regardless of its actual tax-deductible contributions.

24. Except as described in the following COL, the amount of PBOP costs that Pacific records and reports for regulatory accounting purposes in 1999 and subsequent years should equal Pacific's intrastate regulated SFAS 106 accrual less any PBOPs funded with surplus pension assets.

25. If the Commission reinstates an earnings-sharing mechanism, the amount of SFAS 106 costs that Pacific records and reports for regulatory purposes should be limited to its tax-deductible contributions for the reasons stated in D.92-12-015. Consistent with D.92-12-015, any SFAS 106 costs in excess of both (i) tax-deductible contributions and (ii) PBOPs funded with surplus pension

assets should be carried forward and recognized as an expense in future years to the extent that Pacific's tax-deductible contributions exceed its SFAS 106 costs.

26. Decision 92-12-015 found that Pacific should fund its SFAS 106 costs and provided Pacific with the means to do so. Although D.98-10-026 eliminated the SFAS 106 Z-Factor, the Decision adopted other changes to NRF (e.g., suspended the earnings-sharing mechanism and eliminated the price-cap index) that provided Pacific with the means to fund its SFAS 106 costs over the long run.

27. Because ratepayers have provided Pacific with adequate resources to fund its PBOP obligations as they are accrued, but Pacific has chosen not to do so, it is necessary to protect ratepayers from the consequences of Pacific's actions.

28. Except as described in the following COL, Pacific should not be allowed to adjust future rates to recover any costs associated with unfunded PBOP liabilities accrued, incurred, or recorded in 1999 and subsequent years, including any interest costs on the liabilities. This includes unfunded PBOP liabilities resulting from (i) SFAS 106 accruals exceeding tax-deductible contributions, and (ii) the diversion of PBOP trust fund assets to non-PBOP purposes.

29. If the Commission reinstates an earnings-sharing mechanism, any costs associated with unfunded PBOP liabilities accrued, incurred, or recorded from January 1, 1999, to the reinstatement of the earnings-sharing mechanism should not be included in the determination of sharable earnings. The issue of whether costs associated with unfunded PBOP liabilities accrued after the reinstatement of an earnings-sharing mechanism should be included in the sharing mechanism should be decided by the Commission if and when the mechanism is reinstated.

30. Pacific should (i) establish procedures to segregate its PBOP costs, assets, and obligations from those of its affiliates for actuarial, accounting, and reporting purposes, and (ii) prepare an annual actuarial report, certified by an enrolled

actuary, that shows Pacific's PBOP costs, assets, and obligations on a stand-alone basis. Pacific should establish the aforementioned procedures within 60 days from today's decision. Pacific should commence the preparation of the stand-alone actuarial report beginning with calendar year 2004.

31. The provision in Ordering Paragraph 3 (OP 3) of D.92-12-015 that made PBOP trust fund assets "hereafter" subject to refund to the extent that such assets are not used to provide PBOPs applies to all PBOP trusts fund assets, including PBOP trust fund assets that existed prior to D.92-12-015.

32. Pacific is required by OP 3 of D.92-12-015 to refund to its ratepayers the amount that it withdrew from its VEBA 1 PBOP trust in 1999 for non-PBOP purposes. The refund should (i) be reduced by any taxes that are paid by Pacific on the refund, and (ii) accrue interest and be implemented in the same manner as any refund of sharable earnings that results from the Commission's decisions issued in Phases 2A and 2B of this proceeding.

33. Pacific should file and serve within 30 days from today's decision a compliance report regarding the VEBA 1 refund described in the previous COL. The compliance report should provide the following information: (i) the amount that Pacific withdrew from its VEBA 1 in 1999 for purposes other than funding PBOPs; (ii) the amount of taxes, if any, applicable to the VEBA 1 refund; (iii) the net amount of the VEBA 1 refund before interest; (iv) interest on the refund; and (v) work papers showing the calculation of the refund, interest, and any taxes. Parties should be allowed to file and serve comments and reply comments regarding Pacific's report. Comments should be due 20 days after the report is filed, and reply comments should be due 30 days after the report is filed.

34. Any taxes that Pacific claims it owes on the VEBA 1 refund described in the two previous COLs but later does not pay should be refunded to ratepayers.

The refund of taxes should accrue interest from January 1, 2000, at the same rate applicable to the VEBA 1 refund.

