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Decision 04-02-063 February 26, 2004

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, depreciation, and the write-off of its PBOP regulatory asset, but misstated the expenses that it reported for certain other PBOP costs and income taxes. The amount of misstated expenses was as follows:

	1997 (millions)	1998 (millions)	1999 (millions)	Total (millions)
Overstated/(Understated) Expenses	(\$7.9)	(\$107.4)	\$234.5	\$119.1

Today's decision does not result in sharable earnings owed to ratepayers. The adjustments ordered here, however, flow through to the Commission's Phase 2B audit decision. If that decision results in a refund to ratepayers, Pacific will be ordered to make that refund to its ratepayers and pay interest on the refund in accordance with the instructions contained in the Commission's Phase 2B audit decision. Today's decision also finds that Pacific improperly

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

withdrew \$180 million from one of its PBOP trust funds in 1999. Pacific is ordered to return \$180 million to the trust fund, plus interest based on the higher of the 3-month commercial paper rate or the interest that would have been earned had the money been left in the PBOP trust fund.

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:

$$\text{New Rate} = \text{Old Rate} \times (\text{inflation} - \text{productivity} \pm \text{Z-Factors})$$

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 classified as Category III services. The price for each Category I service

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

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 floor and price ceiling. 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 conducted 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 service quality issues of this phase were resolved in D.03-10-088). 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 § 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 Overland Exhibit Phase 2B: 409, pp. 5 and 8.

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.

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:

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

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, workforce reductions, 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 of 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

¹¹ D.88-03-072, 27 CPUC 2d 550, 554.

¹² Pacific Exhibit Phase 2A: 307, Q&A 22, and Phase 2A: Exhibit 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 witnesses 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. Moreover, 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

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.

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, the value of the assets held by Pacific's pension plans 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 technical issue is whether Pacific is required to report negative pension costs for regulatory purposes as Overland and ORA contend, or zero pension costs as Pacific contends. The central regulatory policy issue, which must drive the accounting treatment, is who has rights to pension fund assets.

We agree with Pacific on resolution of the accounting issue because we believe that it is the intention of both federal and state policies to protect the pension assets of workers from expropriation by shareholders, public utilities, or ratepayers. Indeed, a central goal of ERISA is to protect pensions for the benefit of employees, retirees, and other qualified beneficiaries.

The argument that booking a negative ACM amount as a corporate profit and requiring sharing with ratepayers will have no effect on pensions lacks credibility. In particular, it is Pacific's revenues that will supply the resources for sharing. Thus, booking a negative ACM amount as a corporate profit and requiring sharing turns a pension asset into a potential liability because paper gains in pension assets will produce real liabilities – funds owed to ratepayers.

We recognize that the primary issue before the Commission in D.88-03-072 was the appropriate regulatory treatment of the costs incurred by telephone utilities to fund their pension plans.²² In considering this issue, the Commission concluded that the ACM should be used for ratemaking and regulatory accounting purposes.²³ Further, under the ACM, when pension assets exceed pension liabilities, contributions to the pension fund drop to zero, thereby reducing pension costs immediately and in all future periods until a balance is achieved. Moreover, under both IRC and ERISA law, pension contributions determined under ACM are never less than zero. This policy, which is embedded in Commission decision and federal law, comports with common sense.

We are not persuaded by Overland and ORA that the failure to recognize negative pension costs when pension assets exceed pension obligations results, in the long run, in more pension costs being recognized for regulatory purposes than the value of the pension benefits actually paid over the long run. Such reasoning fails to consider that when the ACM formula produces a “negative” amount, Pacific makes no further contribution to the pension fund, even though it continues to incur pension liabilities for new workers. Thus, over time, the pension fund should return to an equilibrium state as liabilities grow to equal assets. For any other result to occur, one must argue that pension benefits to Pacific will be free forever. Such an outcome, at best a theoretical possibility, does not comport with the common sense world that we know, and there is no credible evidence in the record to suggest that such an outcome will occur.

²² D.88-03-072, 27 CPUC 2d 550, 551.

²³ D.88-03-072, 27 CPUC 2d 550, 557.

The record in this proceeding leaves no doubt that Pacific's pension plans held more funds than needed during the audit period. Overland testified that the fair market value of the assets in Pacific Bell's pension trusts as measured by SFAS 87 exceeded Pacific's projected pension benefit obligation by \$5.9 billion, or 78%, as of December 31, 1999.²⁴ The proper application of the ACM for regulatory purposes will amortize Pacific's surplus pension assets as a reduction in pension expense to zero until a balance is once again achieved. Moreover, pension assets fluctuate over time. Between December 31, 1999 to December 31, 2001, excess pension fund assets as measured by SFAS 87 dropped by over \$3 billion, from \$5.9 billion to \$2.7 billion.²⁵

We are persuaded by Pacific's argument that its pension plans experienced unexpectedly high earnings on its pension assets. The purpose of funding pension plans is to accumulate assets that, together with anticipated earnings on those assets, will be sufficient to pay for pension benefits. There are two elements to the protection of pension benefits: first, preventing the diversion of pension funds to other uses; second, insuring that the pensions are adequately funded. We address the first element later in today's decision, while the ACM takes care of the second element. Thus, the amount of funding in the pension at any time is inextricably linked to the return on plan assets. If the assets in the pension plan earn more than anticipated, then excess funding occurs. Conversely, if assets earn less than expected, then inadequate funding occurs. In

²⁴ Overland Exhibit Phase 2A: 404, Volume 2, pp. 7-12 and 7-13. It is important to note that the ACM calculations used by Overland to determine the negative pension costs that are adopted by today's decision recognized only 80% of the market value of the pension assets during the audit period (Exhibit Phase 2A: 404, Volume 2, p. 7-10).

²⁵ Pacific Exhibit Phase 2A: 307, p. 66.

our view, the ACM method provides for gradual amortization of excess funding and gradual “catch-up” for inadequate funding.

It is inappropriate to treat the surplus pension assets for ratemaking purposes as if they are company profits. Pension assets and earnings are held in trust for Pacific’s current and future retirees, not Pacific or its ratepayers. Moreover the recognition of surplus pension assets as company profits for regulatory purposes will affect the management of the pension assets. In particular, if a company is required to share earnings from its pension fund above a certain amount, then a rational company will make investment decisions in its pension funds in a way that avoids or manages its regulatory liabilities. In addition, the recognition of negative pension costs for regulatory purposes and the distribution of “overfunding” to ratepayers would require a prudent utility to maintain sufficient liquidity to meet its potential obligations to ratepayers in the event that pension assets realize earnings above historic levels. This could reduce the cash available for new investments and infrastructure development.

Recent stock market performance suggests that surplus pension assets may prove chimerical, while pension liabilities remain solid. Moreover, since “sharing” of earnings is asymmetric, treating pension earnings as company profits would require the distribution of assets in years when earnings are good, but not permit recovery in years when pension funds incur losses. This structure, although reasonable when it comes to earnings from company operations, is unreasonable and fundamentally unfair to workers and shareholders, who would find pension funds impounded in good earning years but have no recourse to make up shortfalls. Moreover, unlike company operations, the company will have only modest control over the performance of pension funds.

Although the record in this proceeding shows that for many years Pacific has recognized negative pension costs in the financial reports that it submits to the SEC, FCC, and its shareholders, the purpose of that reporting is to provide information useful to investors, particularly information concerning any hidden liabilities. This contrasts with the purpose of our regulatory accounts, whose chief purpose is to set rates. Thus, it is not reasonable to argue that the recognition of negative pension costs as required in financial reports provides any normative justification for treating pension earnings as company profits in a regulatory accounting system, which would order rebates to ratepayers based on pension fund earnings.

We agree with Pacific's contention that the recognition of negative pension costs is inconsistent with NRF. NRF itself presumed ACM accounting treatment in setting the startup revenue requirement that went into the "base year" that was subsequently used by the price cap indices. It would therefore be inconsistent with NRF to change the regulatory treatment of pension assets at this time without a compelling reason to do so. No such reason exists here.

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 sharable earnings, Pacific would need to finance the amount of negative pension costs refunded to ratepayers in the form of sharable earnings. This would require the creation of a fictive "prepaid pension asset" in rate base. This is not an appropriate outcome. A primary purpose of price cap regulation was to reduce the complexity and increase the transparency of regulation. The creation of fictive "pension assets" goes in the wrong direction. Moreover, as our discussion later in this decision regarding the PBOP regulatory

asset indicates, these regulatory assets can face uncertain recovery and disparate future regulatory treatment. It is wiser to avoid creating new ones.

For the foregoing reasons, we conclude that Pacific Bell properly recorded zero pension costs during the years 1997 through 1999 and order no adjustments.

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)²⁶ to the extent allowed by the Internal Revenue Code (IRC) and employee unions.²⁷ 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.²⁸ The funds were transferred to Pacific as cash available for

²⁶ The PBOPs provided by Pacific consist of (i) post-retirement discounts on telephone service and (ii) medical, dental, and life insurance benefits.

²⁷ D.92-12-015, OP 2.g., 46 CPUC 2d 499, 533.

²⁸ Overland Exhibit Phase 2A: 409, Table 7 of 7.

unrestricted corporate use.²⁹ 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 \$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.

²⁹ 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.)

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.³⁰ 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

³⁰ D.92-12-015, 46 CPUC 2d 499, 515.

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 been had the § 420 transfer not occurred.³¹ 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.³² The obvious purpose of the Commission's order was to reduce the PBOP costs that Pacific reported for regulatory purposes.³³ Pacific Bell frustrated the intent of the Commission's

³¹ The reduction would be reflected when the ACM produces positive pension costs.

³² D.92-12-015, OP 2.g., 46 CPUC 2d 499, 533.

³³ D.92-12-015, 46 CPUC 2d 499, 516, 524, and 533.

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 \$41 million as taxable income for federal tax purposes, which demonstrates that Pacific was, in fact, enriched by the transaction.³⁴ 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.³⁵

³⁴ 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.

³⁵ 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.

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,³⁶ 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., 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.

In its comments on the Alternate Proposed Decision, Pacific argues that today’s decision commits legal error because it does not conform to SFAS 106 adopted by D.92-12-015. Pacific asserts that the source of PBOPs funding – whether a § 420 transfer or otherwise – is irrelevant to the amount of expense recorded under SFAS 106. As the Commission stated in D.97-04-043:

The cost of the PBOP obligation as determined by . . . [SFAS 106] must not be confused with the financing of that cost. The total cost of the PBOP obligation is not changed by the manner in which a utility may choose to finance that obligation during a given accounting period. (D.97-04-043, 71 CPUC 2d 653, 665.)

Pacific argues that reducing its SFAS 106 costs by the amount of the § 420 transfer misapplies SFAS 106 and violates D.92-12-015.

Pacific misconstrues D.92-12-015. Adopting Pacific’s approach would allow Pacific to report PBOP costs that it will never pay out of its own pocket. This is not what D.92-12-015 intended. Decision 92-12-015 ordered Pacific to use

³⁶ Overland Exhibit Phase 2A: 402, Part 2, p. S7-2.

surplus pension assets to pay for PBOP costs to the extent possible.³⁷ As stated previously, the obvious purpose of the Commission's order was to reduce the PBOP costs that Pacific reported for regulatory purposes.³⁸

Pacific also misconstrues D.97-04-043. TURN's reply comments on the Alternate Proposed Decision correctly note that the provision in D.97-04-043 cited by Pacific addresses the narrow issue of whether SFAS 106 costs qualified for Z-Factor recovery. Thus, the cited provision in D.97-04-043 is irrelevant because it does not address the matter at issue here, i.e., whether the SFAS 106 costs that Pacific reports for regulatory purposes should exclude PBOP costs paid with surplus pension assets.³⁹

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 (FMV) of the assets in Pacific'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

³⁷ D.92-12-015, OP 2.g., 46 CPUC 2d 499, 533.

³⁸ D.92-12-015, 46 CPUC 2d 499, 516, 524, and 533.

³⁹ D.92-12-015, OP 8, limited the amount of SFAS 106 costs that Pacific could recover from the Z-Factor to its tax-deductible contributions to PBOP trust funds. Consequently, Pacific was never going to recover via the Z-Factor any SFAS 106 costs that were paid with surplus pension assets. Hence, the provision in D.97-04-043 that is cited by Pacific did not apply to SFAS 106 costs paid with surplus pension assets.

other beneficiaries.⁴⁰ 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.

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

⁴⁰ \$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 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 obligation made in accordance with the ACM. As of December 31, 1999, the FMV 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.

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.⁴¹”

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

The record in this proceeding leaves no doubt that Pacific’s pension plans were over funded during the audit period.⁴² 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, consistent with federal law. 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

⁴¹ D.92-12-015, FOF 32, 46 CPUC 2d 499, 530.

⁴² Overland Exhibit Phase 2A: 404, Volume 2, pp. 7-12 and 7-13.

pension plans.⁴³ 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 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.

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 PBOPs 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.

⁴³ Overland Exhibit Phase 2A: 403, p. 4. Pacific Telesis was Pacific's parent company prior to Pacific's merger with SBC.

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 benefits are earned by employees.⁴⁴ 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.⁴⁵

⁴⁴ 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.)

⁴⁵ 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.)

Decision 92-12-015 ordered Pacific to record as a regulatory asset any SFAS 106 costs that exceeded its tax-deductible contributions. The regulatory asset was to be recorded pursuant to SFAS 71.⁴⁶ SFAS 71 states that if a regulatory agency provides assurance that costs incurred by a utility in the current period will be recovered in future rates, the utility must capitalize such costs as a regulatory asset.⁴⁷ Under D.92-12-015, “recovery” of the PBOP regulatory asset was to occur when Pacific’s tax-deductible contributions exceeded its SFAS 106 costs and continue until the regulatory asset reached a zero balance.⁴⁸ Additionally, Pacific’s recovery of the regulatory asset via the Z-Factor was limited to the parameters identified in the following paragraph.

Decision 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.⁴⁹

Following the issuance of D.92-12-015, Pacific recovered \$107.5 million in SFAS 106 costs via the Z-Factor in 1993⁵⁰ and \$99.5 million per year during 1994 through 1998,⁵¹ for a total of \$605 million.⁵² 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.

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

⁴⁷ D.92-12-015, 46 CPUC 2d 499, 521.

⁴⁸ D.92-12-015, OP 4, 46 CPUC 2d 499, 533.

⁴⁹ D.92-12-015, OP 8, 46 CPUC 2d 499, 533.

⁵⁰ D.01-04-019, 2001 Cal. PUC LEXIS 306, *2; Resolution T-15160, *mimeo.*, pp. 9 and 11.

⁵¹ D.98-10-026, 82 CPUC 2d 335, 366; Resolution T-15442, *mimeo.*, pp. 3 5, and 7.

⁵² Overland Exhibit Phase 2A: 403, p. 6.

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 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 line⁵³ 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 \$191.3 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

⁵³ 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.

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.

Overland recognizes that Ordering Paragraph (OP) 4 of D.92-12-015 ordered Pacific to record 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 71.⁵⁴ 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

⁵⁴ D.92-12-015, 46 CPUC 2d 499, 522, and Conclusions of Law 8, 9, and 10 at 531-32.

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 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, atypical, uncusomary, and infrequently recurring loss.⁵⁵ Therefore, if

⁵⁵ 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

Footnote continued on next page.

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 SFAS 106 transition benefit obligation (TBO).⁵⁶ 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.⁵⁷ 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.⁵⁸ ORA argues that it is illogical to conclude that OP 4, by

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.

⁵⁶ 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.

⁵⁷ SFAS 71, Paragraph 55, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 21.

⁵⁸ D.92-12-015, Conclusion of Law (COL) 12 and OP 4.

