STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER,

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

March 02, 2004

Agenda ID# 3310
(Alternate Order to Agenda ID# 2987)
Ratesetting

TO: PARTIES OF RECORD IN A.99-10-010

Enclosed is Alternate Draft Decision of Commissioner Wood to the Draft Decision of Administrative Law Judge (ALJ) Walker previously mailed to you.

When the Commission acts on this agenda item, it may adopt all or part of it as written, amend or modify it, or set aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Public Utilities Code Section 311(e) requires that an alternate to a draft decision be served on all parties, and be subject to public review and comment prior to a vote of the Commission. Rule 77.6(d) provides that comments on the alternate draft decision be filed at least seven days before the Commission meeting.

Comments on the alternate decision must be filed and served March 9, 2004. Reply comments are due March 12, 2004.

Pursuant to Rule 77.3 comments shall not exceed 15 pages. Finally, comments must be served separately on the ALJ and the assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail, or other expeditious method of service.

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

ANG: mnt

Enclosure

167760

Decision **ALTERNATE DRAFT DECISION OF COMMISSIONER CARL WOOD**
(Mailed 3/2/2004)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of GTE California Incorporated for Authority Pursuant to Public Utilities Code Section 851 to Lease Space to Third Parties and Affiliates, and to Share Certain Assets with Affiliates.	Application 99-10-010 (Filed October 15, 1999)

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OPINION

Summary

Verizon California Inc. (Verizon) has amended this 1999 application, which now seeks approval under Pub. Util. Code § 851 of 18 lease and license agreements, as well as other relief. The amendment incorporates recommendations by the Commission's Office of Ratepayer Advocates (ORA) based on ORA's audit of Verizon in the fourth triennial review of the New Regulatory Framework, or NRF.[1] We approve these agreements and also approve Verizon's shared asset methodology of dealing with office space and office equipment used by three Verizon affiliates that perform administrative functions for Verizon and other subsidiaries of Verizon's parent company. We also approve an option by which Verizon in the future may make a triennial filing for Section 851 approval of space and office equipment leases by three affiliates, subject to the shared asset methodology of accounting and subject to annual advice letter updates. Our order closes this proceeding.

I. License and Lease Agreement

Factual Background

In 1998, in Application (A.) 98-12-022, the former GTE California Incorporated (now Verizon)[2] sought approval of 59 license and lease agreements that it had executed between 1994 and 1997. In Decision (D.) 99-06-092, the

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[1] Order Instituting Rulemaking 01-09-001/Order Instituting Rulemaking 01-09-002.

[2] The original application was filed by GTE California Incorporated, which changed its name to Verizon California Inc. following the merger of GTE Corporation and Bell Atlantic Corporation in June 2000, forming the parent company, Verizon Communications. All subsequent references in this decision are to Verizon regardless of the time period involved.

Commission approved the transactions under Pub. Util. Code § 851. In doing so, the Commission noted that Verizon's failure to seek approval earlier was based on a mistaken belief that Section 851 did not apply to certain transactions involving surplus property.[3] Therefore, the Commission directed Verizon to conduct a further review of lease and license agreements during and subsequent to 1990 for any other transactions that may not have been approved.

Through its Real Estate Services Department, and with the help of consultant Cushman & Wakefield, a real estate brokerage and consulting firm, Verizon conducted an internal audit of real estate records from three separate sources, cross-referencing the results. By this process, 17 additional transactions were identified and are included in this application. Verizon states that it now has identified all such transactions to the best of its knowledge. It states that it also has put in place mechanisms by which all such future transactions with third parties will be identified in a timely manner to permit prior Commission approval where required.

Verizon states that the leases and licenses addressed here involve either under-utilized space in existing Verizon facilities or surplus land where only part of a parcel is necessary in the utility's provision of telecommunications services. Verizon states that the excess space generally has been the result of consolidation of utility operations or the result of new technology and upgraded equipment requiring less space.

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[3] Section 851 requires Commission approval prior to the sale or lease of public utility property. However, Section 851 also provides: "Nothing in this section shall prevent the sale, lease, encumbrance or other disposition by any public utility of property which is not necessary or useful in the performance of its duties to the public…"

Verizon states that the leases and licenses considered here benefit Verizon customers by producing revenue for the company. Verizon states that none of the leases impair the utility's ability to serve its customers. All of the agreements require that the lessee's use of the property or facilities will not interfere with Verizon operations.

Nature of Leases and Licenses

Verizon has attached to its application copies of all of the leases and licenses for which it seeks approval. Also attached are the company's confidential fully allocated cost calculations for each property and a market analysis of fair rental value of each property. Verizon states that each of the leases with third parties was based on market valuations. In leases to affiliates, affiliates pay the higher of market value or Verizon's fully allocated cost plus return on investment. Verizon states that leases and licenses with affiliates have been amended where necessary so that the pricing is in accord with the Commission's affiliate transaction rules.

ORA, in its examination of the agreements, has divided them into two categories – third-party leasing / licensing agreements and affiliate leasing / licensing agreements. A representative sampling of the agreements in each of the two categories follows.

Third-Party Leasing/Licensing Agreements

<u>Lane Mountain, San Bernardino</u>. This lease granted a non-exclusive access easement of a 30x30-foot parcel of excess land to Total TV of Victorville for television cable operations.