35. Pacific should file and serve a compliance report no later than 30 days from today's decision that states whether, and to what extent, it withdrew funds from PBOP trusts in 2000 and subsequent years for non-PBOP purposes. Parties should be allowed to file and serve comments and reply comments regarding Pacific's report. Comments and reply comments should be due 20 days and 30 days, respectively, after the report is filed.

36. If Pacific did withdraw funds from PBOP trusts in 2000 and subsequent years for non-PBOP purposes, it should refund the withdrawal(s) to ratepayers in accordance with the procedure adopted by today's decision for refunding the VEBA 1 withdrawal in 1999. Any future withdrawals from PBOP trusts that are used for non-PBOP purposes should be refunded to ratepayers in a manner consistent with D.92-12-015 and today's decision.

37. Decision 91-07-006 authorized utilities to pre-fund PBOP obligations because, in part, the Commission deemed such pre-funding to be analogous to the pre-funding of pension and nuclear decommissioning obligations.

38. Pacific's contributions to its VEBA 3 trust in 1989 and 1990 should have been recorded as an expense at the time the contributions were made for the reasons described in the body of this decision.

39. The 20-year amortization of Pacific's PBOP TBO that is part of Pacific's annual PBOP costs under SFAS 106 should be reduced by an amount that reflects the expensing of Pacific's contributions to its VEBA 3 trust in 1989 and 1990.

40. The balance of Pacific's PBOP regulatory asset in 1998 should be reduced by the cumulative reduction in Pacific's annual SFAS 106 costs during the period of 1993 through 1998 that is described in the previous COL.

41. Pacific violated D.92-12-015 when it treated the transfers of funds from the VEBA 3 trust to the VEBA 5 trust in 1997 and 1998 as "tax-deductible contributions" for the purpose of determining the amount of SFAS 106 costs that Pacific was authorized to record and report for regulatory purposes under D.92-12-015.

42. The SFAS 106 costs that Pacific recorded and reported for regulatory accounting purposes in 1997 and 1998 should be reduced by the amount of VEBA 3 transfers during those years.

43. The annual calculation of Pacific's PBOP costs under SFAS 106 for regulatory purposes should include all VEBA 3 trust assets, including the assets contributed to the trust in 1989 and 1990.

44. SFAS 106 accruals, and not tax-deductible contributions to PBOP trusts, should be used to determine the amount of PBOP costs to capitalize in construction and plant investment accounts.

45. Decision 98-10-026 authorized Pacific to determine depreciation expense for all of its depreciable assets, including assets acquired prior to D.98-10-026.

46. Pacific's decision to implement a six-year RDA of $612 million annually starting in 1999 was within the scope of authority granted by D.98-10-026.

47. It is unnecessary to determine if Pacific's RDA is reasonable or should be recorded below the line. Decision 98-10-026 authorized Pacific to record depreciation expenses using any basis it chooses. Implicit within this authority is that whatever depreciation expenses Pacific chooses to record should be recorded above the line.

48. Decision 98-10-026 did not authorize Pacific to recover in rates any increase in depreciation expense (e.g., the RDA) for investments made prior to

D.98-10-026. The Decision deferred the issue of rate recovery of historic stranded costs to the application procedures adopted in D.96-09-089.

49. Decision 98-10-026 barred Pacific from adjusting rates to recover the RDA or other depreciation costs recorded above the line in 1999 and subsequent years.

50. In D.59926, issued in 1960, the Commission held that it was unlawful for a utility to charge to its operating expenses or recover in rates any amount for income taxes in excess of the taxes actually paid by the utility. The practical effect of D.59926 was to establish a *de facto* policy of using flow-through tax accounting for regulatory accounting and ratemaking purposes.

51. The California Supreme Court has issued several decisions that either (i) upheld the Commission's policy of setting rates based on flow-through tax accounting, or (ii) annulled Commission decisions that applied normalized tax accounting in a way that resulted in rates for a utility that included amounts for income taxes in excess of the taxes actually paid by the utility.

52. In D.84-05-036, the Commission held that its flow-through policy should remain in effect for regulatory purposes to the extent allowed by law.