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 the Z-Factor would provide Pacific with sufficient funds to recover the entire regulatory asset. Therefore, when D.98-10-026 eliminated the Z-Factor, it was not reasonable to assume, as Pacific did, that the write-off should be recorded above the line. In fact, ORA believes that Pacific's above-the-line write-off violated D.92-12-015 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”).⁵⁹ 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 provision in 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 provision in D.92-12-015 that limited Pacific’s SFAS 106 costs to its contributions. TURN opines that a more reasonable reading of D.98-10-026 is that the Decision limited SFAS 106 costs to contributions, but replaced direct recovery of SFAS 106 costs via the Z-Factor with indirect opportunities to recover these costs. These 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.⁶⁰ 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.)

⁵⁹ D.92-12-015, 46 CPUC 2d 499, 520.

⁶⁰ D.92-12-015, COL 10, 46 CPUC 2d 499, 532.

TURN asserts 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. Pacific responded by stating 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.⁶¹ 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.

TURN argues that if Pacific had truly believed that eliminating 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 shows that Pacific believed at the time that no write-off was required. The other likely explanation is that Pacific knew at the time that eliminating 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 71.⁶² 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

⁶¹ ORA Exhibit Phase 2A: 118, Attachment 3, last 2 pages, and “Question 4 – Impact of Eliminating Z-Factors.”

⁶² D.92-12-015, 46 CPUC 2d 499, at 520-523, and 533.

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 prohibit an above-the-line write-off. Second, D.92-12-015 found that SFAS 106 costs are a legitimate cost of providing service.⁶³ 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.91-07-056,⁶⁴ 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.

⁶³ D.92-12-015, 46 CPUC 2d 499, 516, 530.

⁶⁴ D.91-07-056, COL 57, 41 CPUC 2d 89, 128.

Pacific states that if their argument had merit, it would have been unnecessary for D.92-12-015 to have authorized 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,⁶⁵ ORA and TURN wrongly assert that this limitation also applies to Pacific's ability to record PBOP 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 1998.⁶⁶ 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.⁶⁷ 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

⁶⁵ D.92-12-015, 46 CPUC 2d 499, 520.

⁶⁶ ORA Brief, p. 18.

⁶⁷ 6 TR 508.

that SFAS 71 does not control the actions of regulatory agencies.⁶⁸ 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.92-12-015.⁶⁹ 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.

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.⁷⁰ 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 71.⁷¹ 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.⁷² Resolution of this issue hinges on Pacific's claim

⁶⁸ 6 Tr. 518.

⁶⁹ D.92-12-015, OP 4, 46 CPUC 2d 499, 533.

⁷⁰ TURN Brief, p. 10.

⁷¹ D.92-12-015, 46 CPUC 2d 499, 520-525.

⁷² Overland Exhibit Phase 2A: 404, Volume 2, p. 7-27, Table 7-8. Today's decision, *infra*, adopts various adjustments to Pacific's regulatory asset. Our discussion of the write-off of Pacific's regulatory asset implicitly incorporates these adjustments.

that its regulatory asset was subject to SFAS 71 and that Pacific was required to write off its regulatory asset in accordance with SFAS 71, D.92-12-015, and D.98-10-015. If we find that it was appropriate for Pacific to write off its PBOP regulatory asset, we must then consider if the write-off should have been recorded above or below the line.

**a. Whether It Was Proper to Write Off the PBOP
Regulatory Asset Pursuant to SFAS 71**

We first consider if Pacific's regulatory asset was subject to SFAS 71. This question is definitively answered by OP 4 of D.92-12-015, which explicitly ordered Pacific to establish and maintain a regulatory asset pursuant to SFAS 71.⁷³ Overland, ORA, and TURN contend that Pacific's regulatory asset was not subject to SFAS 71 because D.92-12-015 contains dicta and conclusions of law that state the Commission is not governed by SFAS 71.

D.92-12-015 does state that SFAS 71 as a matter of law does not govern the Commission. 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.)

However, OP 4 explicitly ordered Pacific to establish and maintain a regulatory asset pursuant to SFAS 71, thereby electing to make SFAS 71 applicable. Ordering paragraph 4 of D.92-12-015 states:

The utilities shall establish and maintain a regulatory asset pursuant to Financial Accounting Standards Board's Statement No. 71 and as discussed in this order. The recovery of such regulatory asset in future rates shall begin during the year

⁷³ D.92-12-015, OP 4, 46 CPUC 2d 499, 533.

when tax-deductible limits exceed PBOP costs and shall continue until the regulatory asset has reached a zero balance.

We find this dispositive of whether Pacific's regulatory asset was subject to SFAS 71.

We note, however, that D.92-12-015 discussed two particular aspects of the regulatory asset. First, the Decision excluded the regulatory asset from rate base.⁷⁴ Second, it required Pacific to include this asset on its regulated books in the event that Pacific determined that the Commission's regulatory promise did not justify inclusion of this asset on its financial books, which are controlled by securities, not utility, law. Indeed, D.92-12-015 states:

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 the statement and their allowable tax-deductible contributions. We advise these two utilities to provide similar treatment in their external financial statements.⁷⁵

Thus, it was clearly the Commission's intention that the utilities establish a regulatory asset on their regulatory books (and on their financial books as well, if possible).

Having concluded that Pacific's regulatory asset was subject to SFAS 71 as discussed in D.92-12-015, we next consider if Pacific was required by SFAS 71 to write off its regulatory asset. 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

⁷⁴ D.92-12-015, OP 5, 46 CPUC 2d 499, 533.

⁷⁵ 46 CPUC2d 499, 1992 Cal. PUC LEXIS 864, *66-*67.

written off to the extent that assurance of recovery of the asset in future rates is lost.⁷⁶ Nothing in D.92-12-015 countermands these controlling features of SFAS 71. Indeed, D.92-12-015 discussed the possible future need to write off the PBOP regulatory asset, noting specifically:

GTEC contends that if recovery cannot continue, then the associated regulatory asset must be written off immediately.⁷⁷

Thus, the Commission in D.92-12-015 was clearly aware that the PBOP regulatory asset might have to be written off some day under SFAS 71 and let this standard accounting treatment pass without further comment.

In addition, we note that a major goal of D.98-10-026 was “to further streamline and simplify NRF, promoting our goal of low cost, efficient regulation.”⁷⁸ The Decision states:

GTE recommends no further Z factor recovery, with all recovery by application or other procedural vehicle. Thus, GTE proposes no further Z factor treatment for PBOPs.

We adopt the proposals of Pacific and GTE to discontinue PBOP recovery by Z factor at the end of 1998.”

Thus, it is clear that D.98-10-026 ended Z-Factor recovery of PBOP expenses.

Since the SFAS 106 Z-factor that was eliminated in D.98-10-026 supported the regulatory asset, SFAS 71 required Pacific to write off the entire regulatory asset. In particular, despite allegations by Overland and the parties, there is no evidence in this proceeding that PAYGO rates would provide sufficient revenues to recover the regulatory asset. Appendix G of today’s decision shows that Pacific’s PAYGO costs were substantially less than its SFAS 106 costs in 1997 and

⁷⁶ SFAS 71, Paragraph 10, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 21.

⁷⁷ D.92-12-015, 46 CPUC 2d 499, 523.

⁷⁸ D.98-10-026, 1998 Cal. PUC LEXIS 669.

1998. The fact that Pacific's annual SFAS 106 costs exceeded its PAYGO costs indicates that Pacific's PAYGO rates could not guarantee the recovery of Pacific's PBOP regulatory asset.

It is clear that the elimination of the Z-Factor cost Pacific hundreds-of-millions of dollars in annual revenues for at least several years. Conversely, there is no evidence that PAYGO rates would eventually recover the PBOP regulatory asset. Thus, pursuant to SFAS 71, Pacific had to write off the PBOP regulatory asset completely.

In summary, since no discussion in D.92-12-015 countermanded this aspect of SFAS 71, we find that Pacific was required by SFAS 71 to write off its PBOP regulatory asset when the Commission eliminated the SFAS 106 Z-Factor in D.98-10-026.

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

Pacific argues that there are several reasons why it was appropriate for the write-off to be recorded above the line. First, D.98-10-026 did not prohibit an above-the-line write-off. Second, in D.92-12-015 the Commission held that SFAS 106 costs are a legitimate cost of service and permitted their recovery through an above-the-line Z-Factor.⁷⁹ Finally, because SFAS 106 costs are a legitimate expense, it would be an improper ratemaking adjustment under NRF to record the write-off below the line.

We agree with Pacific that D.98-10-026 did not explicitly prohibit an above-the-line write-off. Moreover, D.98-10-026 focuses on above-the-line regulatory adjustments for PBOP costs. Consequently, the only reasonable conclusion that

⁷⁹ D.92-12-015, 46 CPUC 2d 499, 516, 530.

we can reach is that with the elimination of the SFAS 106 Z-Factor that financed the booking of the regulatory asset above-the-line, then an above-the-line write-off of the regulatory asset is the appropriate accounting treatment.

We also agree with Pacific that in D.92-12-015 the Commission held that SFAS 106 costs are an appropriate cost of service, and providing “above-the-line” treatment for the write-off is consistent with this decision. Furthermore, we do not find the failure of D.98-10-026 to discuss the write-off of this regulatory asset as indicative that the decision anticipated “below-the-line” treatment of this asset. The principal effect of D.98-10-026 was to guarantee to ratepayers an immediate \$99.5 million reduction in rates for that year and every year going forward.⁸⁰ Although the write-off of Pacific’s regulatory asset above the line could potentially affect rates to the extent it reduced the amount of earnings that Pacific would have to share with its ratepayers in 1998 under the NRF earnings-sharing mechanism, it was not clear that there would be a rate consequence of D.98-10-026. Seeking to make complicated adjustments concerning the regulatory asset write-off now based on a consideration of shareable earnings in 1998 by its nature introduces post-hoc rationales at odds with the stated intent of D.98-10-026 to simplify regulation and the explicit *quid pro quo* of the regulatory bargain – which eliminated Z-Factors, provided an immediate and ongoing \$99.5 million rate reduction, and eliminated a regulatory asset. The treatment of the regulatory asset did not require explicit discussion in 1998 because the standard treatment – a write-off of an above-the-line asset by an above the line adjustment – was simple, consistent with the decision, and uncontroverted by

⁸⁰ 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.)

any discussion in D.92-12-015, which determined the treatment for this regulatory asset on the regulated accounts. Moreover, the failure to discuss the alternative of below-the-line treatment of the regulatory asset in D.98-10-026 suggests that this alternative does not (and did not) merit serious discussion.

TURN argues that in the proceeding that led to D.98-10-026, the Commission asked Pacific to identify the rate impacts of eliminating the Z-Factor, and that Pacific failed to identify the need to write off the regulatory asset. Pacific's failure to identify the write-off does not justify disallowing the write off at this time. First, the main ratemaking impact of eliminating the Z-Factor was the \$99.5 million decrease in rates, and this was clearly identified. Second, since sharing was only a possibility, the regulatory write-off of the regulatory asset had no certain impact on rates, only a potential impact on rates. Third, even if identified, the write-off of the regulatory asset was a minor consequence of D.98-10-026 when compared with the \$99.5 million decrease in rates and the regulatory goal of simplifying the price cap mechanism.

Overland's and the parties' argument that D.92-12-015 limits the recovery of PBOPs expenses in any one year requires below-the-line treatment of the write-off of the regulatory asset is not convincing. First, they fail to recognize that D.98-10-028 constitutes a new regulatory deal – no Z-Factor adjustments, a \$99.5 million decrease in rates, and simplified regulation. Thus, D.98-10-028 supercedes D.92-10-015 concerning the recovery of PBOP expenses and the attendant regulatory asset. Second, their approach violates the spirit of both NRF and D.98-10-028, which sought to reduce ratepayer rates while simplifying regulation. Their approach seeks to reduce rates, but it also complicates regulation with esoteric arguments concerning PAYGO rates and the “potential” to recover costs. In D.98-10-028, the Commission sought simplicity and certainty.

Finally, it is well to keep in mind the nature of PBOPs expenses and the policies that affect these employee benefits. PBOPs expenses reflect the costs of providing benefits to workers in the period following retirement. Health benefits constitute the single largest element of PBOPs costs. Moreover, these PBOP expenses arise from the benefits granted to employees who provided regulated telecommunications services. These other labor cost receive “above-the-line” accounting treatment. As a consequence, writing these PBOPs costs off “above-the-line” is consistent with the origin of these costs and the accounting treatment of similar costs.

Second, these post-retirement benefits, unlike pension benefits, remain subject to the control of the utility providing them and are not subject to the principal federal regulations concerning pensions. For managerial workers not covered by union contracts, a utility may withdraw these benefits. For employees covered by a contract, these benefits are subject to collective bargaining arrangements and can change. Establishing a regulatory policy that now relegates recovery of these costs to the non-regulated side of the utility introduces uncertainty concerning the ultimate costs of these benefits and ultimately increases the cost of providing this benefit. This adverse regulatory treatment of this employment benefit produces a powerful incentive for a utility to discontinue such benefits. In addition, the Commission has had a long-standing policy preference of avoiding intrusions into labor management relations. As a consequence, providing below-the-line treatment of the write off of this regulatory asset would be inconsistent with both the Commission’s policy goal of creating a regulatory structure that supports good jobs and the policy of avoiding intrusions into labor-management relations.

For the preceding reasons, we accept Pacific Bell’s above-the-line write-off.

of its \$400 million regulatory asset in 1998, the year that the Commission eliminated recovery of these costs through Z-Factors.

In D.98-10-026, the Commission indicated that it would consider other outstanding PBOP recovery issues in the Forum OII,⁸¹ but set no timetable for doing so. In Resolution T-16102, issued on 9/16/97, the Commission described ORA's allegation that Pacific had recovered an excessive amount of PBOP costs via the Z-Factor. Although the Resolution makes no judgments on the merits of the issues in dispute, it explicitly ordered the ALJ Division to address PBOPs in the Forum OII. In particular, Resolution T-16102 states:

The Commission directs the ALJ Division to address PBOPs in the Forum OII (I.90-02-047) and to hold a prehearing conference as soon as is practicable to establish a procedural schedule and to identify the issues to be addressed.

Although the ALJ Division failed to open the OII, many of the major issues raised in the resolution, such as what PBOPs costs were eligible for Z-Factor recovery, were resolved or rendered moot either in D.98-10-026 or in today's decision. Concerning the specific issue of over-collection, D.98-10-026 is particularly agnostic on the merits of ORA's allegation, saying:

Nor can we rule, as ORA would have it, that there is a pending issue of \$115 million in overcollections. We also do not rule as to which issues, if any, should be included in the Forum OII or subsequent proceeding. (D.98-10-026, 82 CPUC 2d 367.)

To date the Commission has not considered PBOP overcollections in any proceeding and this issue has long lay moribund. Since the Z-Factor has not

⁸¹ D.98-10-026, 82 CPUC 2d 335, 367, and 371.

been used in the last 5-years, it is unclear whether a proceeding to consider the Z-Factor collections during the period 1993-1998 constitute a wise use of regulatory resources. We will therefore allow parties to file comments in Phase 3B of this proceeding as to whether there is any outstanding issue that requires resolution.

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 \$98 million.⁸²

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

⁸² \$98 million = \$178 million - \$80 million. The intrastate regulated amount of Pacific's SFAS 106 accrual (including depreciation) in 1999 was \$178 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). 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.)

refund all Z-Factor revenues not invested in PBOP trusts as required by D.92-12-015.⁸³ 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.

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.⁸⁴ 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.⁸⁵ Pacific says that situation in 1999 was entirely different. Pacific could not recover its SFAS 106 costs in rates because the

⁸³ D.01-06-077, *mimeo.*, pp. 78-80. Rehearing denied in D.01-12-024.