<u>210 West South Street, Lone Pine</u>. This lease granted the California Highway Patrol access to 7,175 square feet of land on this underutilized central office site.

Mojave, Kern County. This lease allowed Bakersfield Cellular Telephone to use a 40x60-foot parcel of excess land to conduct cellular radio telephone operations.

390 North Rosemead Boulevard, Pasadena. This license granted Fidelity Tax Services the use of 23 parking spaces at an underutilized Verizon facility. This is a revocable license that Verizon may terminate on 30 days' notice.

One GTE Place, Thousand Oaks. This license granted the California Institute of Technology the use of a 3x2-foot storage room for installation and monitoring of seismographic equipment. This is a revocable license that Verizon may terminate on 30 days' notice.

ORA in its review concluded that the eight agreements with third parties involved about $40,000 in annual revenue to Verizon.

Affiliate Leasing/Licensing Agreements

Highway 58, California City. By this lease, Contel Cellular of California, Inc. (later GTE Mobilnet of Central California, Inc.) was granted access to an 80x60-foot parcel of unused land to conduct cellular radio telephone operations.

12501 Imperial Highway, Norwalk. This lease provided what was then GTE Intelligent Network Services with 800 square feet of excess office space for the affiliate's sales and technical support.

201 Flynn Road, Camarillo. This revocable license granted Verizon Communication Systems Corporation use of 5,600 square feet of unused warehouse space.

13155 Alondra Boulevard, Santa Fe Springs. This license granted Verizon Media Ventures Incorporated the use of 4,000 square feet of a parking lot that was excess to Verizon's needs.

ORA in its analysis stated that the annual revenue to Verizon from the agreements with affiliate corporations was about $100,000 annually. ORA noted that the affiliate transactions required more analysis than those with third parties, since the agreements must not have anti-competitive effects or result in cross-subsidization of non-regulated enterprises.

Our obligation in reviewing transactions like these under Section 851 is clear. As we have stated:

> "The Commission reviews these transactions to ensure that the transactions will not impair the utility's ability to provide service to the public. The Commission must also ascertain whether the transactions are accounted for properly. This requires ensuring that any revenues from the transactions are accounted for correctly, and that the utility's rate base, depreciation, and other accounts accurately reflect the transactions. The Commission will also consider benefits to the utility's customers and the public from the proposed lease." (*Re Pacific Bell* (1997) 71 CPUC2d 192, 193.)

Verizon states that these requirements have been met here. The agreements involved unused, excess space that was either within Verizon facilities or on Verizon property. Verizon states that the leases did not impair Verizon's provision of telecommunications service to the public, and revenues from these transactions were properly recorded. Verizon states that the agreements with affiliates are in compliance with the Commission's affiliate transaction rules, and that they involve no cross-subsidization. In addition, Verizon has amended its internal guidelines for leasing real estate assets to include mandated procedures for the proper review of California transactions.

Environmental Review

The California Environmental Quality Act (CEQA) requires the Commission to consider the environmental impacts of certain actions that it takes. (Pub. Res. Code §§ 21000, *et seq.*) The Commission is required to consider the environmental consequences of its discretionary approval of Section 851 applications. (Pub. Res. Code § 21080.) All of the licenses and leases are several years old and any activity which took place that may have warranted our timely CEQA review has already taken place. Thus, it can be seen with certainty that the discretionary approval sought here will have no significant effect on the environment.

30-Day Revocation

In addition to seeking approval of these leases and licenses, Verizon asks that the Commission exempt from Section 851 review any license in which Verizon has retained the right to revoke or terminate the arrangement without cause within 30 days. The Commission has previously ruled that property arrangements that could be terminated at any time at the sole discretion of the property owner constituted revocable licenses not subject to Section 851 review because the property was not "encumbered." (*Re Pacific Bell* (1996) 65 CPUC2d 324, 328.) Verizon states that a limited notice period of 30 days would more reasonably satisfy the needs of licensees in a realistic business setting, would as a practical matter constitute little or no encumbrance, and would still preserve the Commission's regulatory responsibility.

ORA Protest and Verizon Amendment

A protest to the application was filed in 1999 by ORA. ORA stated that it was in the process of investigating whether Verizon met all requirements of Section 851 and the Commission's affiliate transaction rules as to the license and lease agreements. ORA asserted that an audit would be necessary to determine if the transactions were being properly booked and were in compliance with the Commission's cost allocation and affiliate transaction rules.

ORA noted that it was conducting a NRF audit of Verizon, and that this audit would cover affiliate transactions and cost allocation issues.

Since filing its protest, ORA has completed its audit as part of Phase 1 of the NRF proceeding. At ORA's suggestion, Verizon, on October 15, 2002, filed an amendment to this application to modify the application in the following two ways:

1. The amendment adds a sublease for Verizon Select Services Inc. (VSSI). During the audit, it was found that several VSSI employees occupied 1,800 square feet of space in a leased Verizon building in Thousand Oaks. While VSSI compensated Verizon for the use of this space, no lease documentation could be found. VSSI vacated the office space in June 2000, and the lease runs only through that date.
2. The amendment expands what Verizon calls a "shared asset methodology" from its use with two affiliates to include a third affiliate, Verizon Data Services, Inc. (VDSI). As part of the audit of Verizon's former California headquarters building, the parties determined that a small number of VDSI employees occupied space that was not documented by a formal lease. VDSI provides data processing services to the Verizon corporate family, and the employees of the affiliate locate on-site at a client company for a period of time. Because of the shifting nature of the VDSI employees' location, Verizon and ORA agreed that such space occupancy would best be reflected in the shared asset methodology described in Verizon's original application.