53. In D.87-12-063, the Commission (i) rejected normalized tax accounting as a general accounting and ratemaking policy, (ii) affirmed its policy of using flow-through tax accounting to the extent allowed by law, and (iii) required Pacific to maintain memorandum records reflecting flow-through tax accounting.

54. It is the Commission's general policy that, to the extent permitted by law, the amount of tax expense reflected in rates and recorded and reported by a utility for regulatory purposes for a given period should not exceed the amount of taxes lawfully assessed and actually paid by the utility for that period. To implement this policy the Commission has generally, but not always, relied on flow-through tax accounting.

55. Pacific's use of normalized tax accounting to record and report income tax expenses during the audit period did not comply with the Commission's general policy described in the previous COL.

56. It is axiomatic that the only taxes or tax benefits included in rates should be those that a utility incurs in the course of providing service to the public. The Commission applied this axiom in D.84-05-036 when it held that its flow-through policy does not pertain to the tax benefits associated with assets that are not being used to provide utility service. By normalizing IDC in D.84-05-036, the Commission ensured that the tax benefits associated with IDC would be reflected in rates only when the assets financed by the IDC were placed into utility service.

57. The normalization of CIAC by D.87-09-026 was consistent with Commission and Court decisions that prohibit utilities, to the extent allowed by law, from recovering more taxes in rates than actually paid by utilities, since the income tax expense associated with CIAC that was normalized (and included in rates) by D.87-09-026 had already been paid by the utilities.

58. The normalization of IDC by D.88-01-061 was consistent with Commission and Court precedent that prohibits utilities, to the extent allowed by law, from recovering more taxes in rates than actually paid by utilities, since the income tax expense associated with IDC that was normalized (and included in rates) by D.88-01-026 had already been paid by the utilities.

59. Although D.88-01-061 authorized utilities to normalize vacation pay, this was limited exception to the Commission's flow-through policy. Accordingly, D.88-01-061 does not support Pacific's claim that it was proper for Pacific to use normalized tax accounting during the audit period.

60. Decision 90-12-034 was a pragmatic response by the Commission to the inability under NRF to use the particular method of flow-through accounting for

CCFT adopted by D.89-11-058. As such, D.90-12-034 does not represent an endorsement of normalized tax accounting under NRF as Pacific contends.

61. Unless the Commission expressly provides otherwise, the Commission's adoption of a stipulation does not constitute (i) Commission approval of any principle expressed in the stipulation or any resolution of issues reached by the stipulation, or (ii) precedent for any future proceeding.

62. There is nothing in D.94-12-022 that indicates the stipulation adopted therein should be considered a precedent on the issue of normalized versus flow-through tax accounting.

63. Decision 94-12-022 does not (i) establish any precedent with respect to Pacific Bell on the issue of normalized versus flow-thorough tax accounting, or (ii) support Pacific's claim that it was proper for Pacific to use normalized tax accounting during 1997 – 1999.

64. Resolution F-634 acknowledges that both SFAS 109 and the FCC's related amendments to the USOA provide for the accounting recognition of the economic effects associated with the flow-through of tax benefits to customers.

65. Neither SFAS 109 nor the FCC's related amendments to the USOA require a utility to use normalized tax accounting for intrastate regulatory purposes.

66. The adoption of normalized tax accounting by Resolution F-634 would have (i) been contrary to several Commission decisions that required the use of flow-through tax-accounting, and (ii) had a significant impact on rates.

67. Pub. Util. Code Section 1708 requires the Commission to provide notice and an opportunity to be heard before modifying or rescinding a prior order or decision.

68. It is unlikely that the Commission intended in Resolution F-634 to replace flow-through tax accounting with normalized tax accounting because

(i) Resolution F-634 contains no dicta or FOFs that indicate the Resolution was implementing a major shift in tax-accounting policy with significant rate impacts, and (ii) the Commission did not provide notice or an opportunity to be heard pursuant to Section 1708 on whether the Commission's flow-through policy adopted in prior decisions should be replaced with normalized tax accounting.

69. Because Resolution F-634 required the implementation of SFAS 109 to be revenue-neutral, it prohibited the use of normalized tax accounting in a way that potentially affected sharable earnings compared to flow-through tax accounting.

70. Pacific implemented Resolution F-634 in a way that affected Pacific's earnings and the potential amount of sharable earnings during the audit period. Consequently, Pacific did not implement Resolution F-634 in a way that ensured revenue neutrality as required by Resolution F-634.

