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Interim Hearing on Diversification of Electric, Gas and Telecommunications Industries

Senate Committee on Energy and Public Utilities

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CALIFORNIA LEGISLATURE
SENATE COMMITTEE ON
ENERGY & PUBLIC UTILITIES
SENATOR HERSCHEL ROSENTHAL, CHAIRMAN

Interim Hearing on
**DIVERSIFICATION OF ELECTRIC, GAS
AND TELECOMMUNICATION UTILITIES**

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November 24, 1986
State Capitol, Room 2040
Sacramento, California

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INTERIM HEARING AGENDA

DIVERSIFICATION OF ELECTRIC, GAS AND TELECOMMUNICATION UTILITIES

Monday, November 24, 1986

Room 2040, 9:30 a.m., State Capitol, Sacramento

PANEL I

ENERGY UTILITY DIVERSIFICATION

Howard V. Golub
Attorney
Pacific Gas & Electric Company

Ronald Daniels
Manager, Revenue Requirements
Southern California Edison Company

William Cole
Vice President
Pacific Lighting Company

Roy Rawlings
Assistant Vice President
Regulatory Affairs
Southern California Gas Company

Paul K. Rasmussen, Director
Division of Mergers & Acquisitions
Pacific Diversified Capital
representing
San Diego Gas & Electric Company

PANEL I

RESPONSE GROUP

Commissioner Donald Vial
President
Public Utilities Commission

Sylvia M. Siegel
Executive Director
Toward Utility Rate
Normalization (TURN)

William B. Marcus
Consulting Economist
representing
Independent Energy Producers
Association

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November 24, 1986, continued

PANEL II

TELECOMMUNICATION UTILITIES

Elliott E. Maxwell
Executive Director
Strategic Planning
Pacific Telesis Group

Jenny Wong
Regulatory Manager
General Telephone Company
of California

Harry Baker, Jr.
President
Sierra Telephone Company
representing
California Telephone Association

PANEL II

RESPONSE GROUP

Peter M. Arth
General Counsel
Public Utilities Commission

Terry L. Murray
Advisor to
PUC Commissioner Victor Calvo

Spencer Kaitz
President
Michael Morris
Director of Regulatory Affairs
California Cable Television
Association (CCTA)

Keith Askew
Vice President
California Teleconnect Assn

Mark Cstrau
Attorney
representing
Businessland

CHAIRMAN HERSCHEL ROSENTHAL: Okay, good morning. I want to welcome all of you to Sacramento. And, on this holiday week, I'd like to give thanks for all of those who are participating in this interim hearing on Utility Diversification.

In the last legislative session, the Senate began an important process of exploring exactly what happens when public utilities diversify into markets which are unregulated. In seminars and through interim and legislative hearings, we heard why consumers, regulators and unregulated competitors are concerned about, what most agree is a rush by utilities to diversify their interests. We also heard from the utilities that diversification is basically a right that they have in a competitive market, and that consumers really have nothing to worry about.

At a conference that I attended on state telecommunication issues, held by the National Conference of State Legislators practically every legislator and regulator who spoke identified "diversification" as the major issue in which states must better prepare their regulatory commissions. I was pleased that I could point to the lead taken this year by the California Legislature.

But, I am still worried that we haven't done all that we can to protect the ratepayers.

I am worried that the constant barrage of acquisitions by utilities of risky ventures somehow will impact the widow who turns on her thermostat, or the small businessman who must pay increasing telephone bills.

I am still worried because, after months of calm talk about careful utility planning with no major surprises, this committee was notified of Pacific Lighting's purchase of Thrifty Drug Stores during the interim. A wise investment? Maybe..., but a major investment that raises questions of ratepayer protection.

I am still worried when this month the issue of fair competition is once again raised by the FCC ruling that inside and outside telephone wiring repair must now be a competitive business. Is it competitive for the phone company to be allowed free advertising in billing envelopes for this service? Do the ratepayers get to share the telephone utility profits from wire repairs when they financed the utility expertise?

So, if we witness increasing federal pressure for utilities to compete in new areas, and the state PUC is destined to move in a new direction, this interim hearing becomes just as pertinent today as when the Senate bills were introduced earlier this year to provide ratepayer protections against cross-subsidization.