ORA Recommendations

Based on its further discovery, ORA states that it does not oppose Commission approval of the 18 lease and license agreements. Moreover, ORA has no objection to the Commission granting the request that Verizon need not in the future submit for Section 851 approval those license agreements with third parties that are terminable on 30 days' notice.

Initially, ORA proposed deferral of the issue of Verizon's shared asset methodology pending completion of the NRF audit. The audit has since been completed, and Verizon has adopted ORA's recommendation that VDSI's occupancy of Verizon office space be included in this application and in the shared asset methodology. However, ORA in its brief filed on June 6, 2003, stated that further investigation of the shared asset methodology now prompts it to recommend that the Commission either deny approval of the methodology or order extensive changes. We deal with the issue of the shared asset methodology in Part II of this decision.

Approval of Lease and License Agreements

In D.99-06-092, we gave Section 851 approval to leases and licenses similar to those here. Verizon stated that it entered into these agreements without first seeking Commission approval because it believed at the time that approval was not necessary if the leased or licensed space was surplus to the utility's needs.

ORA has conducted discovery and analyzed the 18 agreements at issue. It states that it had some concern about accounting issues in certain of the leases and licenses, but it states that these accounting issues are not so significant as to delay approval of these agreements. It has joined Verizon in recommending that approval be granted. In view of this, and in consideration of the record as a whole, our order today grants the parties' joint recommendation and approves the agreements in this application.

In D.99-06-092, we examined 59 license and lease agreements that Verizon had executed between 1994 and 1997. We concluded that those agreements, including two sublease agreements with affiliates, were subject to Section 851 and should have been presented to us for prior approval. While we declined to impose a penalty under Pub. Util. Code § 2107, we adopted ORA's proposal to require Verizon to conduct a further search for the period 1990 to the present to determine if there were any similar lease and license transactions that had not been brought to us for prior approval.

As noted, Verizon retained outside consultants and conducted an internal audit of its real estate records, cross-referencing the results from three different sources. The 17 agreements identified in the audit, and the one additional lease identified in ORA's investigation, are similar to those for which we gave approval in D.99-06-092. Verizon states that it now has identified all such transactions to the best of its knowledge, and it assures us that its addition of a new Section 851 checklist to its corporate lease guidelines will ensure that all future leases will be in compliance with Section 851 requirements.

We conclude on this record that the 18 agreements examined here are subject to Section 851. However, as we found in D.99-06-092, the failure to obtain prior approval was based on a mistaken interpretation of the rules governing surplus space, and Verizon has acted diligently to correct that error. We agree with ORA, and we so find, that approval of these 18 agreements is appropriate on this record. We also find, as we did in D.99-06-092, that no sanctions beyond the additional audit requirement is necessary.

We conclude that the 18 agreements comply with our affiliate transaction rules and that they involve no cross-subsidization. Revenues from these transactions are properly recorded.

While the Commission in 1999 gave retroactive approval to the 59 lease and license agreements executed between 1994 and 1997, the Commission since that time has limited the use of retroactive approval. As we determined in D.03-05-033 and D.03-06-069, the authority that we grant today should apply prospectively, and not on a retroactive basis. One of the purposes of Section 851 is to enable the Commission to review a proposed encumbrance on utility property before it takes place, in order to take such action as the public interest may require. Granting the application on a retroactive basis would thwart the purpose of Section 851. Since we do not grant retroactive authority, the transactions are void under Section 851 for the period of time prior to the effective date of this decision.[4] Verizon is at risk for any adverse consequences that may result from its having entered into the contracts without prior Commission authority.

ORA also states that it has no objection to the Commission granting Verizon's request that license agreements with third parties terminable on 30 days' notice not be required to have Section 851 approval. ORA recommends that the Commission rule that license agreements containing such a provision need not be submitted for approval in the future. License agreements are generally governed by G.O. 69-C. The G.O. provides an exception to the Section 851 requirement for prior Commission approval of an encumbrance of

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[4] We note, however, that Section 851 does not require prior approval of a lease or encumbrance of property "which is not necessary or useful in the performance of its duties to the public." The statute further provides that "any disposition of property by a public utility shall be conclusively presumed to be of property which is not useful or necessary in the performance of its duties to the public, as to any purchaser, lessee or encumbrancer dealing with such property in good faith for value…"

utility property. The G.O. provides that a utility may convey licenses, easements, permits or other limited uses of land to third parties without prior Commission approval. The G.O. establishes three key criteria for permitting a utility to grant minor interests in utility property. These are:

(1) The interest granted must not interfere with the utility's operations, practices, and services to its customers;

(2) The interest granted must be revocable either upon the order of the Commission or upon the utility's determination that revocation is desirable or necessary to serve its patrons or consumers (*i.e.* at will); and

(3) The interest granted must be for a "limited use" of utility property.