71. Resolution F-634 continued the Commission's generic policy of using flow-through tax accounting for regulatory purposes to the extent allowed by law, with one technical change. Prior to Resolution F-634, deferred income tax liabilities were not recognized for items that received flow-through ratemaking treatment. Under the technical change adopted by Resolution F-634, deferred income tax liabilities were recognized for items that received flow-through treatment and offsetting regulatory assets or liabilities were also recognized. The technical change "grossed-up" the balance sheet by increasing assets and liabilities by equal amounts with no impact on net income.

72. Decision 89-12-048 did not (i) consider if Pacific's startup revenue requirement under NRF conformed to the Commission's flow-through policy, or (ii) explicitly or knowingly approve of the normalized income tax expense included in Pacific's startup revenue requirement.

73. There is no indication in D.89-12-048 that the Commission intended to abandon its flow-through policy when it established Pacific's startup revenue requirement.

74. Given the many Commission and Court decisions that require flow-through tax accounting for regulatory purposes to the extent allowed by law, it is unreasonable to conclude that the Commission in D.89-12-048 abandoned its flow-through policy without uttering a single word that it was doing so.

75. Decision 91-07-056 did not consider or affirm the use of normalized tax accounting in Pacific's NRF startup revenue requirement.

76. Resolution F-627 and D.92-12-015 demonstrate that the Commission's flow-through policy remained in effect under NRF.

77. The burden was on Pacific to disclose, and not on the Commission to discover, that the reports Pacific had submitted to establish its NRF startup revenue requirement and the financial monitoring reports that Pacific has submitted since 1990 reflected normalized tax accounting for many items of revenue and expense in violation of the Commission's flow-through policy.

78. Pacific's tax accounting for CHCF-B revenues failed to comply with the Commission's flow-through policy in that Pacific recorded and reported income tax expenses for its CHCF-B revenues that had not been paid by Pacific.

79. It is unfair to ratepayers to fund the CHCF-B revenues received by Pacific and for Pacific to reap all the tax benefits associated with CHCF-B revenues.

80. It is fair for Pacific and ratepayers to share the tax benefits associated with CHCF-B revenues in accordance with the earnings-sharing mechanism that was in effect during 1998. There was no sharing mechanism in effect during 1999, thereby allowing Pacific to retain all the CHCF-B tax benefits for that year.

81. CHCF-B revenues should not receive normalized tax treatment just because CIAC revenues receive such treatment. The situation with CIAC is different from CHCF-B revenues in that the utilities pay income taxes on CIAC revenues up front and then amortize the taxes over the life of the assets funded by CIAC. Unlike CIAC revenues, Pacific pays no income taxes on its CHCF-B revenues. Instead, Pacific pays higher income taxes (via lower depreciation expense) over the tax lives of the assets acquired with CHCF-B revenues.

82. Pacific's recorded income tax expense for 1997 – 1999 should be adjusted to reflect the Commission's flow-through policy.

83. Any party that henceforth claims a particular Commission ratemaking policy or ratemaking adjustment has been reflected in Pacific's rates since the inception of NRF should have the burden of demonstrating that its claim is true.

84. It is the Commission's policy that end-users are the appropriate recipients of any refund of sharable earnings that may occur under NRF.

85. Access services should not receive a pro rata share of any refunds that result from Commission decisions issued in Phases 2A and 2B because there does not currently exist a practical way to ensure that the refunds will reach the end-users of these services.

86. Pacific should file an advice letter within 60 days that contains (i) amended financial monitoring reports for 1997 and subsequent years that reflect all revisions to Pacific's revenues, expenses, NOI, rate base, and accounting and reporting practices adopted in Phases 2A and 2B of this proceeding; (ii) work papers that demonstrate that all of the adopted revisions are properly reflected in the amended financial monitoring reports; and (iii) documentation that demonstrates Pacific's accounting and reporting practices will henceforth comply with today's decision. The aforementioned

documentation should include a sworn declaration by an officer of Pacific Bell that (i) Pacific no longer engages in the prohibited accounting and reporting practices, and (ii) Pacific has implemented procedures to ensure that its accounting and reporting practices will henceforth comply with today's decision.