⁸⁴ D.92-12-015, 46 CPUC 2d 499, 517.

⁸⁵ D.01-06-077, *mimeo.*, pp. 78-80.

Commission had eliminated the SFAS 106 Z-Factor and suspended 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.

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, but limited the SFAS 106 costs that Pacific could record and report as an expense and recover in rates to the amount of its tax-deductible contributions to PBOP trusts. Any SFAS 106 costs in excess of contributions had to be deferred as a regulatory asset. The deferred SFAS 106 costs could be recorded and reported as an expense and recovered in rates when contributions exceeded SFAS 106 costs.⁸⁶

Decision 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. Once SFAS 106 was no longer used for ratemaking purposes, there was no longer a need to limit the amount of SFAS 106 costs recognized for regulatory purposes to tax-deductible

⁸⁶ D.92-12-015, 46 CPUC 2d 499, 505, 517, 523, 531, 532. As described previously 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 funded with surplus pension assets.

contributions. Accordingly, we find that it was reasonable for Pacific to report its full SFAS 106 accrual in 1999 of \$178 million,⁸⁷ regardless of its actual tax-deductible contributions.

We are not persuaded by ORA that allowing Pacific to report its full SFAS 106 accrual in 1999 is inconsistent with D.01-06-077. There, the 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.92-12-015.⁸⁸

Unlike the situation in D.01-06-077, we are not being called upon to decide if Pacific recovered an excessive amount 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 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 tax-deductible 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. In particular, the Commission will consider in Phase 3B whether to reinstate an earnings-sharing mechanism. If a sharing mechanism is reinstated, the amount of SFAS 106 cost reported by Pacific could affect the amount of

⁸⁷ \$178 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 \$178 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 1 –15). To avoid double counting, the figure of \$178 million does not reflect the reduction to Pacific's SFAS 106 costs for 1999 by the amount of such costs that were funded with surplus pension assets.

⁸⁸ D.01-06-077, *mimeo.*, pp. 78-80.

earnings that Pacific might have to share with its ratepayers. Accordingly, we invite parties to address in Phase 3B whether the SFAS 106 costs that Pacific records and reports for regulatory purposes should be limited to its tax-deductible contributions if sharing is reinstated.

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 1999,⁸⁹ even though Pacific's SFAS 106 costs increased from \$155 million in 1998⁹⁰ to \$178 million in 1999.⁹¹ Moreover, as described later in today's decision, Pacific withdrew \$180 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 \$178 million in 1999, 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.

⁸⁹ 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.)

⁹⁰ Appendix G of today's decision, Line 13.

⁹¹ \$178 million = \$176 million (Overland Exhibit Phase 2A: 404, Volume 2, Attachment 7-8) plus \$2 million (Appendix G of today's decision, Line 11).

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. The 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 trust) 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.⁹²

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:

⁹² The VEBA 1 withdrawal increased Pacific Bell's 1999 taxable income by \$180 million. Pacific did not report 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

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.⁹³ 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 to 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, D.91-07-006 noted that IRS, ERISA, and NLRA requirements "ensure that PBOPs assets are used for only PBOPs benefits."⁹⁴ Based on these findings, D.91-07-006 concluded that the safeguards already in place would "ensure that funds placed in a PBOPs plan will be used only for PBOPs benefits."⁹⁵ Nowhere in D.91-07-006 is there

⁹³ Pacific Exhibit Phase 2A: 308, p. 34.

⁹⁴ 40 CPUC 2d 638, 658.

⁹⁵ 40 CPUC 2d 638, 658.

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 the 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 trust 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 agreement and did not enrich Pacific. Moreover, had the transfer not occurred, Pacific's expenses would have been considerably higher as a result of the VEBA 1 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. Pacific states that 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 believes 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, Pacific argues that 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 was 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 alter the amount of expense recognized under SFAS 106.

In its comments on the Alternate Proposed Decision, Pacific argues that requiring it to refund the VEBA 1 withdrawal to ratepayers would constitute unlawful retroactive ratemaking. On the other hand, Pacific does not believe a Commission order requiring Pacific to return \$180 million to the VEBA 1 trust and to use the VEBA 1 trust assets for the sole purpose of providing PBOPs would violate the rule against retroactive ratemaking.⁹⁶

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.92-12-015.⁹⁷ Ordering Paragraph 3 states as follows:

⁹⁶ Pacific’s opening comments on the Alternate Proposed Decision, pp. 6 – 8.

⁹⁷ The intrastate regulated portion of the withdrawal was equal to \$136 million. (Overland Exhibit Phase 2A: 402, Part 2, p. S7-11, Table 7S-2.)

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,⁹⁸ 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 VEBA 1 trust, Pacific reduced the amount of assets available to produce earnings to offset future PBOP costs, thereby increasing overall costs under SFAS 106.⁹⁹

In D.92-12-015, the Commission authorized utilities to implement large rate increases in order to set aside 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 fund 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 fund assets, regardless of when the assets were contributed. In D.91-07-006, which

⁹⁸ Pacific Phase 2A reply brief, pp. 31 – 33; Pacific Exhibit Phase 2A: 308, p. 34.

⁹⁹ Pacific's use of VEBA 1 trust assets for non-PBOP purposes also increased Pacific's aggregate unfunded PBOP liability under SFAS 106.

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 only PBOP benefits.¹⁰⁰” 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.¹⁰¹” 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.¹⁰² 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 should refund \$180 million to ratepayers as required by OP 3 of D.92-12-015 or, alternatively, return \$180 million to the VEBA 1 trust. We will require the latter because the purpose of the VEBA 1 trust is to provide PBOPs to Pacific’s employees.

Pacific shall return \$180 million to the VEBA 1 trust no later than 30 days from the effective date of today’s decision, plus interest equal to the higher of the 3-month commercial paper rate or the interest that would have been earned had Pacific left the money in the VEBA 1 trust.¹⁰³ Pacific shall also file a compliance

¹⁰⁰ 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.)

¹⁰¹ D.91-07-006, 40 CPUC 2d 638, 658. See also FOFs 19 and 59, Id., 662 and 663.

¹⁰² D.92-12-015, FOF 55, 46 CPUC 2d 499, 531.

¹⁰³ 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 return \$180 million to

Footnote continued on next page.

report within 30 days from the effective date of this decision that (1) states the rate of interest that applies the funds returned to the VEBA 1 trust and (2) provides supporting work papers.

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, Pacific shall 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 any of its PBOP trusts since 1999 for non-PBOP purposes. If there were such withdrawals, Pacific shall return the withdrawals to the PBOP trust funds by the time the compliance report is filed, plus interest calculated in the manner described previously for the VEBA 1 withdrawal in 1999. Parties may file and serve comments and reply comments regarding Pacific's report. Comments and reply comments will be due 20 days and 30 days, respectively, after the report is filed.

As a final matter, we are troubled by Pacific's use of PBOP trust assets for non-PBOP purposes. 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 used the surplus VEBA 1 assets to pay for the healthcare costs of its active employees. We agree with TURN that the transaction enriched Pacific because Pacific used VEBA 1 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. To prevent Pacific from again using PBOP trust fund assets for

the VEBA 1, we conclude that it is unnecessary to reduce the amount of Pacific's healthcare costs recognized for regulatory purposes in 1999 by \$180 million.

non-PBOP purposes, we will order Pacific to henceforth use all PBOP trust fund assets (including assets returned to PBOP trust funds pursuant to today's decision) for the sole purpose of providing PBOPs. The use of PBOP trust fund assets for other purposes may result in financial penalties and other sanctions.

D. Accounting for Contributions to the VEBA 3 Trust

1. Audit Findings and Pacific's Response

Pacific Bell 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.92-12-015.¹⁰⁴

Pacific 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, 1993.¹⁰⁵ In 1993, Pacific announced that it would substantially reduce its workforce. Following the announcement, Pacific wrote off 26.5% of its TBO pursuant to SFAS 106. The amount of the TBO write-off was \$632 million. Most of the write-off was booked to Pacific's PBOP regulatory asset in accordance with D.92-12-015.¹⁰⁶ Because Pacific's TBO included \$208 million of VEBA 3 contributions, the TBO write-off and the PBOP regulatory asset likewise included VEBA 3 contributions. The total amount of VEBA 3

¹⁰⁴ D.92-12-015, OP 6, 46 CPUC 2d 499, 533.

¹⁰⁵ Pacific's TBO on January 1, 1993, was \$2.4 billion. (Overland Exhibit Phase 2A: 404, Volume 2, p. 7-20, Table 7-5.)

¹⁰⁶ Overland Exhibit Phase 2A: 404, Volume 2, pp. 7-20 and 7-21.

contributions included in the TBO write-off and the PBOP regulatory asset was \$55.1 million.¹⁰⁷ The after-tax intrastate regulated amount was \$22.7 million.

The Commission required the TBO to be amortized over 20 years for the purpose of determining annual SFAS 106 costs for regulatory purposes.¹⁰⁸ The amount of VEBA 3 contributions included in Pacific's TBO, net of the TBO write-off in 1993, was \$152.9 million (\$208 million - \$55.1 million). The inclusion of VEBA 3 contributions in the TBO increased Pacific's annual SFAS 106 cost by \$7.6 million (\$152.9 million divided by the 20-year amortization of the TBO) in 1993 and subsequent years. The after-tax intrastate regulated amount of the increase was \$3.1 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.

¹⁰⁷ \$55.1 million = \$208 million x 0.2648.

¹⁰⁸ D.92-12-015, OP 1.c, 46 CPUC 2d 499, 532.

Fourth, Pacific Bell sought to recover the VEBA 3 contributions as a Z-Factor over a 12-month period.¹⁰⁹ According to Overland, Z-Factor recovery is only allowed for costs that can be recognized under the Commission's 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.¹¹⁰ 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.92-12-015, the Commission specifically acknowledged “Pacific Bell has recorded its pre-funded contributions as a prepaid asset.”¹¹¹ The Commission took no steps to reverse that action by Pacific in 1992, and we see no reason to do so now.

¹⁰⁹ D.91-07-006, OP 4, 40 CPUC 2d 638, 646.

¹¹⁰ D.91-07-006, OP 4, 40 CPUC 2d 638, 664.

¹¹¹ 46 CPUC 2d 499, 526.

In addition, D.92-12-015, when it denies recovery of pre-funded contributions to VEBA 3, it noted that this would increase the size of the TBO. Specifically, it stated “If the Commission denies recovery of its [Pacific Bell’s] pre-funded contributions for 1989 and 1990, the Pacific Bell’s TBO would need to be recalculated to reflect a higher obligation.”¹¹² The decision did deny recovery, and the TBO was therefore recalculated to reflect that higher obligation.

Moreover, showing that this indeed was its intent, the D.92-12-015 goes on to note that “Such a recalculation would not result in retroactive ratemaking because Pacific Bell has yet to expense its 1989 and 1990 pre-funded PBOP contributions. Pacific Bell has recorded its pre-funded contributions as a prepaid asset. Retroactive ratemaking results from the recovery of past expenses in future rates.”¹¹³ Not only does the decision contemplate the readjustment in the TBO, but explicitly overcomes the objections filed by commenting parties concerning the issue of retroactive ratemaking.¹¹⁴ We cannot but conclude that Pacific followed the regulatory accounting treatment envisioned in D.92-12-015.

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 retired 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”).

¹¹² 46 CPUC 2d 499, 526.

¹¹³ Ibid.

¹¹⁴ See Comments of the Division of Ratepayer Advocates on the Proposed Decision, October 26, 1992, pp 21-22 and Comments of Toward Utility Rate Normalization on the Proposed Decision of ALJ Galvin, October 26, 1992, pp. 11-13.

The amount of the VEBA 3 transfers was \$13 million in 1997, \$79 million in 1998, and \$90 million in 1999.¹¹⁵

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.

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

¹¹⁵ 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.

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 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.¹¹⁶ 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.92-12-015.¹¹⁷ The after-tax intrastate regulated amount of the VEBA 3 transfers in 1997 and 1998 was \$5.8 million and \$35.6 million, respectively.

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.¹¹⁸ Second, the transfers were not "contributions," but the shifting of assets from one VEBA trust to another.¹¹⁹ Pacific erred when it treated the VEBA 3 transfers in 1997 and 1998 as "tax-deductible contributions" for regulatory accounting purposes. We will require Pacific to file revised financial monitoring reports for

¹¹⁶ 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.

¹¹⁷ There is no issue regarding the VEBA 3 transfers in 1999.

¹¹⁸ Overland Exhibit Phase 2A: 404, Volume 2, pp. 7-26 and 7-27.

¹¹⁹ 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.)

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. 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.

In its comments on the Proposed Decision, Pacific presents the following argument:

The [Proposed Decision] correctly points out that if [Pacific's] contribution is reduced by the amount of the VEBA 3 Transfer, there is an increase to [Pacific's] PBOP regulatory asset in an equal amount. The necessary increase in the regulatory asset.... demonstrates why [Pacific] could never have applied the analysis used in the PD. For the sake of argument, assume that [Pacific] did not write-off the regulatory asset in 1998 . . . [and] that the Commission granted full recovery of the regulatory asset in 1999. Under these assumed circumstances, the increase in the regulatory asset caused by the PD's VEBA 3 accounting adjustment results in additional recovery for [Pacific] – an unintended windfall. In other words, through an accounting artifice, [Pacific] would have increased the value of its regulatory asset and, ultimately, its recovery of that asset. This would have resulted in the indirect recovery of the assets resulting from its VEBA 3 contributions. It is not sufficient to answer the clear implications of this example with the response that it does not matter because the assumptions did not occur. If the accounting does not work in the fundamental circumstance that assumes SFAS 106 recovery occurred, the accounting is wrong.

The above example demonstrates the true impact of the PD's failure to account for the VEBA 3 transfer correctly under D.92-12-015. It is axiomatic that a utility should record a liability in a regulatory asset to the extent the utility actually has a liability. Under the PD's analysis, the amounts transferred from VEBA 3 would be recorded in the regulatory asset despite the fact that the liabilities (i.e. the pay-as-you-go costs) had been satisfied by VEBA 3 and were thus no longer in existence. The bottom line is

that the PD's analysis is irreconcilable with D.92-12-015, SFAS 71, and reality. (Pacific's opening comments on the Alternate Proposed Decision, p. 11. Footnotes and italics omitted.)

Pacific's convoluted argument contains two fatal flaws. First, Pacific sought to "recover" its VEBA 3 transfers in 1997 and 1998. Today's decision denies recovery in 1997 and 1998, which increases the regulatory asset by an amount equal to the denied recovery. Under Pacific's hypothetical scenario, the VEBA 3 recovery it sought in 1997 and 1998 occurs instead in 1999, resulting in a "windfall" for Pacific in 1999. We fail to see why allowing Pacific to recover its VEBA 3 transfers in 1997 and 1998 would be any less of a "windfall" than recovering the VEBA 3 transfers in 1999. If it is wrong to recover a "windfall" in 1999, as Pacific appears to suggest, then it is equally wrong to recover the "windfall" in 1997 and 1998.

Finally, Pacific wrongly asserts that the treatment of the VEBA 3 transfers by today's decision errs because it results in the transfers being "recorded in the regulatory asset despite the fact that the liabilities (i.e. the pay-as-you-go costs) had been satisfied by VEBA 3 and were thus no longer in existence." Under SFAS 106, Pacific is required to annually record PBOP expenses (debit) and PBOP liabilities (credit). Decision 92-12-015 limited the SFAS 106 costs that Pacific could recognize for regulatory purposes to the amount of tax-deductible contributions. Any SFAS 106 costs in excess of contributions had to be placed into the regulatory asset and could be recognized as an expense in future years when tax-deductible contributions exceeded SFAS 106 costs.