Consistent with this standard, agreements which meet each of the three key criteria of G.O. 69-C are not subject to Section 851 approval. We make no specific findings regarding applicability of G.O. 69-C to the transactions in this application because a) Verizon has requested Section 851 review; and 2) we note several agreements contemplate revocation only with cause (as opposed to "at will" or by order of the Commission), may otherwise not fit the criteria of the G.O., and/or are leases which by definition require Section 851 approval.[5]

II. Shared Asset Methodology

Proposed Accounting Method

In addition to requesting approval of the leasing and licensing agreements, Verizon in this application makes a novel proposal for tracking the

[5] Section 851 requires Commission approval for a utility to "sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its…line, plant, system, or other property…"

use of Verizon office space and office equipment by three affiliates that provide administrative services for Verizon and other Verizon Communications businesses. Verizon asks the Commission to approve a shared asset methodology for computing payment to Verizon for such uses of its space and office equipment, and that this methodology take the place of Section 851 filings for the routine use of space and office equipment by the three affiliate service organizations.

Verizon states that, as part of its restructuring, many functions have been consolidated, and corresponding employees have been transferred. Two Verizon corporate entities, Service Corp and Consolidated Services Incorporated (CSI), provide administrative functions to all Verizon business units. These functions include product marketing, finance, data processing, human resources, legal services, regulatory and legislative affairs, billing and network integration services.

As part of these services, Service Corp and CSI employees are located in Verizon facilities and use office equipment owned by Verizon. Based on the shared asset arrangement, a fully allocated cost of the shared uses is compared to a market price, and the higher amount is used to allocate expenses to Service Corp and CSI. This arrangement, according to Verizon, allows Verizon to recover operating expenses and earn a return on investment for assets being used by Service Corp and CSI.

Under the methodology, the total Verizon investment in a facility is multiplied by the ratio of Service Corp/CSI employees to total employees at the location. The result is the amount of gross investment allocated to Service Corp/CSI. The gross investment is reduced by accumulated depreciation and deferred taxes to compute the net investment. A return on investment (ROI) is computed based on net investment multiplied by the allowable rate of return for the facility. The ROI is booked as revenue to Verizon's Account 5240, and ultimately results in a reduction to expense on Verizon's books. A similar calculation divides the facility's maintenance expenses, depreciation and property taxes. The final result is compared to market rates so that the amount charged to Service Corp / CSI is at the higher of cost or market, in compliance with the Commission's affiliate transaction rules.

In its amendment to the application on October 15, 2002, Verizon adopted ORA's recommendation to add VDSI as a third subsidiary for which approval of the shared asset methodology is sought. As noted earlier, VDSI provides data processing services to Verizon Communications entities, including Verizon California, and the employees of the affiliate locate on-site at a client company for varying periods of time.

Remaining Issues

In a Prehearing Conference last year, the parties agreed that an evidentiary hearing on remaining issues in this proceeding was unnecessary. Instead, they agreed to submit written position statements by June 14, 2003, addressing two questions:

1. Should the Commission approve the applicant's proposed shared asset methodology in place of Section 851 applications for dealing with the use of space and office equipment by service affiliates of Verizon?
2. Is further investigation warranted as to applicant's transfer of certain business units without prior approval under Pub. Util. Code § 851?

ORA Recommendations on Shared Asset Methodology

In its comments, ORA recommends that the Commission disapprove use of the shared asset methodology as a substitute for 851 filings or, alternatively, require substantial changes in the methodology process. ORA argues that, otherwise, Verizon will not be getting advance approval of these affiliates' use of Verizon space and equipment when required by Pub. Util. Code § 851.

On the other hand, ORA states that it is sympathetic to Verizon's concern that unless a shared asset methodology is used, Verizon will be compelled to enter into leases and licenses with the three service entities and then make numerous Section 851 applications for approval of the transactions. (At the time the application was filed, Verizon had more than 30 such shared-use arrangements, most of which were likely to be amended from time to time as service personnel moved from place to place.) ORA states that, like Verizon, Commission resources are limited, and the Commission may not be able to review frequent 851 filings thoroughly. With that in mind, ORA states that if the Commission approves the shared asset methodology as a substitute for 851 applications, it should make the following modifications to Verizon's practices:

- Verizon should be required to file an 851 application every three years (or file the information as part of the triennial NRF review) to estimate upcoming use of space and property by affiliates.
- Verizon should be required to file an advice letter annually to update use of shared assets. If actual usage exceeds the estimates in the earlier 851 filing, there should be a true-up of the cost allocation plus a late charge payment of 18% so that the regulated utility is not disadvantaged by allowing affiliates to share its resources.
- The shared assets should be reviewed as part of regular audits of Verizon.
- To ensure that ratepayers benefit from the sharing arrangement, there should be a direct flow-through

surcredit based on 10% of fully allocated cost if cost is higher than market value, or the difference between the market and cost if market cost is higher.

- All gain on sale from shared assets, if any of them are sold, should be a direct flow-through to ratepayers because ratepayers have borne the risk of these assets.
- While affiliate services should continue to follow affiliate transfer pricing rules, services provided by affiliates to the regulated utility should be based on the lower of cost or market in order to mimic an arm's-length transaction.