I've asked that we explore the unique differences between how electric utilities diversify from telecommunication utilities, since a major criticism of the Senate bills

was their generic approach. But I also want to ask each witness representing a utility or holding company three major questions:

1. What recent acquisitions have been made and why?
2. What future diversified path can we expect?
3. What ratepayer protections are the utility or holding company implementing?

From the groups here to respond to utility testimony, I want to hear about specific regulatory concerns or problems that could impact ratepayers and how we might specifically address those concerns. I'd like to start the Energy Utility Panel off today with a representative of the utility whose president just this month said, "PG&E will have to make an exerted effort to seek new markets outside the traditional service area."

Mr. Golub. We are going to have up here all of Panel I, so if you will please come on up. Following that, we will then have the response group come up here to respond to specifics which may be raised by the utilities.

You may want to turn those nameplates around so that we can see who you are, you know who you are.

Mr. Golub, Attorney for Pacific Gas and Electric Company, please.

MR. HOWARD GOLUB: Yes, sir. Good morning. I'm not sure, is this on?

I am Howard Golub. Basically, to just give you a quick overview of PG&E in this matter. PG&E is, as are the other utilities, concerned about the change in the energy industry and the fact that it has changed to a competitive industry and is in the process of changing. We are a little unusual, however, compared to the other utilities in that we have chosen not to diversify out of the utility industry. Our corporate decision has been to concentrate our energies in delivering energy to our customers at the lowest price possible. And that is our basic corporate plan at this time.

CHAIRMAN ROSENTHAL: Very good. And is that your statement at this point?

MR. GOLUB: Yes, sir. I'll be glad to address the questions you asked, if you'd like.

CHAIRMAN ROSENTHAL: All right.

MR. GOLUB: We have had no major recent acquisitions. Our future diversified path is to basically stay in the energy industry, to perhaps use innovative techniques to deliver energy products, but to remain in the energy industry. And with regard to ratepayer protection, as I say, we have very little in the way of diversification, but we have nonetheless, implemented some strict accounting rules internally and we've also moved those very minor unregulated activities we have into a separate subsidiary to more clearly delineate its activities from the utility.

CHAIRMAN ROSENTHAL: Your President, Richard Clarke, said recently that, "Increasing competition among energy producers will be greatly detrimental to the PG&E

ratepayers," a \$1 billion revenue loss by 1990, as I understand; yet his answers to the dilemma is competition in other unregulated ventures. Can you explain?

MR. GOLUB: I am not so sure the second part of that correctly characterizes our position. Maybe I can explain. Our intention is to be more effective in the energy business. And when he -- when the references to go into new areas -- I don't have the exact quote in front of me -- the intention there is that we provide energy services more effectively, use new techniques to deliver them, get new customers on the utility system. If we do not keep the large industrial customers on the system, the cost to our residential customers will rise dramatically, and it's already beginning. We have to keep the customers on the system, bring new customers on the system to spread the fixed costs.

CHAIRMAN ROSENTHAL: A Wall Street Journal article, November 13th, says that, "PG&E is looking for new markets outside its traditional service area, to make up for lost sales within it."

MR. GOLUB: And that's basically the same point, sir.

CHAIRMAN ROSENTHAL: Right. How active do you intend to be with establishing affiliates to produce independent energy sources that could be sold back to the utility?

MR. GOLUB: Well, we have not really done anything in that area to date, unlike some of the other utilities; we are considering that as an option, and -- but once again, it would only be, if it can effectively reduce the cost of delivering energy services.

CHAIRMAN ROSENTHAL: All right. Thank you very much. For the moment you might want to stay there in case you have something further you'd like to add.

Mr. Daniels, Manager of Revenue Requirements with Southern California Edison.

MR. RONALD DANIELS: Good morning, Senator.

Basically, Edison is in much the same position as PG&E in that our main interest and main purpose is to provide electric service to our customers. We have not gotten into an active diversification program, we have had no major acquisitions or changes since the -- appearing before you earlier in the year.

We do feel that there may be opportunities that would be beneficial to the ratepayers, the employees, and the stockholders that could come up and could appear and should be taken advantage of, but at this time we haven't made any major moves as far as diversification is concerned. We do feel that there are provisions that the Public Utilities Commission has available in reviewing the records and books of the company and can now make the appropriate review to avoid cross-subsidization of our customers. We would recommend that the Legislature maintain the flexibility or adopt positions that would allow flexibility in case there are opportunities that could be taken by the utilities in diversification matters.