The regulatory accounting for SFAS 106 costs adopted by D.92-12-015 had no effect on the PBOP liability that Pacific recorded under SFAS 106. For example, if Pacific had \$100 of SFAS 106 costs during a given year, it would also record a PBOP liability of \$100. However, if Pacific made only \$75 of tax-deductible

contributions during that year, then \$25 of SFAS 106 costs (\$100 - \$75) would be placed into the PBOP regulatory asset in accordance with D.92-12-015. The end result would be \$75 of SFAS 106 costs for the year, a regulatory asset of \$25, a PBOP liability of \$100, and PBOP trust fund assets of \$75. If Pacific had used its contributions to pay off the PBOP liability, the end result would have been \$75 of SFAS 106 costs for the year, a regulatory asset of \$25, a PBOP liability of \$25, and PBOP trust fund assets of \$0 (zero).¹²⁰ This example demonstrates two crucial points: (1) the PBOP liability was unaffected by amount of SFAS 106 costs that were deferred as a regulatory asset pursuant to D.92-12-015; and (2) the regulatory asset was unaffected by when and how the PBOP liability was paid off.¹²¹

The previous example shows that Pacific is incorrect when it asserts that the PBOP regulatory asset cannot include costs for PBOP liabilities that had already been paid by the VEBA 3 transfers. Pacific's PBOP regulatory asset was completely independent of Pacific's PBOP liabilities. Changes to Pacific's PBOP regulatory asset had no effect on Pacific's PBOP liabilities, and vice versa.¹²²

¹²⁰ Pursuant to the USOA, PBOP trust fund assets and PBOP liabilities are shown as a single, net amount on the balance sheet. The fact that the two items are netted together on the balance sheet does not affect the substance of the accounting described in the body of this decision or the associated discussion.

¹²¹ An analogous situation would be the purchase of an office building with mortgage financing. The value of the office building and associated depreciation expense recorded on the books would be unaffected by (i) the mortgage, or (ii) when and how the mortgage is paid off. Similarly, the PBOP regulatory asset and SFAS 106 costs recorded pursuant to D.92-12-015 were separate from the PBOP liability. When and how the PBOP liability was paid off had no effect on the PBOP regulatory asset.

¹²² The PBOP trust fund assets that resulted from Pacific's VEBA 3 contributions in 1989 and 1990 and tax-deductible contributions in 1993 and subsequent years were used to pay off PBOP liabilities. The extinguishments of PBOP liabilities had no effect on SFAS 106 costs or the PBOP regulatory asset. Thus, the use of the VEBA 3 contributions in 1989 and 1990 to pay off PBOP liabilities in 1997 and 1998 had no effect on the SFAS 106 costs or the changes to the PBOP regulatory asset that Pacific recorded in 1997 and 1998.

We note that the adopted reduction to Pacific's tax-deductible contributions decreases Pacific's SFAS 106 costs and increases Pacific's PBOP regulatory asset. In 1998, D.98-10-026 triggered a write off of the entire PBOP regulatory asset. Therefore, the adopted reduction to the tax-deductible contributions that Pacific recorded for regulatory purposes in 1997 and 1998, which resulted in an increase in Pacific's regulatory asset, was largely offset by the write off of the regulatory asset in 1998. This result, however, is perfectly consistent with D.98-10-026, which sought to simplify the entire process of PBOP regulatory and Z-factor adjustments.

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 9% of its SFAS 106 accruals during the audit period.¹²³ 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 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 by \$18.4 million in 1997 and by \$14.7 million in 1998.¹²⁴

¹²³ Overland Exhibit 404, Volume 2, Attachments 7-7, 7-8, and 7-9.

¹²⁴ \$18.4 million = \$224.6 million - \$206.2 million (Overland Exhibit 404, Volume 2, Attachment 7-7). \$14.7 million = \$179.2 million - \$164.5 million (Id., Attachment 7-8).

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.¹²⁵ We interpret this provision as authorizing utilities to fully recover their current tax-deductible contributions (within the limits prescribed by D.92-12-015). Adopting Overland's proposal to capitalize a portion of tax-deductible contributions would mean that utilities could not fully recover their current tax-deductible contributions, at least in the short run. Therefore, we decline to adopt the proposal. 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

¹²⁵ D.92-12-015, COL 7 and OPs 2.b and 8, 46 CPUC 2d 399, 531, 532, 533. The tax-deductible contributions that utilities can recover in any given year cannot exceed their SFAS 106 accrual for the year, less any SFAS 106 costs capitalized during the year, plus "depreciation" of previously capitalized SFAS 106 costs, plus any amortization of the PBOP regulatory asset.

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.

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.¹²⁶ 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.

Overland believes that an FCC order casts 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

¹²⁶ D.98-10-026, 82 CPUC 2d 335, 361 - 62.

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.

* * * *

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 FCC ORDER 00-396 affirmed that reserve deficiency adjustments should be recorded below the line. That Order addressed a request by SBC and three other LECs 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.

* * * *

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 determination in D.98-10-026 that Pacific should bear full responsibility for depreciation expense.¹²⁷ 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.

¹²⁷ D.98-10-026, 82 CPUC 2d 335, 361, 362, 363, and 377.

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.¹²⁸ 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.

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.¹²⁹ 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.¹³⁰ 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 deficiency immediately and not over six years. So even if

¹²⁸ D.98-10-026, 82 CPUC 2d 335, 361-62.

¹²⁹ Overland Exhibit Phase 2A: 402, p. 27.

¹³⁰ Overland Exhibit Phase 2A: 404, p. 8-21.

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.

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.¹³¹” However, rather than embracing this position, D.98-10-026 responded by stating that “if relevant, parties may make that argument in protest to any application that might be filed pursuant to Ordering Paragraph 7 of D.96-09-089.¹³²”

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

¹³¹ Pacific Exhibit Phase 2A: 332, pp. 9-10.

¹³² D.98-10-026, *mimeo.*, p. 54.

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.

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."¹³³ 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.¹³⁴ 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.96-09-089.¹³⁵ 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

¹³³ D.89-10-031, FOF 53, 33 CPUC 2d 43, 217.

¹³⁴ D.96-09-089, OP 7, 68 CPUC 2d 209, 239.

¹³⁵ D.98-10-026, *mimeo.*, p. 54.

mitigation efforts the utility has considered to reduce its stranded costs, even if not undertaken.¹³⁶ TURN states that D. 98-10-026 is clear on how to proceed—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.¹³⁷ 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.¹³⁸ 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.¹³⁹ 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

¹³⁶ D.98-10-026, *mimeo.*, pp. 54-55.

¹³⁷ D.95-12-063, 64 CPUC 2d 1, 59.

¹³⁸ D.95-12-063, 64 CPUC 2d 1, 62.

¹³⁹ D.97-06-060, *mimeo.*, p. 50-51.

“under depreciated assets” were beyond the scope of the proceeding.¹⁴⁰ Decision 98-10-026 cites Pacific’s representations on this point with approval.

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.¹⁴¹ 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.¹⁴² The Decision specifically states that this authority “applies to all plant.”¹⁴³ 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, 1999.¹⁴⁴

¹⁴⁰ TURN Exhibit Phase 2A: 503, pp. 19 and 31.

¹⁴¹ Pacific Exhibit Phase 2A: 118, Attachment 3.

¹⁴² D.98-10-026, *mimeo.*, pp. 26-27, 53, and 93.

¹⁴³ D.98-10-026, *mimeo.*, p. 54.

¹⁴⁴ D.98-10-026, 82 CPUC 2d 335, 361.

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 prior to 1999, but instructed Pacific to continuously mitigate the depreciation reserve deficiency problem associated with that period.¹⁴⁵

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

¹⁴⁵ D.98-10-026, *mimeo.*, p. 54.

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.

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.¹⁴⁶

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.98-10-026 and the resulting discussion of those comments in the final D.98-10-026. The comments stated, in relevant part, as follows¹⁴⁷:

The [draft D.98-10-026] concludes that 'We do not only suspend . . . 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

¹⁴⁶ D.98-10-026, 82 CPUC 2d 335, 361. The RDA achieves the same result as adjusting depreciation rates. (8 TR 660-661.)

¹⁴⁷ 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.)

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 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 expense 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.98-10-026.¹⁴⁸

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.¹⁴⁹ The matter of rate recovery of historic stranded costs such as the RDA was explicitly deferred to the application procedures set forth in D.96-09-089.¹⁵⁰

¹⁴⁸ Today's decision makes no findings as to whether Pacific did, in fact, have a depreciation reserve deficiency during the audit period.

¹⁴⁹ 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.

¹⁵⁰ 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

Footnote continued on next page.

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

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.”

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.

In its comments on the Alternate Proposed Decision, Pacific asserts that it would be legal error to consider the reinstatement of depreciation reviews in Phase 3B. Pacific states that D.98-10-026 permanently eliminated depreciation reviews for a number of reasons, thereby foreclosing the possibility of reinstating depreciation reviews at later time even if sharing were reinstated.¹⁵¹

Pacific is correct that D.98-10-026 eliminated depreciation reviews for a number of reasons. However, as TURN notes in its reply comments on the Proposed Decision,¹⁵² the primary rationale given by D.98-10-026 for eliminating depreciation reviews was that “[d]epreciation reviews and approvals are largely necessary only in connection with sharing.¹⁵³” Thus, if sharing is reinstated in Phase 3B of this proceeding, it would be appropriate, and not legal error as alleged by Pacific, for the Commission to also consider in Phase 3B if depreciation reviews and approvals should likewise be reinstated.

Pacific is also correct that D.98-10-026 “permanently” eliminated depreciation reviews. However, this is not binding on future Commissions. The Commission has authority under Pub. Util. Code § 1708 to modify a prior

¹⁵¹ Pacific’s opening comments on the Alternate Proposed Decision, pp. 12-13.

¹⁵² TURN reply comments on the Alternate Proposed Decision, pp. 10-11.

¹⁵³ D.98-10-026, Finding of Fact 45, 82 CPUC 2d 335, 375.

decision after providing a notice and an opportunity to be heard. Today's decision provides notice that the Commission will consider in Phase 3B if depreciation reviews should be reinstated if sharing is reinstated, and parties will have an opportunity to be heard on 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.¹⁵⁴ 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:

¹⁵⁴ 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				
• <i>SFAS 106 – VEBA 3 to VEBA 5 Transfer</i> ¹	4,009	(4,009)	- -	0
• <i>Decrease in PBOP Costs from Transfer of Pension Assets</i> ¹	- -	- -	28,012	28,012
Subtotal	4,009	(4,009)	28,012	28,012
II. Recorded Costs and Revenues				
• <i>Recorded PBOP Costs, Net of the Adopted Adjustments</i> ²	(11,447)	156,894	2,054	147,501
• <i>Recorded Pension Costs</i> ³	25,200	43,691	(91,172)	(22,281)
• <i>CHCF-B Revenues</i> ⁴	- -	(98,999)	(104,619)	(\$203,618)
Subtotal ⁵	13,753	101,586	(193,737)	(\$78,398)
Total Increase/(Decrease) in Income Tax Expense ⁶	\$17,762	\$97,577	(\$165,725)	(\$50,386)
Note 1 – Source: Appendix I Note 2 – Source: Appendix I, Tables for 1997, 1998, and 1999, Column L, Line 2. Note 3 – Source: Appendix I, Tables for 1997, 1998, and 1999, Column L, Line 1. Note 4 – Source: Appendix I, Tables for 1998 and 1999, Column L, Line 3. Note 5: Ties to Appendix D, Line 3. Note 6: Ties to Appendix K, 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 \$28,012,000 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 \$28,012,000).

Applying flow-through tax accounting to Pacific's recorded PBOP and pension costs, net of the adopted adjustments to these costs, would have

increased Pacific's income tax expense during the audit period by \$125,220,000 (\$147,501,000 - \$22,281,000) compared to normalization.¹⁵⁵ 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 \$203,618,000.¹⁵⁶

Overland asked Pacific Bell to explain why it had deviated from the Commission's flow-through 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.

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. This is

¹⁵⁵ 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 I, Tables for 1997 – 1999, Column K, Line 1.)

¹⁵⁶ 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.

evident from the fact that the Resolution never states that it is adopting normalized tax accounting.

[SFAS 109] 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.¹⁵⁷

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."¹⁵⁸ Resolution F-634 concludes:

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

¹⁵⁷ Overland states that Pacific admitted that prior to Resolution F-634, the Commission had (i) required flow-through treatment of timing differences (Overland Exhibit Phase 2A: 404, Volume 2, p. 9-15.), and (ii) only authorized normalized tax accounting for two items. Those two items were federal accelerated depreciation and the California Corporate Franchise Tax accrual. (Overland Exhibit Phase 2A: 402, Part 2, p. S9-1.)

¹⁵⁸ Resolution F-634, *mimeo.*, p. 3.

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.¹⁵⁹ 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 companies.¹⁶⁰ 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.

¹⁵⁹ D.84-05-036, COL 6, and D.87-12-063, 26 CPUC 2d 349, 361.

¹⁶⁰ Pacific Exhibit Phase 2A: 318, p. 7.

ORA also disputes Pacific's contention that Resolution F-634 adopted normalized tax accounting.¹⁶¹ 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 §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.¹⁶² In D.87-09-026, the Commission adopted normalized tax accounting for contributions in aid of construction.¹⁶³ In D.88-01-061, the Commission adopted normalized tax accounting for vacation pay and allowance for funds used during construction.¹⁶⁴ In D.94-12-022, the Commission adopted a stipulation that used normalized tax accounting to set rates for Southwest Gas

¹⁶¹ Pacific Exhibit Phase 2A: 318, p. 7.

¹⁶² D.84-05-036, 15 CPUC 2d 42, 45-47.

¹⁶³ D.87-09-026, 25 CPUC 2d 299, 305-309.

¹⁶⁴ D.88-01-061, 27 CPUC 2d 310, 317-318.

Corporation.¹⁶⁵ 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.¹⁶⁶ 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 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.

¹⁶⁵ D.94-12-022, OP 1, 57 CPUC 2d 646, 651.

¹⁶⁶ D.90-12-034, 1990 Cal. PUC LEXIS 1292, *7 and *13.

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.¹⁶⁷ Pacific had been submitting this monthly report to the Commission since at least 1979, and the report contained a combination of flow-through and normalized tax accounting.¹⁶⁸ The Commission specifically found in D.89-10-031 and D.89-12-048 that it was

¹⁶⁷ D.89-10-031, 33 CPUC 2d 43, 192.

¹⁶⁸ 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.

reasonable to use this report for the NRF startup revenue requirement.¹⁶⁹

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.

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.¹⁷⁰ Hence, any suggestion that Pacific intentionally avoided flow-through accounting is specious.

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.

¹⁶⁹ D.89-12-031, FOF 175, 33 CPUC 2d 43, 224; D.89-12-048, FOF 10, 34 CPUC 2d 155, 184.

¹⁷⁰ Pacific Exhibit Phase 2A: 318, p. 9.

Pacific avers that the Commission formalized the 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-through accounting for those elements of income tax expense that were being flowed through prior to Resolution F-634. Otherwise, any change from flow-through 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 to 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 32.22.¹⁷¹ 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

¹⁷¹ Overland Exhibit Phase 2A: 402, p. 58; ORA Exhibit Phase 2A: 111, p. 7, footnote 2.

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.)

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 K 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.¹⁷² 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.¹⁷³ The 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

¹⁷² 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.

¹⁷³ 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 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.

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 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.' (*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 laws¹⁷⁴ effectively mandated the use of normalized tax accounting for accelerated depreciation and ITC.¹⁷⁵ 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.