ORA also recommends that the Commission reject the use of headcount as an allocator in the shared asset methodology, substituting a formula developed by ORA that adopts the square footage used by affiliates as the allocator. Verizon would be required to update square footage usage in each of its three-year 851 filings.

Verizon's Response to ORA Recommendations

Verizon argues that its shared asset methodology streamlines Section 851 compliance through a self-executing mechanism that appropriately charges the service affiliates for their shared asset usage while avoiding the need for formal leases and redundant 851 applications. It denies ORA's assessment of "risk" to ratepayers from affiliates' use of excess office space and office equipment. Consolidation of administrative-support functions benefits ratepayers, according to Verizon, because otherwise Verizon would have to bear these costs alone.

Verizon states that its use of headcount as an allocator produces a more accurate estimate of costs than ORA's square footage formula. For example, it states, one building (115 E. Lime Ave.) has 90,200 square feet and a total employee headcount of 18, which under ORA's formula would mean assigning

5,011 square feet of that building to each employee, an overstatement of use that skews ORA results. Verizon states that its average of 368 square feet of space per affiliate employee under the shared asset methodology more closely resembles a typical office with standard cubicles and is more reasonable than the weighted average under the ORA approach of 719 square feet, an amount that exceeds the square footage of many one-bedroom apartments.

Verizon argues that its shared asset methodology was developed as a practical accounting approach in the area of administrative consolidation, which has become a fact of life in the telecommunications industry. It states that ORA's proposal to require speculative triennial 851 applications and annual advice letters would defeat this purpose and would be more cumbersome than separate 851 lease applications.

Verizon claims that ORA's proposal to change affiliate pricing rules to reflect a 10% markup on costs charged to the affiliates repeats a proposal that was rejected in the decision leading to this docket. (*See* D.99-06-092, at 9.) Verizon's existing affiliate pricing rules are set forth in Verizon's Cost Allocation Manual, which the Commission approved in Resolution T-15950 (December 9, 1996).

Discussion of Shared Asset Methodology Proposal

There is merit in Verizon's proposal to use a self-executing process for tracking service affiliate use of Verizon office space and equipment and using this process, with proper safeguards, for what otherwise would be dozens of Section 851 applications. For the kind of routine transactions at issue here, a properly drafted method for streamlining the approval process is welcome both in terms of administrative efficiency and NRF regulation. We agree that such a process benefits ratepayers by timely crediting Verizon for the use of this space and office equipment while at the same time reducing the time and cost required for preparing formal leases and filing Section 851 applications.

The shared asset methodology has been used first by GTE California Incorporated and then by Verizon since 1997. The results on the books of the regulated utility are audited regularly by ORA. Indeed, ORA's most recent audit recommended that a third service affiliate, VDSI, be added to those that use the shared asset methodology or a variation of that methodology.

It is important to note that the shared assets at issue here are office space in buildings owned or leased by Verizon and the office furnishings and equipment that accompany such space, such as cubicles, desks, chairs, desktop computers, file cabinets, and the like. Verizon represents that these are assets that it neither needs nor uses, since the overhead functions they serve have been consolidated in the three service affiliates. By using the assets to provide consolidated administrative-support functions to Verizon, the three service affiliates relieve Verizon from administrative burdens that it would otherwise have to bear on its own.

Affiliate transaction pricing rules require Verizon to charge the three service affiliates the higher of fully allocated cost (FAC) or fair market value (FMV) for their shared use of Verizon's general support assets. Verizon determines this charge by estimating the total number of square feet that the three affiliates occupy in Verizon's buildings, then multiplying that amount by the highest of (1) average FAC for all the shared buildings; (2) the FAC for the building with the majority of the service company employees, or (3) the FMV of the building with the majority of the service company employees (*i.e.*, generally the headquarters building where the highest percentage of shared employees are located).

This pricing calculation – developed in cooperation with ORA during one of its onsite inspections in this docket – results in a conservative approach to compliance with the affiliate pricing rules. ORA states that it agrees with this approach. The sole remaining issue with respect to the methodology itself is how best to estimate the number of square feet allocated to the three service affiliates.

Verizon estimates this square-footage allocation in the aggregate based on a percentage headcount of total employees versus service-affiliate employees co-located in Verizon's buildings. ORA on the other hand would estimate the number of square feet that the service affiliates occupy on a building-by-building basis. The difficulty with ORA's approach is that it assumes that each shared building is fully occupied, when in fact occupancy can range between 50% and 90%. Moreover, it assumes that each building is fully dedicated to administrative functions, when in fact operational use frequently dominates and administrative space may be limited. These assumptions cause ORA's methodology to overstate space usage by the service affiliates.

We conclude that Verizon's methodology provides a more accurate depiction of affiliate usage, and we decline to change the methodology to use ORA's square-footage measure instead of Verizon's headcount measure.

Should the Methodology Take the Place of 851 Filings?

We turn then to Verizon's request that the shared use methodology take the place of Section 851 filings where the three administrative service affiliates are involved. Verizon maintains that Section 851 does not necessarily require pre-approval of every lease. Instead, according to Verizon, it requires prior approval of any "encumbrance" of utility property. Verizon here seeks Commission approval of a limited category of such "encumbrances" – those where office space and office equipment are used by three service affiliates performing administrative work for several corporate entities, including Verizon.