87. The advice letter filing described in the previous COL should include a compliance report that identifies what rates, charges, price ceilings, or price floors previously adopted by the Commission or currently being considered by the Commission would change based on the revisions to Pacific's revenues, expenses, NOI, rate base, and accounting and reporting practices adopted in Phases 2A and 2B of this proceeding. Pacific should identify the amount of any such change and provide work papers that show the derivation of the amount. Parties should be allowed to file and serve comments and reply comments on Pacific's compliance report that (i) suggest remedies and (ii) identify other possible effects stemming from the adopted revisions to Pacific's accounting and financial reporting. The comments and reply comments should be due 30 and 45 days, respectively, after Pacific's compliance report is filed.

88. All intrastate financial monitoring reports filed by Pacific should henceforth reflect the revisions to Pacific's reported revenues, expenses, NOI, rate base, and accounting and reporting practices adopted in Phases 2A and 2B.

89. Parties should be allowed to address the following matters in Phase 3B of this proceeding:

i. Whether Pacific collected more revenue from its SFAS 106 Z-Factor than was authorized by D.92-12-015 and, if so, whether the excess revenues should be refunded to Pacific's ratepayers, how the refund should be implemented, and the appropriate rate of interest to apply to the refund.

ii. Whether (a) Pacific should be penalized pursuant to Pub. Util. Code Section 2107 for the violation of D.92-12-015 that occurred when Pacific

improperly treated the transfers of funds from the VEBA 3 trust to the VEBA 5 trust in 1997 and 1998 as tax-deductible contributions for the purpose of determining and reporting SFAS 106 costs for regulatory accounting purposes, and (b) the amount of any such penalty.

iii. Whether Pacific recovered any of the contributions to its VEBA 3 trust in 1989 and 1990 via the SFAS 106 Z-Factor that was in effect during 1993 - 1998 and, if so, whether Pacific should be penalized pursuant to Pub. Util. Code Section 2107 and the amount of any such penalty.

iv. Whether, and to what extent, it is necessary or appropriate under NRF to monitor Pacific's management of ratepayer-funded PBOP trusts in order to ensure that the assets in such trusts are used for the sole purpose of providing PBOPs to Pacific's retirees.

v. Assuming the Commission reinstates an earnings-sharing mechanism, (a) whether the Commission should review and approve depreciation expenses, (b) which Category I and II services should be included in the earnings-sharing mechanism, and (c) what procedures, if any, are needed to ensure that refunds of sharable earnings are passed through to end-users, including refunds allocated to flexibly priced services and/or intermediary services such as access services and UNEs.

vi. How NRF should be modified based on the findings in today's decision.

90. The next audit of Pacific Bell should include an examination of the pension assets, obligations, and costs that Pacific reported during 2000 and subsequent years. The amount of pension assets, obligations, and costs reported for these years should be adjusted, as appropriate, to reflect the audit findings. The audit may examine years prior to 2000 if the auditors determine this would be necessary or desirable for understanding Pacific's pension assets, obligations, and costs in 2000 and subsequent years. The auditors should obtain the services of an enrolled actuary, if appropriate, to assist in the audit.

91. The next audit of Pacific Bell should include an examination of whether Pacific used pension assets to fund PBOPs in 2000 and subsequent years. The

PBOP costs reported for these years should be adjusted, as appropriate, to reflect the audit findings.

92. The following order should be effective immediately so that its provisions may be implemented expeditiously.

INTERIM ORDER

IT IS ORDERED that:

1. SBC Pacific Bell Telephone Company's (Pacific's) intrastate regulated revenues, expenses, net operating income (NOI), and rate base for the years 1997 through 1999 that are set forth in the Appendices attached to this Order are adopted for regulatory purposes.

2. Pacific shall refund to its ratepayers the amounts shown in the Appendices attached to this Order. The refund shall (i) accrue interest as set forth in the Commission's decision issued in Phase 2B of this proceeding regarding audit issues, and (ii) be implemented in accordance with the procedures described in the Phase 2B audit decision.

3. The refund of the money that Pacific withdrew from its Voluntary Employee Benefit Association Trust No. 1 in 1999 ("the VEBA 1 refund") may be reduced by any taxes that Pacific is required to pay on the refund.