¹⁷⁴ The Economic Recovery Tax Act of 1981.

¹⁷⁵ D.93848, 7 CPUC 2d 332, 333, 334 – 337, and 340.

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.¹⁷⁶ 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 [newly revised 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 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.

¹⁷⁶ D.84-05-036, 15 CPUC 2d 42, 53 – 54, 60, and 61.

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 retained previously adopted USOA rules mandating the use of flow-through accounting¹⁷⁷ and required Pacific to maintain memorandum accounting records reflecting flow-through accounting. Pacific's contention that it was not required to use flow-through tax accounting for regulatory accounting purposes reveals a profound and troubling disregard for Commission decisions. Moreover, it is a fundamental regulatory principle that ratemaking controls accounting.¹⁷⁸ 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.¹⁷⁹

¹⁷⁷ D.87-12-063 considered if the FCC's old USOA, known as Part 31, should be replaced with the FCC's new USOA, known as Part 32. The Commission had previously adopted Part 31 for regulatory accounting purposes. (See OIR 87-02-023 for a general discussion of the Commission's previous adoption of Part 31.) Part 31 required flow-through tax accounting except for depreciation. (FCC Order 89-271, Paras. 5 and 12.) Part 32 required normalized tax accounting. D.87-12-063 adopted much of Part 32, but the Decision rejected normalized tax accounting and ordered telephone utilities to continue to use Part 31 accounting for income taxes (i.e., flow-through accounting). (26 CPUC 2d 349, 360-61, 370, 371, 372.)

¹⁷⁸ 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.

¹⁷⁹ 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

Footnote continued on next page.

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

excess of the taxes actually paid to the extent required by federal law or warranted by other special circumstances.

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, 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.¹⁸⁰

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-through policy should remain in effect to the extent allowed by law.¹⁸¹ This holding eviscerates Pacific's claim that D.84-05-036 somehow shows that the Commission did not have a flow-through 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.¹⁸² Public utilities are required by federal law to pay income taxes on CIAC in the year the contributions are received.¹⁸³

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

¹⁸⁰ 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.)

¹⁸¹ D.84-05-036, 15 CPUC 2d 42, 53-54, 60, and 61.

¹⁸² 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.

¹⁸³ D.87-09-026, 25 CPUC 2d 299, 306.

CIAC,¹⁸⁴ 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 replace the FCC's old USOA, known as Part 31, with the FCC's new USOA, known as Part 32. Part 31 required flow-through tax accounting except for depreciation.¹⁸⁵ Part 32 required 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.)

In addition, D.87-12-063 at COL 26, COL 32, and OP 1 required Pacific to maintain previously established accounting requirements unless changes were authorized by the Decision.¹⁸⁶ Part 31 previously adopted by the Commission

¹⁸⁴ 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.

¹⁸⁵ FCC Order 89-271, Paras. 5 and 12.

¹⁸⁶ D.87-12-063, 26 CPUC 2d 349, 361, 372.

required flow-through tax accounting.¹⁸⁷ There is nothing in D.87-12-063 that authorized Pacific to deviate from this accounting requirement.

The Commission's reasons in D.87-12-063 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 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 excerpt from D.87-12-063 demonstrates 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

¹⁸⁷ OIR 87-02-023, 1987 Cal. PUC LEXIS 894, *1, *3 - *5; FCC Order 89-271, Paras. 5 and 12.

tax, external financial reporting, and regulatory purposes.¹⁸⁸ 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 accounting for Commission regulatory purposes even though the FCC had switched to normalization. In any event, D.87-12-063 expressly rejected normalized tax accounting,¹⁸⁹ retained the requirement to account for income taxes in accordance with the flow-through method set forth in Part 31, 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 these requirements.

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.

¹⁸⁸ D.87-12-063, FOF 38, 26 CPUC 2d 349, 370.

¹⁸⁹ D.87-12-063, COL 30, 26 CPUC 2d 349, 372.

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.¹⁹⁰ 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.

The Commission concluded in D.88-01-061 that utilities should normalize the income tax effects associated with IDC.¹⁹¹ 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.¹⁹² 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 less costly to ratepayers to apply normalized tax accounting to vacation pay instead of flow-through

¹⁹⁰ Unlike interest costs, equity costs (including capitalized equity costs) cannot be deducted for federal tax purposes.

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

¹⁹² 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.

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.¹⁹³ Thus, Pacific's argument that D.88-01-061 demonstrates that Commission did not have a flow-through policy is without merit.¹⁹⁴

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.¹⁹⁵ 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

¹⁹³ D.88-01-061, 27 CPUC 2d 310, 323.

¹⁹⁴ 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.

¹⁹⁵ 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.

inability under NRF to use the particular method of flow-through accounting for CCFT adopted by D.89-11-058.¹⁹⁶

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.¹⁹⁷ As Pacific is well aware, Rule 51.8 provides that the 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

¹⁹⁶ 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.

¹⁹⁷ D.94-12-022, 57 CPUC 2d 646, 651, and 657.

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.¹⁹⁸ 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.

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 1967¹⁹⁹ and for FCC purposes since 1988.²⁰⁰ 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 for regulatory purposes, SFAS 109 requires utilities to present a deferred income tax liability and an associated regulatory asset or liability as separate items on the balance sheet.²⁰¹ 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

¹⁹⁸ Appendix K of today's decision, Column D, Line 4.

¹⁹⁹ Resolution F-634, *mimeo.*, p. 2; Pacific Exhibit Phase 2A: 333, Binder 2, Tab 17.

²⁰⁰ D.87-12-063, 26 CPUC 2d 349, 353, 360-61, 368.

²⁰¹ SFAS 109, Para. 29, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 26.

presentation for items that receive flow-through treatment did not have any impact 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 sheets a deferred tax liability and an offsetting regulatory asset or regulatory liability “for the tax benefits that are flowed through to customers.”²⁰²

To implement the new balance sheet presentation required by SFAS 109, the FCC added the following three new accounts to the USOA²⁰³:

Account 1437 – Deferred Tax Regulatory Asset.

Account 4341 – Net Deferred Tax Liability.

Account 4361 – Deferred Tax Regulatory Liability.

The purpose of the new accounts was to implement the deferred tax liability and the regulatory asset/liability required by SFAS 109 for the “tax effects of temporary differences accounted for under the flow-through method.”²⁰⁴

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

²⁰² SFAS 109, Para. 29, Pacific Exhibit Phase 2A: 333, Index Tab 26. Emphasis added.

²⁰³ FCC Order 94-28, Paras. 10-13 and Appendix B, Pacific Exhibit Phase 2A: 333, Binder 3, Tab 30.

²⁰⁴ FCC Order 94-28, Para. 10 and Appendix B, Section 32.4341, Pacific Exhibit Phase 2A: 333, Binder 3, Tab 30. Emphasis added

amendments to the USOA establish new accounting requirements with respect to flow-through ratemaking.²⁰⁵

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 for both accounting and ratemaking purposes; (2) the Commission had previously rejected normalized tax accounting, to the extent allowed by law, for both accounting and ratemaking purposes; (3) the Commission had previously held that the use of normalized tax accounting for ratemaking was unlawful in many circumstances; and (4) the adoption of normalized tax accounting would have had significant implications for ratemaking.²⁰⁶ 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-through policy was subject to Pub. Util. Code § 1708.²⁰⁷ These

²⁰⁵ Resolution F-634, *mimeo.*, pp. 3 and 4.

²⁰⁶ 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 K of today's decision, Column D, Lines 1 and 2.)

²⁰⁷ § 1708 states, in relevant part, as follows: "The commission may ...upon notice...and with opportunity to be heard...rescind, alter, or amend any order or decision made by it."

circumstances strongly suggest that the Commission did not intend to abandon its flow-through policy in Resolution F-634.²⁰⁸

We are not persuaded by Pacific's argument that the provisions in § 1708 that require the Commission to provide notice and an opportunity for hearing prior to modifying a previously issued decision were satisfied because, as stated in Resolution F-634, Pacific's Advice Letter (AL) 17024 was noticed in the Commission's Daily Calendar and mailed to interested parties.²⁰⁹ AL 17024 did not state that Pacific sought to replace the Commission's flow-through policy with normalized tax accounting. Rather, AL 17024 stated that SFAS 109 and the related amendments to the USOA established new accounting requirements for "items accounted for under the flow through method."²¹⁰ The Advice Letter also stated that "the adoption of SFAS 109 will have no impact on future income statement related accounts."²¹¹ As explained below, it is highly likely and easily foreseeable that switching from flow-through accounting to normalized tax accounting would have affected income statement accounts.²¹² In sum, AL 17024

²⁰⁸ 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.

²⁰⁹ 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.

²¹⁰ AL 17024, p. 2.

²¹¹ AL 17024, p. 3. Emphasis added.

²¹² As shown in Appendix K, 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

Footnote continued on next page.

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 the companion amendments to the USOA be implemented on a revenue-neutral basis.²¹³ 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.²¹⁴

It is highly 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.²¹⁵ Pacific's own experience shows why. During 1997 and 1998 when the earnings-sharing mechanism was in effect, Pacific's use of normalized tax accounting with respect to Phase 2A issues increased Pacific's net income by \$115.3 million compared to flow-through tax accounting.²¹⁶ The change in Pacific's earnings affected its revenues via the earnings-sharing mechanism.²¹⁷ Thus, the lesson from Pacific's experience is clear: Resolution F-634 could not have authorized normalized tax

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 accounts.

²¹³ Resolution F-634, *mimeo.*, pp. 1, 4, 5, and 6.

²¹⁴ D.87-12-063, OP 12.b, 26 CPUC 2d 349, 373; Resolution F-634, OP 3, *mimeo.*, p. 6.

²¹⁵ 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.)

²¹⁶ Appendix K of today's decision, Column D, Lines 1 and 2.

²¹⁷ Today's decision finds that Pacific had sharable earnings in 1998.

accounting because doing would have rendered meaningless the Resolution's revenue-neutrality requirement.²¹⁸

Pacific argues that although Resolution F-634 required SFAS 109 and the related amendments to the USOA to be implemented in a revenue neutral manner, this requirement did not apply to future revenue requirements.²¹⁹ Pacific's interpretation of Resolution F-634 strains credulity. Because Resolution F-634 required the accounting changes adopted therein to be implemented in a revenue neutral manner, the Resolution waived the requirement in 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 revenue requirements during the current year and three future years.²²⁰ Obviously, the Commission would not have waived the requirement to submit a study unless it believed the adoption of SFAS 109 and the related amendments to the USOA would not affect future revenue requirements for a period of at least three years.

Pacific argues that Resolution F-634 could not have adopted only the amendments to USOA Section 32.22. 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

²¹⁸ 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 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.

²¹⁹ Pacific's opening comments on the Alternate Proposed Decision, p. 15.

²²⁰ Resolution F-634, OP 3, *mimeo.*, p. 6; D.87-12-063, OP 12, 26 CPUC 2d 349, 373; FCC Order 86-221, Appendix A, Section 32.01(06).

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.²²¹

Pacific's characterization of the adopted amendments to the USOA is misleading. The adopted amendments included the entire text of three new accounts that were intended to reflect flow-through ratemaking,²²² not just scattered words as Pacific implies. For example, the adopted amendments included all of USOA Section 32.4342, which states as follows:

Sec. 32.4341 Net Deferred Tax Liability Adjustments.

- (a) This account shall include the portion of deferred income tax charges and credits pertaining to Accounts 32.1437, Deferred Tax Regulatory Asset, and 32.4361, Deferred Tax Regulatory Liability.
- (b) This account shall be used to record adjustments to the accumulated deferred tax liabilities recorded in Accounts 4100 and 4340 for:
 - (1) **Tax effects of temporary differences accounted for under the flow-through method** or treated as permanent differences.
 - (2) Reclassification attributable to changes in tax rates (Federal, state and local). As tax rates increase or decrease, the

²²¹ Pacific's opening comments on the Alternate Proposed Decision, pp. 15 - 16.

²²² FCC Order 94-28, Appendix B. (Pacific Exhibit Phase 2A: 333, Binder 3, Tab 30.)

offsetting debit or credit will be recorded in Account 1437 and / or 4361 as required by paragraph (a).

- (3) The tax effects of carryforward net operating losses and carryforward investment tax credits expected to reduce future taxes payable that are reported in published financial statements.
- (4) Reversals of the tax effects of carryforward net operating losses and carryforward investment tax credits previously recorded in this account at the time they become recognized as reductions in current taxable income and current taxes payable on tax returns.
- (c) This account shall be exempt from the vintage year detail record requirements of Section 32.22(e)(2). (FCC Order 94-28, Appendix B. Emphasis added.)

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 items²²³:

- 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. Rather, it adopted technical refinements to

²²³ 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.

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. These technical refinements did not alter the Commission's flow-through policy in any substantive way.

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 1989.²²⁴ Pacific testified that the income tax expense shown in these reports included items that received normalized tax treatment.²²⁵ 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.²²⁶

Attachment 1 shows convincingly that Pacific's startup revenue requirement included items that received normalized tax treatment in contravention of the Commission's flow-through policy. However, there is no

²²⁴ D.89-10-031, OP 14, 33 CPUC 2d 43, 192.

²²⁵ Pacific Exhibit Phase 2A: 318, pp. 15 – 16.

²²⁶ Deferred income tax expense only occurs with normalized tax accounting; there is no deferred income tax expense with flow-through accounting.

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.²²⁷ In particular, the reports that Pacific submitted to establish its startup revenue requirement were not usually used for ratemaking purposes,²²⁸ and there was apparently no disclosure in the reports that the tax expenses reflected therein did not conform to the Commission's flow-through policy.²²⁹ It also appears that Pacific did not inform the Commission that the reports did not conform to the Commission's flow-through policy.²³⁰ 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.²³¹ No evidentiary hearings were held but workshops took place on November 17 and 28.²³² Final pleadings were filed three days later on December 1, 1989. The Commission's own review ended

²²⁷ 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.

²²⁸ D.91-11-023, 41 CPUC 2d 647, 657.

²²⁹ 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.

²³⁰ 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.

²³¹ D.89-10-031, OP 14, 33 CPUC 2d 43, 234.

²³² D.89-12-048, 34 CPUC 2d 155, 165.

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 doing so.²³³ A more plausible explanation is that the Commission expected that Pacific would submit reports to establish its startup revenue requirement that complied with the Commission's flow-through policy. Indeed, only two years earlier D.87-12-063 had ordered Pacific to use flow-through for both accounting and ratemaking purposes, and D.89-10-031 had ordered Pacific to submit reports for establishing its startup revenue requirement that used "recorded intrastate ratemaking demand, expenses, and revenues...."²³⁴ As it turns out, the reports that Pacific submitted did not report income tax expense in accordance with D.87-12-063 and D.89-10-031. In its hurried adoption of Pacific's multi-billion dollar startup revenue requirement, the Commission failed to discover that Pacific had not complied with the Commission's Orders.

Pacific, like the Commission, apparently did not realize that its startup revenue requirement contained many items of normalized tax expense in

²³³ 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 § 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 § 1705, strongly suggests that the Commission did not intend to abandon its flow-through policy in D.89-10-048.

²³⁴ D.89-10-031, OP 14.d, 33 CPUC 2d 43, 214. Emphasis added.

contravention of the Commission's flow-through policy. More specifically, in D.89-11-058 the Commission ordered Pacific to apply flow-through tax accounting to CCFT.²³⁵ 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.89-11-058.²³⁶ 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-through 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 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

²³⁵ D.89-11-058, 33 CPUC 2d 495, 506.

²³⁶ 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.

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]²³⁷ to calculate the revenue requirement associated with embedded compensated absences.²³⁸"

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

²³⁷ 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.