As far as the questions are concerned, we haven't gotten into any major

diversification. As far as the current condition at the PUC, we believe that their audits and reviews of our records have, in fact, allowed them to investigate any forms of potential subsidization by any class. Thank you.

CHAIRMAN ROSENTHAL: What is the status of your joint ventures with oil companies to build qualified facilities?

MR. DANIELS: What we've done is to have agreements which are below the avoided cost that existed at the time of contract signing; therefore, the purchases of power from those oil company arrangements are, in fact, lower than an avoided cost contract and we believe are to the benefit of our customers.

CHAIRMAN ROSENTHAL: Any questions from the members of the committee?

Mr. Cole, Vice President, Pacific Lighting Company.

MR. WILLIAM COLE: Good morning Mr. Chairman, Senators.

My name is William Cole, I'm Vice President of the Pacific Lighting Corporation. In my hopefully brief presentation, I would like to cover three areas and I think that they will, for the most part, respond to the issues that you had earlier, Mr. Chairman.

We would like to give you a brief description of Pacific Lighting Corporation, which most of you, I think, have already heard. We would like to get into a little bit of our philosophy on diversification. We would like, as you indicated, to tell you a little bit about our more recent acquisitions including Thrifty.

Mr. Rawlings, Assistant Vice President of Southern California Gas Company, is here with us today, and he will discuss the gas company and how we keep the gas company completely separate and insulated from the parent company. With that, perhaps I can proceed and tell you again — I think he knows I'll be very brief and just tick off the items.

Pacific Lighting is a holding company only, it is not an operating company. It is completely separate, a completely separate corporate entity from the gas company which Mr. Rawlings will get into. However, the gas company is our largest subsidiary, and as of last year, if you take into account the Thrifty acquisition, the gas company represented about 59 or 60 percent of the total assets of the system. Our other major subsidiaries, again, I think you know, the Thrifty, the discount -- the drugstore operation, other specialty retailing that we acquired when we acquired Thrifty, oil, and gas operations both domestic and foreign, land development and some leasing and alternative energy operations.

CHAIRMAN ROSENTHAL: Would you pull that microphone?

MR. COLE: Sure, sorry.

CHAIRMAN ROSENTHAL: Just seems to be a little trouble hearing.

MR. COLE: Okay. I'll try to speak up.

CHAIRMAN ROSENTHAL: Thank you.

MR. COLE: We also have some other operations that, for example, are some interstate gas transmission operations. We do not look upon them as our -- being part of our diversification effort. Those operations were started in the decade of the 70's, and they were a response to the gas supply shortage of the 70's and they are strictly -- and they are definitely related to the utility, and they were formed for that reason. Again, they are not part of what we consider the -- our diversification effort.

I want to emphasize that Pacific Lighting is not a public utility, it has never been a public utility, and it has never dedicated its property as a public utility.

It started originally, a 100 years ago as a matter of fact, in San Francisco with the Gas Street Light operation up there. It acquired gas distribution companies; it is not a situation where it originally was a utility and then became a holding company. Likewise, with respect to Pacific Lighting, this question of diversification is not a new one. We have been diversifying into unrelated areas for over 20 years. And we would submit that we have not had any problems with respect to the utility or ratepayers, or utility regulation with respect to that diversification that has been going on. We have a track record, it is there for everybody to see. I think you know we now have about 125,000 shareholders of which approximately 50,000 or more are California residents.

Now getting to our philosophy on diversification. The first point is, we diversify into unrelated areas, unrelated businesses, businesses unrelated to the utility. Now, immediately I'm sure in various people's minds the question of the Mojave pipeline and our interest in that comes up, and I would be happy to discuss that if time allows. I think, suffice for the moment to say, we are no longer in the Mojave project, we never considered that as part of our diversification effort, but if anybody is interested, we can get back and discuss that.

But point one, we go into areas unrelated to the utility.

Point two, all of these are kept as separate entities, completely separate from the gas company, and they are subsidiaries of the parent; they are not subsidiaries of the gas company. There is no relationship between those entities and the gas company.

Third, it is our policy, and I think the record bears it out, we acquire established businesses with good track records. We do not go into new businesses, they are for the most part, established operations and they have good financial track records. The gas -- it is also our policy that the gas company, the utility, will remain as the largest and most important operating unit within the Pacific Lighting system; there is no -- and we are dedicated to having good utility service to the ratepayers at the lowest reasonable cost.