ORA opposes this approach, arguing that it skirts the requirement of prior Commission approval of each of the service affiliates' leases of Verizon space and equipment.

We begin our analysis by noting that Verizon's licenses for the use of office space and equipment by these affiliates do not require Section 851 approval, and may be performed pursuant to G.O. 69-C under the shared use methodology. Our decision today grants Verizon's request that G.O. 69-C license agreements terminable on 30 days' notice do not require Section 851 approval. To the extent, therefore, that Verizon can fashion its space use agreements with affiliates as licenses terminable on notice of 30 days or less, no Section 851 approval is required. Such license agreements, of course, must meet the three criteria governing G.O. 69-C licenses:

1) The interest granted must not interfere with the utility's operations, practices, and services to its customers.
2) The interest granted must be revocable either upon the order of the Commission or upon the utility's determination that revocation is desirable or necessary to serve its patrons or consumers (*i.e.*, at will); and
3) The interest granted must be for a limited use of utility property.

The use of leases for affiliate use of office space and equipment presents a more difficult issue. As ORA points out, Section 851 specifically requires prior approval of leases. The shared use methodology addresses proper accounting of such lease arrangements, but it does not provide for prior approval of the leases. Without some provision for prior Commission approval of such lease agreements, a utility using only the shared asset methodology to account for these transactions would be at risk of violating Section 851.

In reviewing applications for approval of leases under Section 851, the Commission applies well-established standards to determine the following issues:

- Ensure that the transaction will not impair a utility's ability to provide service to the public;
- Ascertain whether the transaction is accounted for properly, including insuring that revenue is accounted for correctly, and that the utility's rate base, depreciation and other accounts correctly reflect the transaction; and
- Where the transaction is with an affiliate, determine whether the transaction has any anticompetitive effects or results in cross-subsidization of the non-regulated enterprise. (*See, e.g., Re Pacific Bell* (1996) 68 CPUC2d 123, 125.)

ORA does not challenge the assertion that the shared asset methodology is intended to consolidate common overhead support functions on a regional or national basis to improve operating efficiencies and cut costs. The Commission has determined that transactions such as these will not impair an incumbent competitive local carrier's ability to serve the public. (*See, e.g., Re Pacific Bell* (1997) 77 CPUC2d 421, approving Pacific Bell's space lease arrangements with affiliates performing administrative support functions.)

Similarly, the accuracy of accounting for this type of space usage is accommodated by the shared asset methodology in tracking the number of service employees and their locations on a monthly basis. The shared asset methodology is linked to Verizon's financial reporting system and is intended to capture all operating expenses associated with Verizon's assets and employees and systematically charges affiliate companies their pro-rata share of expenses, plus a return on investment. The method adjusts on an annual basis to accommodate changes in headcount and costs associated with the space occupied. The shared assets remain part of Verizon's rate base and are reflected in its depreciation accounts.

Similarly, when a transaction is with an affiliate, as here, the Commission in its Section 851 review seeks assurance that there are no anti-competitive effects or cross-subsidization of non-regulated enterprises. We have held that where the administrative services are exclusively in-house, there is no opportunity for anti-competitive effect as the result of collocation, or customer confusion, with respect to the affiliates. (*Re Pacific Bell,* 68 CPUC2d at 126.) Similarly, we have held that when the assets are basically office furnishings and equipment such as computers and desks, the assets are not the kind that would confer unique advantages on the utility's affiliates, as would intellectual property or telecommunications facilities. (*Re Pacific Bell,* 69 CPUC2d 206, 210.)

The final element of Commission review under Section 851 concerns the potential for cross-subsidization of affiliate operations through the provision of services from the utility to the affiliate at below-cost prices. In ruling on an earlier Section 851 request by Verizon's predecessor, the Commission concluded that under the utility's California Cost Allocation Manual, the provision of non-tariffed goods and services to other non-regulated affiliates must be priced at the higher of FAC (including ROI) or fair market value. Thus, the cross-subsidization concern is not at issue here.

In sum, we find that the use of the shared asset methodology to deal with encumbrances of Verizon's office space and office equipment by three administrative service organizations (Service Corp, CSI and VDSI) meets the requirements of Section 851 – except for the requirement of prior approval.

ORA acknowledges the administrative appeal of avoiding individual 851 applications for as many as 30 leases to cover the relatively routine use of space and office equipment by Service Corp / CSI / VDSI employees located on Verizon property.

ORA suggests a unique form of Section 851 approval. Since leases of Verizon space and office equipment by Service Corp / CSI / VDSI are all similar, ORA suggests that Verizon be permitted the option of filing an 851 application every three years (or filing the 851 information for approval as part of the triennial NRF review) that would forecast upcoming leases of space and property by Service Corp / CSI / VDSI. If Verizon elects this option for its affiliate leases, it would also be required to file an advice letter annually to update actual use of the lease arrangements that have been approved in advance by the Commission under this procedure. Verizon already does an annual update as part of its shared asset methodology.