4. Within 30 days from the effective date of this Order, Pacific shall file and serve a compliance report that contains (i) the amount that Pacific withdrew from its VEBA 1 in 1999 for purposes other than funding post-retirement benefits other than pensions (PBOPs) provided to Pacific's retirees; (ii) the amount of taxes, if any, applicable to the VEBA 1 refund; (iii) the net amount of the VEBA 1 refund before interest; (iv) interest on the refund; and (v) work papers showing

the calculation of the refund, interest, and any taxes. Parties may file and serve comments and reply comments regarding Pacific's report. Comments shall be due 20 days after the report is filed. Reply comments shall be due 30 days after the report is filed. Any taxes that Pacific claims in the compliance report but, for whatever reason, does not pay shall be refunded to ratepayers as soon as possible and accrue interest at the same rate applicable to the VEBA 1 refund.

5. Pacific shall comply with the Commission's regulatory accounting and reporting policies described in the body of this Order, Findings of Fact (FOFs), and/or Conclusions of Law (COLs).

6. All intrastate financial monitoring reports filed by Pacific shall henceforth reflect (i) the revisions to Pacific's reported revenues, expenses, NOI, and rate base that are adopted by the Commission in Phases 2A and 2B of this proceeding; and (ii) the Commission's regulatory accounting and reporting policies described in the body of this Order, FOFs, and/or COLs.

7. Within 60 days from the effective date of this Order, Pacific shall file an advice letter that contains (i) amended intrastate financial monitoring reports for 1997 and subsequent years that reflect all revisions to Pacific's revenues, expenses, NOI, rate base, and accounting and reporting practices adopted by the Commission in Phases 2A and 2B of this proceeding; (ii) work papers that demonstrate that all of the adopted revisions are properly reflected in the amended financial monitoring reports; and (iii) documentation that demonstrates that Pacific's accounting and reporting practices will henceforth comply with today's Order. The aforementioned documentation shall include a sworn declaration by an officer of Pacific Bell that (i) Pacific no longer engages in the disallowed accounting and reporting practices, and (ii) Pacific has

implemented procedures to ensure that Pacific's accounting and reporting practices will henceforth comply with today's Order.

8. Pacific shall include within the advice letter described in the previous Ordering Paragraph a compliance report that identifies what rates, charges, price ceilings, or price floors previously adopted by the Commission or currently being considered by the Commission would change based on the revisions to Pacific's revenues, expenses, NOI, rate base, and accounting and reporting practices adopted by the Commission in Phases 2A and 2B of this proceeding. Pacific shall identify the amount of any such change and provide work papers that show the derivation of the amount. Parties may file and serve comments and reply comments on Pacific's compliance report that (i) suggest remedies and (ii) identify other possible effects stemming from the adopted revisions. The comments and reply comments shall be due 30 and 45 days, respectively, after the compliance report is filed.

9. Pacific shall use its pension assets for the sole purpose of providing pension benefits and, to the extent authorized by Decision (D.) 92-12-015, PBOPs to Pacific's retirees. Any pension assets not used for this purpose shall be refunded to Pacific's ratepayers.

10. Pacific shall establish procedures to segregate its pension costs, assets, and obligations from those of its affiliates for actuarial, accounting, and reporting purposes. Pacific shall implement these procedures within 60 days from the effective date of this Order. Pacific shall also prepare an annual actuarial report, certified by an enrolled actuary, that shows Pacific's pension costs, assets, and obligations on a stand-alone basis. The preparation of the actuarial report shall commence with calendar year 2004.

11. Pacific shall establish procedures to segregate its PBOP costs, assets, and obligations from those of its affiliates for actuarial, accounting, and reporting purposes. Pacific shall implement these procedures within 60 days from the effective date of this Order. Pacific shall also prepare an annual actuarial report, certified by an enrolled actuary, that shows Pacific's PBOP costs, assets, and obligations on a stand-alone basis. The preparation of the actuarial report shall commence with calendar year 2004.

12. If the Commission reinstates an earnings-sharing mechanism, the amount of costs that Pacific records and reports under Statement of Financial Accounting Standard No. 106 (SFAS 106) for regulatory purposes shall be limited to its tax-deductible contributions to external PBOP trusts. Any SFAS 106 costs in excess of both (i) tax-deductible contributions and (ii) PBOPs funded with surplus pension assets may be carried forward and recognized as an expense in future years to the extent that Pacific's tax-deductible contributions to external PBOP trusts exceed its PBOP costs determined in accordance with SFAS 106.