Another policy that we have is that all transactions -- or any transactions I should say -- between the utility on the one hand, and the nonregulated subsidiaries on the other, are either nonexistent or they are kept to a minimum. And the best example

that I can give of this is that, with respect to our oil and gas operation, the non-utility subsidiary, we have a policy that there will be no direct sales between our oil and gas operations and the utility even though we, at the moment, have shut in gas wells with respect to that -- to those operations. We do not have any direct sales nor do we have the policy of not having any direct sales between that operation and the utility, to be sure that we keep the concept of no transaction between the non-utility subsidiaries and the utility intact.

Now, with respect to some of our recent acquisitions -- and I think perhaps here I am one of the culprits that you were alluding to earlier, Mr. Chairman. As you know, we made the Thrifty acquisition in -- announced it in May, or in June I think, and I'll come back to that in a moment; but prior to that, in the immediate past, we acquired a major oil and gas operation, the one that I alluded to, it's headquartered in Tulsa, Oklahoma; we have both domestic and international oil and gas operations. We have had for a good many years a land development operation, not only in California but throughout the southwest states and in Hawaii, that was augmented several years ago when we acquired the Presley home operation which is one of the largest single residential builders in California.

Getting then to the question of the Thrifty acquisition that I know you are interested in. First of all, let me say this, we have for a long period of time been interested prior to the acquisition of Thrifty in acquiring a fourth major line of business. This is not something that just happened overnight. We had been studying that; that has been one of our goals for at least two or three years or even perhaps longer. We had told everybody that. That's been announced in our annual reports to shareholders, and our quarterly reports to shareholders. Mr. Chairman, just almost a year ago to this day when we were down at your interim hearings at UCLA, I testified to you that we were in the process of looking at another major acquisition and that it would be in an unrelated area, an area unrelated to the gas company, and that's what I testified to. We have made no secret about that to anyone.

The acquisition of Thrifty, as was the case with the acquisition of the earlier Presley homes and the oil and gas operations, those acquisitions were made with Pacific Lighting stock. No funds from the utility were used whether funds through dividends or funds otherwise, were not used to make those acquisitions at all. They were made 100 percent with Pacific Lighting issuing additional shares of stock. In the case of the oil and gas acquisition I think it was 60 percent stock and some cash, and the cash was later redeemed when we issued additional stock or got parent company credit.

I indicated that this was not a spur of the moment acquisition, it was the result of studies that had been going on. As a matter of fact, we were looking at nine different lines of businesses, nine different industries -- we utilized, I think, seven

or eight outside independent consultants, and we narrowed down the industry we wanted to get into as the fourth major line of business, it was narrowed to retail drugstores. From that point we looked at which companies within that industry should we be looking at and our studies indicated that it should be Thrifty and hence we made the approach to Thrifty and ultimately made the acquisition.

With respect to Thrifty, let me just say this: I think you probably know by now it has an excellent financial track record; its net income has increased in 29 of the last 31 years; its sales have increased for the last 56 consecutive years' its return has averaged 18 percent over the last five years, which is significantly better than the average return we've experienced with the gas utility. The Thrifty market -- its market is growing faster than the U.S. economy as a whole. California is the best U.S. market for per capita drugstore sales in the country. We -- the management of Thrifty -- has agreed to stay on and run that organization as they have done so well over the past. I think you are aware of the fact that the Thrifty headquarters is located just, if you will, up the street from our headquarters, and that is significant. The Thrifty operation is one that is completely independent of energy prices and energy cycles. The drugstore business is not necessarily a cyclical business, and we feel that we get growth and stability of earnings for the parent with the Thrifty acquisition.

Now, if I may, let me just quickly get into where we think we are going from here as we did a year ago. We do not plan to get into any new major lines of business in the near term. What we plan to do is to focus on developing our existing business lines. There may be some new acquisitions but they will be relatively minor and they will be in the existing lines of business that we already have. And that's what we are looking at over the near term. And with that Mr. Chairman, I will respond to your questions.

CHAIRMAN ROSENTHAL: Yes. Do you see any possibility, and let's not say Thrifty, let's say, for example, -- I understand you also own Big 5 Sporting outfits here.

MR. COLE: Yes. That was a subsidiary of Thrifty that we acquired when we acquired Thrifty.

CHAIRMAN ROSENTHAL: Right, and I understand that there are some legal actions against those particular companies.