ORA also proposes various financial penalties if under this option Verizon fails to accurately forecast the actual leased usage of space by these three affiliates. Absent a showing of ratepayer harm in an inaccurate forecast of leased space, we do not at this time adopt the penalty recommendations in ORA's proposal. Verizon's shared asset methodology charges the service affiliates based on their actual usage determined by current-year headcounts. At the beginning of each fiscal year, Verizon estimates the charges to the affiliates based on the previous year's headcount. Prior to the end of the fiscal year, another headcount is taken to update the shared asset study so that actual charges are recorded in Verizon's books in the year that they occur. This procedure, properly audited, ensures that ratepayers will receive the benefit of this use of utility assets.

We conclude that ORA's recommendation for an 851 filing every three years for the type of leases at issue here complies with the law, serves the public interest, and enhances administrative efficiency. In summary, our order today charts the following course for Verizon in licensing or leasing utility space and office equipment to Service Corp, CSI and VDSI:

(1) Verizon may grant licenses (revocable on notice of 30 days or less) for use of space and office equipment to Service Corp, CSI and VDSI, provided the licenses comply with G.O. 69-C requirements. No prior approval of these arrangements is required under Section 851. The shared asset methodology would continue to be used to account for the use of licensed assets.

(2) Verizon may file a Section 851 application every three years for advance approval by the Commission of all forecasted leases (and licenses that do not comply with G.O. 69-C) of space and office equipment to Service Corp, CSI and VDSI. Alternatively, Verizon may file the 851 information for approval as part of its triennial NRF review. If Verizon elects this option for its affiliate leases, Verizon will be required to file an advice letter annually to update actual use of the lease arrangements that have been approved in advance by the Commission under this procedure. The shared asset methodology would continue to be used to account for the use of leased assets.

(3) Verizon may continue to file individual Section 851 applications for approval of each lease, particularly if the use of G.O. 69-C licenses limits the number of required leases for these affiliates. The shared asset methodology would continue to be used to account for the use of leased assets.

Our order today also requires that the shared asset methodology be included in all future audits of Verizon conducted by ORA or by the Commission. We also adopt ORA's recommendation that the Section 851 procedure that we grant today is limited to the shared space and equipment usages of the three named service entities. Verizon must file a separate application if it seeks similar authority for other activities or other organizations within the corporate structure.

Further Investigation

The second question posed to the parties at the Prehearing Conference on June 14, 2003, was whether further investigation is warranted as to Verizon's transfer of certain business units without prior approval under Section 851. ORA believes further investigation is needed into the transfer of various business units, including product marketing, finance, human resources, legal and public affairs, to Verizon's central service organizations. Verizon opposes further investigation, stating that the transfers were reviewed during ORA's 1999 NRF audit and, in any event, involve the transfer of employees only, not physical assets. ORA states that it intends to address the matter in an upcoming Section 314.5 NRF audit and does not recommend that the issue be addressed in this proceeding. In view of that, we do not reach the issue and will deal with it if and when it comes before us in another proceeding.

Categorization of Proceeding

In Resolution ALJ 176-3025 dated October 21, 1999, the Commission preliminarily categorized this proceeding as ratesetting, and preliminarily determined that no hearings would be necessary. Our examination of the record persuades us that a public hearing is not necessary, nor is it necessary to alter the preliminary determinations.

Comments on Draft Decision

The draft decision of the Administrative Law Judge in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g) and Rule 77.1 of the Rules of Practice and Procedure. In its comments, ORA challenged the draft decision's conclusion that the shared asset methodology could take the place of Section 851 filings for the Service Corp / CSI / VDSI affiliates on grounds that the finding failed to provide advance approval by the Commission of leases to the affiliates. We agree with ORA's criticism of the draft decision, and we have revised the method of dealing with such leases to more closely track the recommendations of ORA. We have emphasized the different regulatory treatment of G.O. 69-C licenses for use of space and office equipment, and given Verizon the option of filing for advance approval of lease arrangements to the three affiliates every three years (with an annual advice letter true-up) or continuing to file an 851 application for each such lease. We also have made certain corrections in the text of the decision as recommended by ORA.

Verizon in its comments objects to ORA's proposal for a triennial filing of anticipated leases of space and office equipment to Service Corp, CSI and VDSI. It notes that the use of the shared asset methodology for leases effectively meets the three standards of approval required under Section 851. While we agree with that assertion, we also have found that the shared asset methodology does not meet the requirement for prior approval under Section 851. Thus, we have clarified our order to provide that (1) Section 851 filings are unnecessary for Service Corp / CSI / VDSI licenses that meet the requirements of G.O. 69-C; (2) Verizon will have the option of filing a Section 851 application every three years for advance approval of all forecasted leases of space and office equipment to the three affiliates; and (3) Verizon may continue to file individual

Section 851 applications for approval of each lease of this nature. We believe that this course of action meets the need for expedited treatment of these routine license and lease arrangements, while at the same time acknowledging ORA's primary objection that prior approval of leases (and licenses that do not meet the requirements of G.O. 69-C) is necessary under Section 851.

Assignment of Proceeding

Carl W. Wood is the Assigned Commissioner and Glen Walker is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. At Commission direction, Verizon has identified 18 lease and license agreements for which it seeks approval under Pub. Util. Code § 851.

2. In D.99-06-092, the Commission gave approval under Section 851 to 59 license and lease agreements that Verizon had executed between 1994 and 1997.

3. Verizon did not seek prior approval for these transactions under the mistaken belief that lease of surplus space was not covered by Section 851.