13. To the extent that Pacific records and reports SFAS 106 costs in 1999 and subsequent years that are not funded and/or diverts PBOP trust fund assets to non-PBOP proposes, the resulting unfunded liability (as measured by SFAS 106) shall be the sole responsibility of Pacific. Except as described in the following Ordering Paragraph, Pacific shall not adjust future rates to recover costs associated with such unfunded liabilities, including any interest on the liabilities.

14. If the Commission reinstates an earnings-sharing mechanism, any costs associated with unfunded PBOP liabilities accrued, incurred, or recorded from January 1, 1999, to the reinstatement of the earning-sharing mechanism shall not be included in the calculation of sharable earnings. The issue of whether costs associated with unfunded PBOP liabilities accrued after the reinstatement of an

earnings-sharing mechanism should be included in the sharing mechanism should be decided by the Commission if and when the mechanism is reinstated.

15. Within 30 days from the effective date of today's Order, Pacific shall file and serve a compliance report that states whether, and to what extent, Pacific withdrew funds from its PBOP trusts in 2000 and subsequent years for non-PBOP purposes. Parties may file and serve comments and reply comments regarding Pacific's report. Comments shall be due 20 days after the report is filed. Reply comments shall be due 30 days after the report is filed. Pacific shall refund any such withdrawals to its ratepayers in accordance with the procedures adopted by today's Order for refunding the VEBA 1 withdrawal in 1999.

16. Any future withdrawals that Pacific makes from its PBOP trusts that are not used to provide PBOPs shall be refunded to ratepayers in a manner consistent with D.92-12-015 and today's Order.

17. Parties may address the following matters in Phase 3B of this proceeding:

i. Whether Pacific collected more revenue from its SFAS 106 Z-Factor than was authorized by D.92-12-015 and, if so, whether the excess revenues should be refunded to Pacific's ratepayers, how the refund should be implemented, and the rate of interest on the refund.

ii. Whether (a) Pacific should be penalized pursuant to Pub. Util. Code Section 2107 for the violation of D.92-12-015 that occurred when Pacific improperly treated the transfers of funds from the VEBA 3 trust to the VEBA 5 trust in 1997 and 1998 as tax-deductible contributions for the purpose of determining and reporting allowable SFAS 106 costs for regulatory accounting purposes under D.92-12-015, and (b) the amount of any such penalty.

iii. Whether Pacific recovered any of the contributions to its VEBA 3 trust in 1989 and 1990 via the SFAS 106 Z-Factor that was in effect during 1993 through 1998 and, if so, whether Pacific should be penalized pursuant to Pub. Util. Code Section 2107 and the amount of any such penalty.

iv. Whether, and to what extent, it is necessary or appropriate under the New Regulatory Framework (NRF) to monitor Pacific's management of ratepayer-funded PBOP trusts in order to ensure that the assets in such trusts are only used to provide PBOPs to Pacific's retirees.

v. Assuming the Commission reinstates an earnings-sharing mechanism, (a) whether the Commission should review and approve depreciation expenses, (b) which Category I and II services should be included in the mechanism, and (c) what procedures, if any, are needed to ensure that refunds of sharable earnings are passed through to end-users, including refunds allocated to flexibly priced services and/or intermediary services such as access services and unbundled network elements.

vi. Whether and how NRF should be modified based on the findings in today's Order.

18. The next audit of Pacific Bell shall include an examination of the pension assets, obligations, and costs that Pacific reported during 2000 and subsequent years. The amount of pension assets, obligations, and costs reported for the period covered by audit should be adjusted, as appropriate, to reflect the audit findings. The audit may examine years prior to 2000 if the auditors determine this would be necessary or desirable for understanding Pacific's pension assets, obligations, and costs in 2000 and subsequent years. The auditors may obtain the services of an enrolled actuary, if appropriate, to assist in the audit.

19. The next audit of Pacific Bell shall include an examination of whether Pacific used pension assets to fund PBOPs in 2000 and subsequent years. The PBOP costs reported for these years should be adjusted, as appropriate, to reflect the audit findings.

This Order is effective today.

Dated _____, at San Francisco, California.