MR. COLE: That's what I was told. I think it was filed here in Sacramento involving down jackets or something. I'm not that familiar with it.

CHAIRMAN ROSENTHAL: Yes, and I'm not familiar with it either. The thing that I'd like to ask is if, for example, that particular legal action went against you or against any of the other entities and as a result, the bonding for your holding company is affected, the rate that you pay for money, how do we guarantee absolutely that that does not affect the bonding rate for the utility?

MR. COLE: Okay. Let me, let me start first, and we'll take it step by step.

In the first place, the parent does not get involved with issuing any bonds for the utility. The utility issues all of its own bonds, those bonds are rated by Moodys and Standard and Poors on a stand-alone basis, and there is no relationship, there is no obligation either way. The bonds are issued by the utility and they stand alone.

Now, to get to what I think perhaps is the crux of the question that you asked, Mr. Chairman: What would happen if we have a diversified entity that goes sour or has a large judgment issued against it? We do -- because of the separateness, because of the insulation that we've structured into the utility, it is our belief and our feeling that there is no way that the creditors of the non-utility subsidiaries can go against the utility, and I'll make it stronger than that. We asked a nationally recognized law firm, in fact, to look into this and this is -- this goes back -- this is last year before we got involved in any of this. It was done at the request of the rating agencies -- one of the rating agencies, to take, if you will, the doomsday scenario -- if something happened to Pacific Lighting, what would be the impact on the utility's assets; and specifically for the purpose of how those rating agencies would rate the utility's bonds. And that opinion came back, that as we have structured this operation and are keeping the utility separate and insulated, it was their opinion that if Pacific Lighting -- we don't see it happening, but if Pacific Lighting were to get into bankruptcy proceedings, the utility's assets should not be involved in those proceedings whatsoever. And as a result of that opinion, Standard and Poors rated the bonds on a stand-alone basis. But, again, Mr. Chairman, we -- that's the reason that we -- one of the reasons why we structured our operation the way we have and have kept the utility as a completely stand-alone, insulated, separate entity.

CHAIRMAN ROSENTHAL: Just one further question. Can you see, for example, another utility not having the same kind of relationship that you have explained, creating problems for the rate base?

MR. COLE: For the utility, I don't know that I can answer that question generally and I'm certainly not a creditor's rights expert, or a bankruptcy expert, Mr. Chairman. So, I think probably it's best I just not answer that. Thank you.

CHAIRMAN ROSENTHAL: All right. Thank you. Yes.

SENATOR REBECCA MORGAN: Mr. Cole.

MR. COLE: Yes, Senator Morgan.

SENATOR MORGAN: There are no direct sales with your gas and oil company in Southern California. Are there indirect sales and how do you account for them?

MR. COLE: Yeah, right. Unfortunately, Senator Morgan, there is a very small indirect sale. And let me explain it, we did not know at the time we acquired the oil and gas operation and learned of it later. But it just so happened that the oil and gas operation had a contract with El Paso Natural Gas Company to sell it a small amount of

gas that goes into its system gas supply. And we are, of course, one of the principal customers of El Paso. They are a completely independent company, I think it's less than 1 million cubic feet per day, it's a small sale, but I cannot stand here and tell you that we don't -- that none of their gas comes to us because a very small amount comes to us via that indirect route. There is no problem with respect to it because it is purchased by an independent company. So, there is an arm's-length transaction there. And again, how much of that gas actually get to us, I don't know, but it's part of their system gas supply. I hope I've answered your question -- it's a diminimus type of thing, but I can't say that it -- that we don't have any of the oil and gas coming.

SENATOR MORGAN: Can you or Mr. Rawlings say how that's accounted for and if your books were reviewed by PUC, how that would be easily identified?

MR. COLE: It's -- I don't think it's ...I'll let Mr. Rawlings supplement this, but it's not identified at all because you see it's coming in from the El Paso Natural Gas Company and we pay them for their system-wide sales.

SENATOR MORGAN: You as Pacific Lighting or Southern Cal Gas?

MR. COLE: Southern Cal Gas.

SENATOR MORGAN: Okay. Thank you. Mr. Chairman, I have about three questions that I'd like to give the committee members a chance to think about, and maybe could be answered after everybody has testified. And they are somewhat unrealted I guess, but I would be interested in hearing from the utility people to the extent they are willing to comment on the staffing at the PUC; your working relationships with them and whether you think it's adequate to understand your businesses and to work with you. I'd like to hear your view on the economy for 1987, particularly as it relates to energy. And I'd like you to tell me what you would not like to see happen in 1987.