²³⁸ 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 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.

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 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 was a need to gross-up SFAS 106 costs that were not currently deductible shows that the Decision viewed 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 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.²³⁹ Noticeably absent from the list was any mention of income taxes.²⁴⁰ Accordingly,

²³⁹ D.89-10-031, 33 CPUC 2d 43, 186, 230-31, and 235; D.91-07-056, 41 CPUC 2d 89, 125; Workshop III Report, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 18 pp. 1, 4, and 5.

²⁴⁰ 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 accounting 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.

D.91-07-056 did not consider, let alone affirm, the regulatory treatment of income taxes in Pacific's startup revenue requirement.²⁴¹

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

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 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.²⁴² Noticeably absent from the list was any mention of income taxes.²⁴³ Accordingly,

²⁴¹ 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.)

²⁴² D.89-10-031, 33 CPUC 2d 43, 186, 230-31, and 235; D.91-07-056, 41 CPUC 2d 89, 125; Workshop III Report, Pacific Exhibit Phase 2A: 333, Binder 2, Tab 18, pp. 1, 4, and 5.

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In its comments on the Alternate Proposed Decision, Pacific argues that even if the Commission unknowingly approved a startup revenue requirement for Pacific that contained many items of normalized income tax expense, the rule

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 accounting 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.

²⁴⁴ 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.)

against retroactive ratemaking prevents any correction at this late date.²⁴⁵ We disagree. The prohibition against retroactive ratemaking stems from Pub. Util. Code § 728, which authorizes the Commission to set rates prospectively. In construing the rule against retroactive ratemaking, we employ the fundamental rule of statutory construction that a statute “must be given a reasonable and common sense interpretation consistent with the apparent purpose and intention of the lawmakers, practical rather than technical in nature, which upon application will result in wise policy rather than mischief or absurdity.”²⁴⁶ The rule against retroactive ratemaking is also based on the presumption that the rate in question was set in accordance with proper procedure. If proper procedure was not followed, the Commission can fashion such remedies as equity may require.²⁴⁷

There is no doubt that it was the Commission’s policy at the time Pacific’s startup revenue requirement was established to use flow-through tax accounting for ratemaking purposes to the extent allowed by law. In addition, D.89-10-031 ordered Pacific to submit reports for establishing its startup revenue requirement that reflected the Commission’s ratemaking policies, but Pacific failed to do so with respect to income taxes. Therefore, in the interest of achieving wise policy and an equitable outcome, we conclude that Pacific’s failure to properly report its income tax expense in 1989 does not shield Pacific from having to properly report its income tax expense in 1997 and subsequent years.

²⁴⁵ Pacific opening comments on the Alternate Proposed Decision, p. 14 - 15.

²⁴⁶ DeYoung v. City of San Diego, 194 Cal.Rptr. 722, disapproved on other grounds in Yamaha Corp. of America v. State Bd. of Equalization, 78 Cal.Rptr.2d 1, 960 P.2d 1031.

²⁴⁷ Wise v. PG&E, 91 Cal.Rptr.2d 479, 487, rehearing denied, review denied.

Pacific also argues in its comments that the courts presume that the Commission has knowledge of the conditions that underlie and motivate its regulatory actions.²⁴⁸ Pacific contends that it is legal error for today's decision to discount the fact that Pacific's startup revenue requirement included items that received normalized tax treatment. In making its argument, Pacific relies on the following passage from United States v. State Water Resources Board:

The Legislature has entrusted the supervision and protection of this valuable resource of this valuable resource of the state to the respondent [Fish and Game Commission], not to the courts. The commission must be presumed to have a knowledge of the conditions which underlie and motivate its regulatory actions and unless it is demonstrated that those actions are not grounded upon any reasonable factual basis the courts should not interfere with the exercise of the discretion vested in it by the Legislature, nor lightly substitute their judgment for that of the commission. (United States v. State Water Resources Board (1986) 227 Cal.Rptr.161, 176, quoting Ferrante v. Fish & Game Commission (1946) 1946 Cal. LEXIS 302, ***17.)

We see no conflict between today's decision and United States. We conclude for the previously stated reasons that there is no "reasonable factual basis" to find that the Commission, without any notice or opportunity for hearing, silently replaced its long-established flow-through policy with normalized tax accounting when the Commission adopted Pacific's startup revenue requirement in D.89-12-048.

Pacific asserts that its startup revenue requirement was based on reports that it had been submitting to the Commission since 1979 pursuant to a letter from Commission staff dated November 5, 1979. Thus, the Commission must

²⁴⁸ Pacific's opening comments on the Alternate Proposed Decision, pp. 14 -15.

have known that Pacific's reports did not reflect flow-through accounting.²⁴⁹ Pacific's argument begs the question of whether the staff's letter dated November 5, 1979, authorized Pacific to submit reports that did not reflect the Commission's flow-through policy²⁵⁰ and, if not, whether Pacific ever disclosed to the Commission that the reports did not reflect flow-through accounting.²⁵¹ Because there is no information in the record to answer these questions, we cannot conclude, as Pacific would have us do, that Pacific was authorized by Commission staff to submit reports that did not reflect the Commission's flow-through policy. But even if Pacific had been authorized at one point, D.87-12-063 required Pacific to use flow-through accounting for both regulatory accounting and ratemaking purposes, and D.89-10-031 ordered Pacific to submit reports that reflected ratemaking. The record of this proceeding demonstrates that the reports Pacific submitted in response to D.89-10-031 did not reflect the Commission's policy of using flow-through tax accounting for accounting and ratemaking purposes.

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

²⁴⁹ Pacific's opening comments on the Alternate Proposed Decision, p. 15.

²⁵⁰ We are skeptical that staff would have authorized Pacific to file reports that did not reflect the Commission's flow-through policy.

²⁵¹ In its comments on the Proposed Decision, Pacific did not contest the finding reached previously in today's decision that there is no evidence in the record of the instant proceeding that Pacific informed the Commission in the proceeding leading to the adoption of Pacific's startup revenue requirement that the reports Pacific had submitted to establish its startup revenue requirement did not conform to the Commission's flow-through policy.

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.²⁵² 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 1999 if it had applied flow-through tax accounting to its CHCF-B revenues instead of normalized tax accounting.²⁵³

²⁵² 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.

²⁵³ 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.)

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 I of today's decision, pp. I-2 and I-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 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 \$204 million of federal income tax expenses 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.²⁵⁴

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

²⁵⁴ The record in Phase 2A suggests that Pacific's cash position is not adversely affected by flow-through tax accounting. The use of flow-through tax accounting for all Phase 2A issues increases Pacific's tax expense in 1997 and 1998 (Appendix K of today's decision, Column D, Lines 2 and 3), which reduces sharing and thereby benefits Pacific's cash position.

on CIAC revenues upfront when they receive the revenues and then amortize the income taxes for regulatory purposes over the life of the assets funded by the CIAC revenues.²⁵⁵ The regulatory treatment of the income taxes on CIAC revenues complies with the Commission's flow-through policy for the reasons described previously. 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. Pacific's decision to recognize all income taxes on CHCF-B revenues upfront, even though Pacific has not yet paid the taxes, does not comply with the Commission's flow-through policy. We find that the regulatory treatment of the income taxes on CIAC revenues does not support Pacific's decision to recognize all income tax expense on CHCF-B revenues upfront for regulatory purposes.

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

The following table summarizes the revisions to Pacific's recorded net operating income (NOI) and rate base adopted in Phases 2A of this proceeding (referred to hereafter as "the revisions") and the refund that Pacific owes to its ratepayers as a result of the revisions.

²⁵⁵ D.87-09-026, 25 CPUC 2d 299, 305-309.

Summary of the Adopted Revisions to Pacific's Recorded NOI and Rate Base			
	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)	(107,415)	234,474
Adopted Net Operating Income	\$644,575	\$815,057	\$1,196,672
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 Rate Base	\$10,057,145	\$10,214,121	\$10,095,975
Rate of Return (ROR) Reported by Pacific	6.49%	9.07%	9.66%
Adopted ROR	6.41%	7.98%	11.85%
Sharing Trigger ROR	11.50%	11.50%	N / A
Sharable Earnings	None	None	N / A

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.²⁵⁶ 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

²⁵⁶ 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.

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 and the Phase 2B audit 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.

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.²⁵⁷ 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 access services might receive a pro rata portion of sharable earnings in the future

²⁵⁷ D.89-10-031, 33 CPUC 2d 43, 188.

if carriers could ensure that the sharable earnings would be passed through to their customers.²⁵⁸ 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.

²⁵⁸ 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.²⁵⁹ Since then, the Commission has moved most end-user services to Category II.²⁶⁰ 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.²⁶¹

B. Discussion

Because our decision today does not result in a refund to ratepayers, this issue is moot. If, however, the actions that we take in the Phase 2B decision result in a customer refund, we will resolve this issue in our Phase 2B decision.

²⁵⁹ D.89-10-031, *mimeo.*, p. 290.

²⁶⁰ D.96-03-020, *mimeo.*, p. 110.

²⁶¹ D.94-06-011, 55 CPUC 2d 1, 34.

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. Parties are invited to address in Phase 3B what modifications should be made to NRF, if any, based on this finding.

X. Comments of the Parties

The alternate proposed decision of assigned Commissioner Kennedy was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.6 of the Commission's Rules of Practice and Procedure. ORA, TURN, Pacific and AT&T filed opening and/or reply comments in this proceeding.

ORA argues in its comments that the Commission should order Pacific to depart from the Aggregate Cost Method of accounting and to recognize "negative pension fund costs" for ratemaking. It argues that the rejection of negative pension costs is "without merit."

ORA's chief argument concerning PBOPs accounting is that in D.98-10-026 the Commission did not know what it was doing. ORA also criticizes D.98-10-026, stating "It is difficult to comprehend under what circumstances a potential refund of this magnitude would not be worthy of serious discussion."²⁶² Therefore, ORA asserts writing-off the regulatory asset in 1998 would erroneously modify the regulatory framework retroactively.

ORA makes several sub arguments to support its position that the Commission did not know what it was doing. First, ORA argues that the Commission "had no reason to suspect Pacific's intention to write it off in 1998,

²⁶² ORA, Opening Comments, p. 3.

since Pacific had failed to identify the write off as an effect of Pacific's proposal to eliminate the Z-factor recovery for PBOP, when asked by the Commission."²⁶³ ORA states that D.98-10-026 was effective on January 1, 1999.²⁶⁴

Second, ORA argues that Pacific failed to identify the rate impacts of writing off the regulatory asset in the proceeding leading to D.98-10-026.

Third, ORA states that it is erroneous to interpret the silence of D.98-10-026 on the alternate of writing-off the regulatory asset as an error. In addition ORA argues that our explanation – that elimination of the PBOP Z-factor dwarfs the PBOP regulatory asset is wrong. ORA asserts that “the conclusion that the elimination of the Z-Factor cost Pacific hundreds-of-millions of dollars in annual revenues for at least several years is factually incorrect.”²⁶⁵

Fourth, concerning the regulatory asset, ORA states that we err “in concluding that SFAS 71 is applicable to Pacific's PBOP regulatory asset and requires Pacific to write off the entire regulatory asset.

Fifth, concerning the regulatory asset, ORA argues that D.92-12-015 limits the recovery of PBOP costs in rates (citing Finding of Fact 52). As a result, ORA concludes that permitting full above the line treatment of the write off of the regulatory asset is inconsistent with D.92-12-015. Further, ORA argues that above the line treatment of this write off is inconsistent with Pacific's own decision to write off its “Transition Benefit Obligation” below the line.

TURN argues in its comments that the fact that Pacific's financial reports do not contain a PBOPs regulatory asset proves that SFAS 71 did not apply to this asset. TURN also argues that writing off the PBOP regulatory asset is “a

²⁶³ Ibid.

²⁶⁴ Ibid.

²⁶⁵ Ibid, p.8.

misreading of SFAS 71.” In addition, TURN contends that as a result of D.98-10-026, which eliminated Z-Factor recovery, “there should have been no expectation that costs that had been subject to Z-Factor recovery could be recovered from ratepayers to the extent they were not recovered in rates.” Finally, TURN argues that we raise, “without any citation to any record evidence,” the specter that limited recovery of PBOP costs provides an incentive for Pacific to discontinue providing PBOPs. TURN argues that the Commission should reject this analysis as “scare tactics.”

AT&T limited its comments to urging that any refunds be applied to switched access and certain UNEs, on the condition that carriers commit to pass these refunds through to their customers.

Pacific filed extensive comments. Pacific’s comments address the accounting for the transfer of pension funds, the accounting for PBOPs, compliance issues concerning the VEBA 1 trust withdrawals, the accounting for contributions to the VEBA 3 trust, compliance issues concerning funds transferred from the VEBA 3 to the VEBA 5 and used to pay current year retiree benefit costs (pay-as-you-go). Pacific also commented on issues concerning the scope of subsequent phases of this proceeding and the need for compliance filings. Pacific commented on our discussion of flow-through vs. normalized accounting treatment for taxes, asserting that the policy of using flow-through accounting constitutes error.

Finally, Pacific asserts that this proceeding “has been tainted from its inception and conducted in a manner that repeatedly denied SBC California’s fundamental rights.” Pacific objects to the involvement in this proceeding of Thomas J. Long, advisor to Commissioner Loretta Lynch, because of his prior

employment by TURN. Further, Pacific alleges that specific scheduling, discovery, and case management decisions denied Pacific its due process rights.

A. Discussion

ORA's comments concerning the accounting for pension funds simply reargue the merits of the aggregate cost method and warrant no further discussion. The aggregate cost method, as ordered by D.88-03-072, does not allow for the recognition of negative pension costs.

ORA's major argument on PBOPs - that the Commission did not know what it was doing in the 1998 decision – has no credible support. In particular, the Commission had a long experience with the PBOPs issue, and prior decisions made it clear that the Commission had a firm grasp of this complex issue. First, D.92-12-015 discussed the accounting treatment of the PBOPs regulatory asset, noting specifically “GTEC contends that if recovery cannot continue, then the associated regulatory asset must be written off immediately.”²⁶⁶ Although D.92-12-015 does not discuss or rule specifically on this accounting treatment, it is clear that the issue was before the Commission. Moreover, the Commission did not dispute GTEC's contention, which was the standard accounting treatment for regulatory assets. Second, D.92-12-015 specifically required Pacific to record a regulatory asset consistent with SFAS 71, which also requires a write-off of a regulatory asset when the promise of recovery is eliminated.²⁶⁷ Any departure from this treatment would require an explicit discussion, but following this traditional treatment would not. Thus, there is no factual basis to support ORA's global assertion that the Commission did not know what it was doing concerning

²⁶⁶ D.92-12-015, 46 CPUC 2d 499, 523.

²⁶⁷ Pacific Exhibit: Phase 2A: 305, pp. 31-32

the accounting treatment of PBOPs. Indeed, we find that the Commission ordered a treatment consistent with standard accounting practice.

ORA's sub arguments are either false or lack merit. ORA's statement that D.98-10-026 "had a January 1, 1999 effective date"²⁶⁸ is false and misleading. Decision 98-10-026 ends with these words: "This order is effective today. Dated October 8, 1998, at Laguna Hills, California." We hope that ORA will use more care in drafting comments in future phases of this proceeding.

ORA's argument that Pacific failed to identify the rate impacts of the write-off fails to consider the timetable of the 1998 NRF review proceeding and the facts available at the time of filing. Pacific filed its estimate of rate impacts in May and June of 1998, when future earnings impacts were uncertain. It is not reasonable to expect that Pacific could have reliably forecast the ratemaking impacts that would occur from the elimination of the PBOP regulatory asset.