4. Seventeen licenses or leases submitted as exhibits to this Application permit various uses of Verizon property or facilities by either third parties or affiliates.

5. An additional sublease with Verizon Select Services, Inc., was identified by ORA and submitted as an amendment to this application.

6. All of the licenses and leases are several years old and any activity which took place that may have warranted our timely CEQA review has already taken place.

7. Verizon seeks a ruling that a license revocable on 30 days' notice does not constitute an encumbrance to the extent that Section 851 review is necessary.

8. ORA and Verizon jointly recommended that the Commission grant Section 851 approval for the transactions at issue and rule that Verizon licenses revocable on 30 days' notice need not be submitted for Section 851 review.

9. Agreements which meet the criteria of G.O. 69-C do not require Commission approval.

10. Verizon also seeks approval of a shared asset methodology as a substitute for separate 851 applications for use of office space and office equipment by three affiliates that provide administrative services for Verizon entities.

11. The shared asset methodology was reviewed by ORA in a NRF audit, and ORA does not contest the accuracy of the methodology as it is presently constituted.

12. At ORA's recommendation, Verizon has included a third service organization, VDSI, in the shared asset methodology.

13. ORA opposes the use of the shared asset methodology as a substitute for Section 851 applications for the types of encumbrances at issue here.

14. If the Commission adopts the shared asset methodology as a substitute for Section 851 applications for the use of space and office equipment by three service affiliates, ORA urges substantial modification of the process.

15. It can be seen with certainty that the discretionary approval request in the application will have no significant impact on the environment.

Conclusions of Law

1. Section 851 requires Commission authorization before a utility may sell, lease, assign. mortgage, or otherwise dispose of or encumber necessary or useful utility property.

2. ORA has examined the 18 lease and license agreements at issue here and has no objection to Section 851 approval of the transactions.

3. Verizon licenses with third parties that meet the criteria of G.O. 69-C do not require Section 851 approval.

4. The Commission should approve Verizon's shared asset methodology as meeting all but the prior-approval requirements of Section 851 for use of office space and office equipment by three affiliates that provide administrative services for Verizon entities.

5. Verizon should be given the option of filing every three years for advance approval of shared-space leases to Service Corp., CSI and VDSI.

6. The shared asset methodology should be included in all future audits of Verizon by ORA and/or the Commission.

7. Use of the share asset methodology as a substitute for all but the prior-approval of Section 851 should be authorized only for the services of Service Corp, CSI and VDSI.

8. A hearing is not warranted on the facts of this application.

O R D E R

IT IS ORDERED that:

1. Pursuant to Section 851 of the Public Utilities Code, the application of Verizon California Inc. (Verizon) for approval of the 18 license and lease agreements in this proceeding is granted. The approval is on a prospective basis and does not include retroactive approval.

2. We grant Verizon's request to exempt from Section 851 review of any license in which Verizon has retained the right to revoke or terminate the arrangement without cause within 30 days, provided that such license must otherwise meet the requirements of General Order (G.O.) 69-C.

3. Verizon need not in the future submit for Section 851 approval those Verizon licenses with third parties that meet the criteria of G.O. 69-C and are terminable at will within 30 days.

4. Verizon may continue to implement its shared asset methodology for dealing with the use of Verizon space and office equipment by Service Corp, Consolidated Services Incorporated (CSI), and Verizon Data Services, Inc. (VDSI).

5. Verizon is granted the option of filing an 851 application every three years (or filing the Section 851 information for advance approval as part of the triennial New Regulatory Framework review) that forecast upcoming leases (or upcoming licenses that do not comply with G.O. 69-C) of Verizon space and office equipment by Service Corp / CSI / VDSI.

6. If Verizon exercises its option of triennial filings of forecasted leases of Verizon space and office equipment by Service Corp / CSI / VDSI, Verizon shall be required to file an advice letter annually to update actual use of the lease arrangements that have been approved in advance by the Commission under the procedure authorized by this order.

7. Verizon shall continue to use the shared asset methodology to account for the use of licenses and leased space and office equipment to Service Corp / CSI / VDSI.

8. Verizon at its option may continue to file individual Section 851 applications for Service Corp / CSI / VDSI leases instead of or in addition to a triennial filing.

9. All licensed and leased use of shared space by Verizon's affiliates shall conform to the requirements of the California Environmental Quality Act.

10. The shared asset methodology shall be reviewed by the Commission's Office of Ratepayer Advocates and/or the Commission in all future audits of Verizon.

11. Application 99-10-010 is closed.

This order is effective today.

Dated _____________________, at San Francisco, California.

CERTIFICATE OF SERVICE

I certify that I have by mail this day served a true copy of the original attached Alternate Opinion and Order of Commissioner Wood as on all parties of record in this proceeding or their attorney of record.

Dated March 2, 2004, at San Francisco, California.

/s/ SUSIE TOY
Susie Toy

N O T I C E

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address to insure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

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The Commission's policy is to schedule hearings (meetings, Workshops, etc.) in locations that are accessible to people with disabilities. To verify that a particular location is accessible, call: Calendar Clerk (415) 703-1203.

If specialized accommodations for the disabled are Needed, e.g., sign language interpreters, those making The arrangements must call the Public Advisor at TTY# 1-866-836-7825 or (415) 703-5282 at least three Working days in advance of the event.