CHAIRMAN ROSENTHAL: Why don't we go on with the agenda and then we'll go back, and as long as they are all sitting here, they'll have an opportunity to reflect on those questions and respond.

Mr. Rawlings, now, Assistant Vice President, Regulatory Affairs of Southern California Gas Company.

MR. ROY RAWLINGS: Thank you, Mr. Chairman and members of the committee.

Southern California Gas Company appreciates the opportunity to come before the committee and first of all answer any questions they have but also tell a little bit about the separation that does exist between Pacific Lighting and the Southern California Gas Company.

Let me make one thing real clear to start with. We are a gas-only utility, which is differentiated from the combination utilities that exist in the state or the Edison Company which is electric. We sell only gas; and secondly, that's all we do; we only are a natural gas distribution company, we do not have any subsidiaries of the Southern

California Gas Company.

The relationship that exists between the Southern California Gas Company and Pacific Lighting is not new. It's been in existence since 1929 and we do not know that that relationship has ever caused any regulatory problems relative to utility operations, and that is for over 50 years. You had an important question, Senator, and that is: How is the company separate and what protections does exist with the PUC regulation of the gas utility?

First of all, let me just repeat what Mr. Cole said. There is a strict segregation between Southern California Gas Company and the parent company, Pacific Lighting Corporation. We have our own Board of Directors; Southern California Gas Company has its own Board of Directors. We have separate officers, our officers are not executives of the Pacific Lighting Corporation, they are not executive officers of Pacific Lighting.

Mr. Cole also mentioned in response to a question you had, Mr. Chairman, regarding the bonding of the gas utility. We do our own financing. That financing is subject to the regulation of the Public Utilities Commission. We also have our own rating. The bonds and the debt of the Southern California Gas Company are rated. Standard and Poors, Delph & Phelps, put out ratings on our debt. In addition, the proceeds of the debt that we issue can only be used for public utility purposes. That's the law. We have -- we file our own reports to not only the Internal Revenue Service, but to the SEC which are independent of the corporation. We cannot and do not, by law, guarantee obligations to the parent or any subsidiaries. The gas company is essentially its own business. As Mr. Cole mentioned, we operate separately of the parent and other affiliates. Our business is generally unrelated to the affiliates that the corporation has purchased. There are very few transactions with the affiliates or the subsidiaries of the corporation since most of them are in an unrelated area. And I think that's important because they are unrelated. The likelihood of any cross-subsidization is very small and almost diminimous.

And another point I know that has been raised by the committee in the past, I guess a year ago, is a question of personnel transfers between the corporation and the Southern California Gas Company, and those are very few and far between that do occur. That's a very -- it's just a minimum number. And I think there is some good reason for it. First of all, the unrelated businesses -- utilities are a distinct kind of business -- require certain skills and capabilities, and generally speaking, a lot of those skills and capabilities are not applicable to unrelated kind of retail activities or something as specific, for example, as oil and drilling operations. You asked a question about how does the Public Utilities Commission protect ratepayers, and we think it does amply protect ratepayers. Now, let me give you just a few examples of what they do. One thing that is probably the most important for any business, but one of which the PUC not only

actively, but very aggressively pursues and that's the audit.

Two points of interest, they are continually auditing the Southern California Gas Company just like they do other utilities; in fact, we have permanent office space available that is used by the Public Utilities Commission auditors on a full-time basis. And then of course, there are the rate cases when they have rate cases before them there is an extensive what we call data collection or data request process whereby the staff goes through and asks an extensive number of questions which by law we have to provide. And just for example, in this last -- while we have not filed a rate case yet, we have filed for what is called a "notice of intent" to file a rate case, the staff has asked questions which at last count, we have responded with about 2,000 pages of response. So, there's just almost no area in which they get -- don't get involved in. The commission controls our ability to issue debt, guarantees, or any other similar financial transactions. That's by law the responsibility we have to file in order to issue debt, they oversee that and approve it. They also have a very, very important -- what I think is authority, and that's the authority to disallow expenses or input revenue when it finds an improper intercompany transaction of cross-subsidization. They have the authority to do that and can do that when and if they find any impropriety.