ORA's statement that that the elimination of the Z-factor did not cost Pacific hundreds of millions of dollars is factually wrong. The rate impact of the change in Z-Factor policy was not for simply one year, but for several years. In addition, concerning the \$400 million dollar regulatory asset, D.92-12-015 states in Ordering Paragraph 4 that: "The recovery of such regulatory asset in future rates shall begin during the year when tax-deductible limits exceed PBOP costs and shall continue until the regulatory asset has reached a zero balance." Thus, it is clear that the recovery of the regulatory asset consistent with Ordering Paragraph 4 would dwarf the effects of the asset write-off.

ORA's statement that SFAS 71 does not apply to the PBOP regulatory asset is simply wrong. Ordering paragraph 4 of D.92-12-015 states, "The utilities shall

²⁶⁸ ORA's Opening Comments, p.5.

establish and maintain a regulatory asset pursuant to Financial Accounting Standards Board's Statement No. 71 and as discussed in this order.” Thus, the Commission order directly contravenes ORA’s assertion.

ORA’s further statement that SFAS 71 “as discussed in this order (referring to D.92-12-015)” does not require Pacific to write off the asset is also wrong. Under SFAS 71, the justification for maintaining the regulatory asset is the regulator’s promise that the regulatory asset will be recovered in rates. Although Pacific did not believe that the promise of recovery was adequate to support the regulatory asset on its financial books, the Commission, on the strength of its recovery mechanism, ordered Pacific to create a regulatory asset as if its promise met the conditions of recovery. Elimination of the Commission’s promise of recovery clearly required the elimination of the regulatory asset on the regulatory books, pursuant to SFAS 71 as discussed in D.92-12-015.

We note that although the PBOP regulatory asset was an above-the-line asset, D.92-12-015 excluded the PBOP regulatory asset from rate base because, as is standard regulatory practice, no money had been spent on the asset. Thus, the exclusion of the regulatory asset from rate base had no bearing on whether the asset was above or below the line. Furthermore, even if the regulatory promise was inadequate to report a regulatory asset for external financial reporting under a strict reading of SFAS 71, D.92-12-015 ordered Pacific to book a PBOP regulatory asset in the regulatory accounts.

ORA’s argument that writing off the full amount of the asset above the line is inconsistent with D.92-12-015 also has no merit. Although OP 8 of D.92-12-015 establishes a complex mechanism for recovery of the PBOP regulatory asset (consistent with Finding of Fact 52), we must also consider OP 4, which, as noted above, clearly contemplates full recovery of the regulatory asset. Thus, if the

mechanism of OP 8 failed to permit full recovery, the Commission would clearly need to consider how to resolve this conflict with OP 4.

In energy regulation, we also find precedent for recovery of PBOPs regulatory assets in 1997, a precedent suggesting that the Commission gave great weight to the regulatory promise contained in Ordering Paragraph 4 of D.92-12-015 (which applies to all utilities, including energy utilities). Decision 97-11-074 provides that precedent. In D.97-11-074, the Commission rejected ORA's argument that PBOP costs are not eligible for transition cost recovery:

We are not persuaded by ORA's arguments. These regulatory assets have been established with our authorization and fit the criteria established by §367. The PBOP regulatory assets, including the PBOP transition obligation, are eligible for recovery through the transition cost balancing accounts and should be amortized ratably over the transition period, with no recovery beyond 2001. (D.97-11-074)

Thus, even as the Commission revised its regulatory framework for energy utilities, it took steps to ensure the recovery of this PBOP regulatory asset.

ORA's argument that Pacific's write off of a "transition benefit obligation" below the line sets a precedent for writing off the PBOP asset below the line is simply inapposite. The Commission never created a regulatory asset for the transition benefit obligation. Thus, its accounting treatment of some "transition benefit obligation" has no relevance for our treatment of any regulatory asset. TURN's comments fail to persuade us to change our conclusions. Concerning the PBOPs regulatory asset, our discussion of ORA's comments concerning D.92-12-015 have made clear that the Commission clearly applied SFAS 71 (with certain modifications) to the PBOP asset. The absence of a PBOP regulatory asset on federal financial reports is inapposite. Finally, as discussed above, Verizon

(then GTEC) had made the Commission aware that modifications in the promise of recover would require writing off the PBOP regulatory asset.

Similarly, TURN's argument that D.98-01-026 should set no expectation for recovery of PBOP costs is also inapposite. Pacific recovered nothing when it wrote off its PBOPs regulatory asset in 1998. TURN confuses cost recognition with rate recovery. Indeed, the write-off of the regulatory asset was required because Pacific would not have rate recovery.

TURN's argument that our observation that businesses face powerful incentives to avoid regulatory uncertainty is not "record based" carries little weight. Some facts fall well within the scope of the competence of an administrative agency. We have broad experience with the consequences of regulatory uncertainty. Moreover, our statutory obligations require us to consider the broad consequences of our policies. The consequences of our decisions on California workers are of concern to this Commission, even when they are not an active party in a proceeding. Finally, we note that this is only one of many considerations that lead to our policy decision to write off these expenses above the line.

AT&T comments concerning the design of the surcharge mechanism are rendered moot because we order no refunds in this proceeding.

Pacific's comments on the substantive issues in this proceeding range over virtually every issue decided in today's decision. For this reason, we have elected to address Pacific's comments throughout the text of the order, rather than in this section.

Concerning Pacific's allegations that this proceeding has been tainted from its inception and conducted in ways that have denied SBC's fundamental rights, we note that the Commission's actions in this proceeding speak for themselves.

Moreover, Pacific requests no alteration in this decision based on these allegations. We also note that Pacific can seek rehearing and judicial review should it seek to pursue its allegations that the Commission has violated its rights. For all these reasons, we decline to address the substance of Pacific's allegations in today's decision.

Finally, in addition to the comments explicitly discussed above, we note that we have reviewed all the comments and replies filed in this proceeding and have amended this order as appropriate.

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. The value of Pacific's pension assets significantly exceeded the present value of Pacific's pension obligations throughout the audit period of 1997 - 1999.
3. When pension assets exceed pension obligations, the ACM formula yields a negative number, and contributions to the pension fund cease.
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. Pacific continues to incur new pension liabilities even when it makes no contributions to its pension funds. As a result, Pacific's pension surpluses will be amortized and pension costs and pension assets should balance over time.

6. The ACM method of setting rates and funding pensions provides for the gradual amortization of excess funding and a gradual “catch-up” for inadequate funding.

7. 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.

8. Pacific has recognized negative pension costs in the financial reports that it submits to the SEC, FCC, and its shareholders in accordance with SFAS 87. Pacific’s recognition of negative pension costs did not cause Pacific to withdraw funds from its pension trusts.

9. A major purpose of the financial reports that Pacific provides to the SEC is to provide useful information to investors. These financial reports are not used to set intrastate rates in California.

10. One purpose of ERISA is to protect pension assets for the benefit of employees and other qualified beneficiaries.

11. Requiring Pacific to share earnings on pension assets with ratepayers treats pension earnings as if they are operational earnings.

12. During 1997 through 1999, Pacific’s pension plans exhibited unexpectedly high earnings on pension assets. Subsequently, Pacific’s pension surplus determined in accordance with SFAS 87 dropped from \$5.9 billion to \$2.7 billion between December 31, 1999, and December 31, 2001.

13. Protecting workers’ pensions requires adequate funding of pensions and the protection of pension assets from other uses.

14. Pacific’s pension assets are held in trust for current and future retirees.

15. The treatment of pension earnings as company profits for ratemaking will affect the management of pension assets. In particular, if a company will incur a

liability to share pension earnings with ratepayers, then a rational company will make investments decisions in its pension funds in a way that manages the regulatory liabilities that its pension funds produce.

16. The treatment of negative ACM amounts as “overfunding” to be distributed to ratepayers would require a prudent utility to maintain sufficient liquidity to meet its potential obligations to ratepayers in the event that pension assets realize earnings above historic levels.

17. The treatment of negative ACM amounts as “overfunding” to be distributed to ratepayers could reduce the cash available for operations, investments, and infrastructure development.

18. The startup revenue requirement in NRF presumed a treatment of pension assets consistent with the ACM methodology.

19. The creation of a fictive “prepaid pension asset” in rate base as part of the financing of the distribution to ratepayers of pension fund earnings is unwise.

20. In 1999, Pacific withdrew surplus assets from one of its pension trust funds to reimburse itself for \$41 million of intrastate regulated PBOP costs that Pacific had paid earlier in the year.

21. 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.

22. 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.

23. Pacific Bell does not have stand-alone actuarial reports for its pension or 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.

24. Decision 92-12-015 required SFAS 106 costs in excess of contributions 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.

25. 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.

26. 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.

27. Decision 92-12-015 required Pacific to record a PBOP regulatory asset on its regulated books consistent with SFAS 71, as discussed in D.92-12-015, even if Pacific did not report a PBOP regulatory asset pursuant to SFAS 71 for external financial reporting purposes.

28. The PBOP regulatory asset was an above-the-line asset.

29. Decision 92-12-015 did not exclude the PBOP regulatory asset from rate base because it was, as ORA alleges, a below-the-line asset. The Decision excluded the PBOP regulatory asset from rate base because no money had been expended on the regulatory asset.

30. There is no evidence in this proceeding that the PAYGO costs built into Pacific's rates would provide sufficient revenues to recover all of Pacific's PBOP regulatory asset.

31. 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.

32. The elimination of the SFAS 106 Z-Factor by D.98-10-026 reduced Pacific's rates by \$99.5 million per year and eliminated the revenues sustaining the PBOPs regulatory asset.

33. The elimination of the SFAS 106 Z-Factor cost Pacific hundreds-of-millions of dollars in annual revenues for at least several years.

34. Decision 92-12-015 contemplated full recovery of PBOPs regulatory assets.

35. Decision 98-10-026 became effective on October 8, 1998.

36. Consistent with D.98-10-026's elimination of the SFAS 106 Z Factor in 1998, Pacific wrote off its entire PBOP regulatory asset in the amount of \$400 million in 1998.

37. Pursuant to SFAS 71 as discussed in D.92-12-015, it was proper for Pacific to write off its PBOPs regulatory asset in 1998.

38. Decision 92-12-015 noted GTEC's contention that if recovery for the PBOPs regulatory asset cannot continue, then the associated regulatory asset must be written off immediately.

39. Decision 92-12-015 required the recording of a regulatory asset on the above-the-line regulatory books. As a consequence, absent another Commission decision, writing-off the asset on the above-the-line was consistent with Commission regulatory policy and reasonable.

40. It was not reasonable for Pacific to anticipate the ratemaking implications of writing off the regulatory asset above the line at the time of its filings in the 1998 NRF review proceeding.

41. Decision 98-10-026 and Resolution T-16102 indicate that the Commission intended to consider if Pacific had recovered an excessive amount of SFAS 106 costs via the Z-Factor, but set no timetable for doing so. To date the Commission has not considered this matter in any proceeding.

42. Since the SFAS 106 Z-Factor has not been used in the last 5-years, it is unclear whether a proceeding to consider the Z-Factor collections during the period 1993-1998 constitute a wise use of regulatory resources.

43. 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.

44. 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 \$178 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.

45. 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.

46. 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.

47. 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.

48. Pacific incurred substantial new unfunded PBOP liabilities in 1999.

49. Pacific's withdrawal of \$180 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.

50. The record suggests that Pacific may have withdrawn additional funds from the VEBA 1 trust subsequent to 1999 for non-PBOP purposes.

51. Pacific stipulates that there is no law, court decision, or Commission decision regarding retroactive ratemaking that prevents the Commission from ordering Pacific to (i) return \$180 million to the VEBA 1 trust, and (ii) use the VEBA 1 trust assets for the sole purpose of providing PBOPs.

52. 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 future PBOP costs. Pacific made no contributions to its VEBA 3 trust after 1990.

53. 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. The amount of the transfers was \$13 million in

1997, \$79 million in 1998, and \$90 million in 1999. 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.

54. 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.

55. 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.

56. 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) by \$208 million when SFAS 106 was adopted for Commission purposes effective January 1, 1993.

57. Pacific wrote off part of its TBO in 1993 when it recorded a TBO curtailment loss in accordance with SFAS 106. The curtailment loss included a portion of the VEBA 3 contributions that were included in the TBO as set forth in the previous Finding of Fact.

58. The majority of Pacific's PBOP regulatory asset consisted of the TBO curtailment loss that Pacific recorded in 1993.

59. 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.

60. Today's decision has not caused a net increase in Pacific's PBOP regulatory asset in 1998.

61. Changes to Pacific's PBOP regulatory asset had no affect on Pacific's PBOP liabilities, and vice versa.

62. 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.

63. 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.

64. The six-year amortization of the DRD increased Pacific’s pre-tax intrastate regulated expense by \$612 million annually in 1999 through 2004.

65. 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.

66. 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.

67. 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.

68. 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.

69. 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.

70. Public utilities are required by federal tax law to treat Contributions in aid of construction (CIAC) as taxable income and pay income taxes on CIAC in the year the contributions are received.

71. 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.

72. Decision 87-12-063 considered if the old USOA, known as Part 31, should be replaced with a new USOA, known as Part 32. Part 31 required flow-through tax accounting except for depreciation. Part 32 required normalized tax accounting. Although D.87-12-063 adopted much of Part 32, the Decision rejected the normalized tax-accounting in Part 32 and required telephone utilities to continue to use flow-through tax accounting embedded in Part 31.

73. Utilities must capitalize more IDC for tax purposes than for ratemaking purposes. Consequently, there is less interest available as a tax deduction for tax purposes than for ratemaking purposes. This causes the income taxes paid by utilities to be higher than the taxes included in rates, all else being equal.

74. 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.

75. 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, D.88-01-061 was clear that allowing utilities to apply normalized tax accounting to vacation pay was a limited exception to the Commission's flow-through policy.

76. 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.

77. 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.

78. 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.

79. 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.

80. By adopting normalized tax accounting, Pacific implemented SFAS 109 in a way that (i) had a substantial impact on its income statement accounts, and (ii) was contrary to AL 17024.

81. 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.

82. 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 did not have any impact on net income.

83. SFAS 109 and the FCC's amended USOA contemplated that utilities might use flow-through tax accounting for regulatory purposes.

84. 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.

85. 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.

86. 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.

87. The amendments to the USOA adopted by Resolution F-634 included the entire text of three new USOA accounts that were intended to reflect flow-through ratemaking. Thus, the adopted amendments were not just scattered words and “gibberish” as Pacific implies.

88. Pacific continued to use flow-through tax accounting for several items of expense after Resolution F-634 was issued. This contradicts Pacific’s assertions that it was required by Resolution F-634 to use normalized tax accounting.

89. Pacific Exhibit Phase 2A: 318, Attachment 1, lists every item that received normalized tax treatment in Pacific’s NRF startup revenue requirement.

90. OP 14 of D.89-10-031 ordered Pacific to submit a compliance filing to establish its startup revenue requirement under NRF. The compliance filing was supposed to reflect Pacific’s ratemaking revenues, expenses, and rate base. Pacific’s compliance filing did not conform to the Commission’s policy of using flow-through tax accounting for both accounting and ratemaking purposes.

91. 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.

92. 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.

93. The Commission’s review of Pacific’s compliance filing containing its multi-billion dollar startup revenue requirement was brief and cursory.

94. The following circumstances indicate that D.89-12-048 did not rescind the Commission's flow-through policy: (i) there was no notice pursuant to Pub. Util. Code § 1708 that the Commission was contemplating the abandonment of its flow-through policy, and (ii) D.89-12-048 did not contain any findings of fact or conclusions of law pursuant to Pub. Util. Code § 1705 regarding the abandonment of the Commission's flow-through policy.

95. There is no reasonable support in the record of this proceeding for Pacific's contentions that (i) the Commission must have known that the reports Pacific had submitted to establish asserts that its startup revenue requirement did not reflect the Commission's flow-through policy, and (ii) Pacific was authorized by Commission staff to submit reports that did not reflect the Commission's flow-through policy. But even Pacific had been authorized at one point, D.87-12-063 required Pacific to use flow-through accounting for both regulatory accounting and ratemaking purposes, and D.89-10-031 ordered Pacific to submit reports that reflected ratemaking.

96. The Workshop III Report adopted by D.91-07-056 did not list income taxes as a "ratemaking adjustment."

97. The ratemaking adjustments addressed by the Workshop III Report excluded the modifications that Pacific was required to make to its books to reflect Commission-mandated exceptions to the FCC Part 32 rules. Decision 87-12-063 rejected those portions of the FCC's Part 32 rules that required the use of normalized tax accounting and ordered Pacific to maintain accounting records reflecting flow-through tax accounting. Consequently, the Commission's policy regarding flow-through tax accounting did not constitute a "ratemaking adjustment" as defined by the Workshop III Report.

98. 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 stated in the previous Finding of Fact, 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.

99. Decision 91-07-056 did not consider, let alone affirm, the regulatory treatment of income taxes in Pacific's startup revenue requirement.

100. 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.

101. 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.

102. 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.

103. 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.

104. 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.

105. 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.

106. The Commission's decision on Phase 2B audit issues will (i) identify 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) specify the methods and procedures that should be used to implement any such refund.

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 and to set rates to fund pension liabilities. To achieve this purpose, the ACM methodology, which does not record "negative" pension fund amounts as company profits, offers a reasonable approach.

2. When a utility's pension plan assets exceed pension obligations, the ACM methodology eliminates payment to the pension fund even as the utility incurs new pension obligations. Thus, this application of the ACM for ratemaking purposes will lead to a balance between pension costs and pension obligations.

3. Pacific properly recorded and reported zero pension costs under the ACM during 1997, 1998, and 1999 because Pacific's pension assets exceeded the present value of its pension obligations during each of those years.

4. Pacific's recognition of negative pension costs in the financial reports that it submits to the SEC, FCC, and its shareholders in accordance with SFAS 87 did not violate federal law because the purpose of those reports is to reflect a corporation's liabilities and assets, not to require a distribution of surplus pension assets.

5. Federal law set forth in ERISA and the IRC does not prohibit Pacific from recognizing negative pension costs for intrastate regulatory purposes, but it does restricts the appropriation of pension assets. Pursuant to ERISA, a company can terminate a pension plan and use surplus assets for corporate purposes only if it fully funds the existing pension obligations.

6. Treating pension earnings as utility profits creates incentives to manage pension funds to reduce utility liabilities, thereby undermining the fiduciary responsibilities of pension fund managers.

7. Using pension earnings to create ratepayer benefits could reduce the cash available to cover operational costs and make new investments. This result is unreasonable.

8. It is not in the public interest to treat pension earnings as utility profits and to require distribution of pension earnings to ratepayers.

9. The recognition of negative pension costs is not consistent with NRF.

10. Creating a prepaid pension asset is not reasonable.

11. 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.

12. 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).

13. 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 to the extent allowed by law.

14. 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.

15. 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.

16. ORA's proposal to true-up Pacific's pension assets in Phase 3 of this proceeding should not be adopted.

17. Pacific's PBOP regulatory asset recorded pursuant to D.92-12-015 was made subject to "SFAS 71 as discussed in D.92-12-015" for regulatory purposes pursuant to Commission fiat.

18. SFAS 71 required Pacific to write off its PBOP regulatory asset in 1998 to the extent the asset became impaired when D.98-10-026 eliminated the SFAS 106 Z-Factor. Nothing in D.92-12-015 either permits or requires any other treatment. Therefore, Pacific appropriately wrote off its asset in 1998.

19. Since the PBOP regulatory asset was recorded in the above-the-line regulatory accounts, it is reasonable to record the elimination of this regulatory asset in the above-the-line regulatory accounts.

20. 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.

21. Because of the timing of filings in the 1998 NRF review and the inherent uncertainty of future financial performance, it is not reasonable to fault Pacific for not reporting to the Commission in the 1998 NRF review the potential ratemaking impacts that might occur from the elimination of the PBOP regulatory asset.

22. D.98-10-026 became effective on October 8, 1998.

23. The elimination of Z-Factor support for the PBOPs regulatory asset in D.98-10-026 necessitated an immediate write-off of this regulatory asset.

24. Because D.98-10-026 ended the use of SFAS 106 for ratemaking purposes and sought to simplify NRF regulation, it was proper for Pacific to report its full SFAS 106 accrual in 1999, regardless of its actual tax-deductible contributions.

25. 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.

26. Decision 92-12-015 found that Pacific should fund its SFAS 106 costs and provided Pacific with the means to do so.

27. Decision 98-10-026 eliminated the SFAS 106 Z-Factor and adopted other changes to NRF (e.g., suspended the earnings-sharing mechanism and eliminated the price-cap index). These changes simplified NRF and provided Pacific with the means to fund its SFAS 106 costs over the long run. However, it eliminated any regulatory guarantee of PBOP recovery.

28. 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.

29. 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.

30. 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.

31. 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.

32. Pacific is required by Ordering Paragraph 3 (OP 3) of D.92-12-015 to either refund to its ratepayers the amount that it withdrew from its VEBA 1 trust in 1999 for non-PBOP purposes or return the withdrawn funds to the VEBA 1 trust.

33. The Commission may require Pacific, without violating the rule against retroactive ratemaking, to (i) return to the VEBA 1 trust the funds that Pacific withdrew from the PBOP trust for non-PBOP purposes, and (ii) order Pacific to henceforth use all PBOP trust funds for the sole purpose of providing PBOPs to Pacific's employees, including any funds returned to the PBOP trusts pursuant to today's decision.

34. Because the purpose of the VEBA 1 trust is to provide PBOPs to Pacific's employees, Pacific should return to the VEBA 1 trust the money that it withdrew in 1999 for non-PBOP purposes no later than 30 days from the effective date of this decision. Pacific should also pay interest on the money that it withdrew. The amount of interest should be based on the higher of (i) the 3-month commercial paper rate, or (ii) the interest that would have been earned had the money been left in the VEBA 1 trust.

35. Pacific should file and serve no later than 30 days from the effective date of today's decision a compliance report that (i) states the rate and amount of interest on the funds returned to the VEBA 1 trust pursuant to the previous COL, and (ii) contains work papers showing the derivation of the interest rate and the amount of interest. Parties should be allowed to comment on Pacific's report.

Comments and reply comments should be filed and served 20 days and 30 days, respectively after the report is filed.

36. 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.

37. If Pacific did withdraw funds from PBOP trusts in 2000 and subsequent years for non-PBOP purposes, it should return the withdrawal(s) to the PBOP trust fund(s) in accordance with the timeframe and procedure adopted by today's decision for returning the VEBA 1 withdrawal in 1999.

38. Pacific should henceforth use PBOP trust fund assets for the sole purpose of providing PBOPs to Pacific employees. Any use of PBOP trust fund assets for non-PBOP purposes should be subject to financial penalties and other sanctions.

39. Decision 92-12-015, OP 6, prohibited Pacific from recovering via the Z-Factor any of the contributions to Pacific's VEBA 3 in 1989 and 1990.

40. The dicta of Decision 92-12-015 acknowledged that denying recovery of the VEBA 3 contributions would require an adjustment in the size of the PBOP TBO.

41. Pacific's prepaid contributions to its VEBA 3 trust in 1989 and 1990 and its adjustments to the PBOP TBO account were recorded consistent with Decision 92-12-015.

42. 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.

43. 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.

44. 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.

45. 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.

46. 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.

47. 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.

48. The primary reason D.98-10-026 eliminated depreciation reviews and approvals was the need for such action ended when the earning-sharing mechanism was terminated. Accordingly, if sharing is reinstated in Phase 3B, it would be logical and appropriate, and not legal error as alleged by Pacific, for the Commission to also consider in Phase 3B if depreciation reviews and approvals should be reinstated.

49. Although D.98-10-026 stated that it was permanently eliminating depreciation reviews and approvals, this was not binding on future

Commissions. The Commission has authority under Pub. Util. Code § 1708 to modify a prior decision, including D.98-10-026, after providing notice and an opportunity to be heard.

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, and (iv) required Pacific to account for income taxes in accordance with the flow-through method embedded in the FCC's USOA known as Part 31.

54. It is the Commission's general policy that, to the extent permitted by law, the amount of tax expense that utilities record and report for regulatory accounting purposes and recover in rates 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-through 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 numerous Commission decisions issued over a 35-year period that required the use of flow-through tax-accounting, and (ii) had a significant impact on rates.

67. Pub. Util. Code § 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 §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 revenue neutral way as required by the Resolution.

71. Resolution F-634 could not have authorized normalized tax accounting because doing so would have rendered meaningless the Resolution's requirement that the accounting changes adopted by the Resolution be implemented in a revenue neutral manner.

72. Because Resolution F-634 required the accounting changes adopted therein to be implemented in a revenue neutral manner, the Resolution waived the requirement in 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 revenue requirements during the current year and three future years. The Commission would not have waived the requirement to submit a study unless it believed the adoption of SFAS 109 and the related amendments to the USOA would not affect future revenue requirements for at least three years.

73. 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.

74. 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.

75. 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.

76. 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.

77. Resolution F-627 and D.92-12-015 demonstrate that the Commission's flow-through policy remained in effect under NRF.

78. Decision 91-07-056 did not consider or affirm the use of normalized tax accounting in Pacific's NRF startup revenue requirement.

79. Resolution F-627 and D.92-12-015 demonstrate that the Commission's flow-through policy remained in effect under NRF.

80. 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.

81. The rule against retroactive ratemaking stems from Pub. Util. Code § 728, which authorizes the Commission to set rates prospectively. It is a fundamental rule of statutory construction that a statute must be given a reasonable and common sense interpretation consistent with the apparent purpose and intention of the lawmakers, practical rather than technical in nature, which upon application will result in wise policy rather than mischief or absurdity. The rule against retroactive ratemaking is also based on the presumption that the rate in question was set in accordance with proper procedure. If proper procedure was not followed, the Commission can fashion such remedies as equity may require.

82. There is no doubt that it was the Commission's policy at the time Pacific's startup revenue requirement was established to use flow-through tax accounting for ratemaking purposes to the extent allowed by law. In addition, D.89-10-031 ordered Pacific to submit reports for establishing its startup revenue requirement that reflected the Commission's ratemaking policies, but Pacific failed to do so with respect to income taxes. In the interest of achieving wise policy and an equitable outcome, Pacific's failure to properly report its income tax expense in 1989 should not shield Pacific from having to properly report its income tax expense in 1997 and subsequent years.

83. 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.

84. 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.

85. 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.

86. 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.

87. Pacific's recorded income tax expense for 1997 – 1999 should be adjusted to reflect the Commission's flow-through policy.

88. It is the Commission's policy that end-users are the appropriate recipients of any refund of sharable earnings that may occur under NRF.

89. 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.

90. Pacific should file an advice letter within 60 days of the Phase 2B audit decision 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 and the Phase 2B audit 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.

91. 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.

92. Parties should be allowed to address the following matters in Phase 3B of this proceeding:

- i. Whether there are any outstanding PBOP issues from D.98-10-026 and /or Resolution T-16102 concerning Pacific's now-expired SFAS 106 Z-Factor that require resolution by the Commission.
- ii. Assuming the Commission reinstates an earnings-sharing mechanism:
 - i. Whether SFAS 106 costs recorded and reported for regulatory purposes should be limited to tax-deductible contributions to external PBOP trust funds.
 - ii. Whether SFAS 106 costs in excess of both (1) tax-deductible contributions and (2) PBOPs funded with surplus pension assets should be carried forward and recognized as an expense in future years when tax-deductible contributions exceed SFAS 106 costs.
- iii. Whether the Commission should review and approve depreciation expenses.

- iv. Which Category I and II services should be included in the earnings-sharing mechanism.
- v. 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.
- iii. How NRF should be modified based on the findings in today's decision.

93. 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.

94. 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. Within 30 days from the effective date of this Order, Pacific shall return to its Voluntary Employee Benefit Association Trust No. 1 (VEBA 1) all funds that it has withdrawn from the VEBA 1 trust in 1999 and subsequent years for purposes other than providing post-retirement benefits other than pensions (PBOPs) to Pacific retirees, plus interest on the withdrawn funds equal to the higher of (i) the 3-month commercial paper rate, or (ii) the interest that would have earned had the funds remained in the VEBA 1 trust.

3. Within 30 days from the effective date of this Order, Pacific shall file and serve a compliance report that contains the following information:

- i. The rate and amount of interest on the funds returned to the VEBA 1 trust in accordance with the previous Ordering Paragraph
- ii. Work papers showing the derivation of the rate of interest and the amount of interest.
- iii. Whether, and to what extent, Pacific withdrew funds from its PBOP trusts in 2000 and subsequent years for non-PBOP purposes.

4. Parties may file and serve comments and reply comments regarding Pacific's compliance report described in the previous Ordering Paragraph. Comments and reply comments shall be due 20 days and 30 days, respectively, after the report is filed.

5. Pacific shall return to its PBOP trust funds all amounts withdrawn for non-PBOP purposes in 2000 and subsequent years. Pacific shall return the funds in accordance with the timeframe and procedures adopted by today's Order for returning the VEBA 1 withdrawal in 1999.

6. Pacific shall use PBOP trust fund assets, including assets returned to PBOP trust funds pursuant to this Order, for the sole purpose of providing PBOPs to Pacific retirees. Any PBOP trust fund assets not used for this purpose shall be returned to ratepayers to the extent allowed by law.

7. 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).

8. 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.

9. Within 60 days from the effective date of the Phase 2B decision, 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 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.

10. 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 these purposes shall be refunded to Pacific's ratepayers.

11. 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.

12. 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.

13. 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.

14. 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 purposes, 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.

15. 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 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.

16. Parties may address the following matters in Phase 3B of this proceeding:

- i. Whether there are any outstanding PBOP issues from D.98-10-026 and / or Resolution T-16102 concerning Pacific's now-expired SFAS 106 Z-Factor that require resolution by the Commission.
- ii. Assuming the Commission reinstates an earnings-sharing mechanism:
 - a. Whether SFAS 106 costs recorded and reported for regulatory accounting purposes should be limited to tax-deductible contributions to external PBOP trust funds.
 - b. Whether any SFAS 106 costs in excess of both (1) tax-deductible contributions and (2) PBOPs funded with surplus pension assets should be carried forward and recognized as an expense in future years when tax-deductible contributions exceed SFAS 106 costs.
 - c. Whether the Commission should review and approve depreciation expenses.
 - d. Which Category I and II services should be included in the sharing mechanism.
 - e. 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.
- iii. Whether and how the New Regulatory Framework should be modified based on the findings in today's Order.

17. The next audit of Pacific Bell shall include an examination of whether Pacific used pension assets to fund PBOPs in 2000 and subsequent years. Pacific's reported PBOP costs shall be adjusted, as appropriate, to reflect the audit findings.

This Order is effective today.

Dated February 26, 2004, at San Francisco, California.

MICHAEL R. PEEVEY
President

GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners

I reserve the right to file a concurrence
/s/ SUSAN P. KENNEDY
Commissioners

I reserve the right to file a dissent
/s/ LORETTA M. LYNCH
Commissioner

I reserve the right to file a dissent
/s/ CARL W. WOOD
Commissioner