In addition, they have a variety of other oversight responsibilities which in general, ensure not only the utilities financial health, but also protect the ratepayers from any impropriety. And that's through a whole host of after-the-fact reviews -- what they call reasonableness reviews to see that we have indeed conducted the business that we have said we've conducted and they've authorized us to do.

I did want to -- and that's all I have except I did want to respond to Senator Morgan regarding the El Paso sale just a little bit. As Mr. Cole indicated, the amount of gas that this affiliate sells into El Paso, is about 1 million cubic feet per day. Now, El Paso is our largest natural gas supplier that's provided us historically about 50 percent of our natural gas into our system. But it also provides gas to Pacific Gas and Electric Company as well as to customers east of California. Our system supply, we bring in about 2.6 billion cubic feet per day. So, it's about 26,000 times larger than the million cubic feet, excuse me, 2,600 times larger than the 1 million cubic feet per day, and we are only getting a fraction of the El Paso sales. In general, we would not have any ability to know which producer's gas is flowing to Southern California Gas Company because it is, in general, a large system supply which is regulated by the Federal Energy Regulatory Commission.

SENATOR MORGAN: ...you said the million cubic feet. What was the 50 percent figure related to?

MR. RAWLINGS: We take about, in our system supply, we take about 2.6 billion cubic feet per day of natural gas and sell it out for retail. El Paso supplies us about -- has

historically on average, supplied us about 50 percent plus of that 2.6 billion cubic feet, or about 1.3 billion cubic feet. A million cubic feet a day is a very small amount of that, and we are only getting part of what El Paso supplies to California. PG&E also has a contract with El Paso as do a number of utilities and customers east of California.

MR. COLE: Perhaps if I could just interject a moment, Senator, to be sure you put this in context because I think if we look at what Mr. Rawlings and Mr. Golub said, I think that El Paso transports and sells a little over 3 billion cubic feet per day, 3 billion cubic feet per day of which this 1 million cubic feet would go into that.

MR. RAWLINGS: So, okay, it is, in fact, --- I think we are looking to find a way to get out of that sale so we don't have to go through this for that small amount -- and can just say from a squeaky clean concept, that none of that gas moves to us. But as I say, that contract was in existence before we made the acquisition and we didn't even know about it.

SENATOR MORGAN: Let me ask then, if you are interested in getting out of the contract for a number of reasons, maybe one of which is the problem you are having looking squeaky clean, but if you are getting this gas at a lower price than you may be getting it elsewhere, is there a possibility that the consumer benefits?

MR. COLE: That's a very good point. And if in fact, I'm not sure we are getting it, I don't know.

SENATOR MORGAN: Can you track that?

MR. COLE: It's about -- I think we can. It's about -- the point I was trying to make, Senator, was, we are trying to bend over backwards to be sure that there be no -- any issue of any impropriety because of transactions between a non-utility subsidiary and a utility, but your point is well taken.

SENATOR MORGAN: Mr. Chairman, my concern is that we bear the responsibility to protect the consumer and the ratepayer as does PUC, but to the extent that we drive companies apart that could provide sales and services that are of a benefit and perhaps to a lesser cost, then I think we've done a disservice. And I think we are walking that fine line right now in many of our relationships.

MR. COLE: I'm sorry.

MR. RAWLINGS: I've concluded.

CHAIRMAN ROSENTHAL: Mr. Rasmussen, Division of Mergers and Acquisitions for Pacific Diversified Capital representing San Diego Gas and Electric Company.

MR. RASMUSSEN: Good morning, Mr. Chairman, Senators.

On the -- actually the title is Director, Mergers and Acquisitions, and Pacific Diversified is a wholly owned subsidiary of San Diego Gas and Electric. For the utility company it's strategic plan, like PG&E's, is to provide the lowest possible rates to its ratepayers, to its customers and as part of that plan we feel that there are a number of

things that the utility must do in order to accomplish that objective. One of those is to provide a very strong financially and stable utility company both in its utility operations and in its non-utility operations. That's part of the reason for the existence of Pacific Diversified and our diversification strategy.

You had asked three questions of all of us, and for me I can go through and...

CHAIRMAN ROSENTHAL: Fine.

MR. RASMUSSEN: ...go through each one individually. Pacific Diversified has recently completed within the last six months two acquisitions. The first, Phase I Development, incorporated a San Diego-based commercial, real estate and office development park developer. The second, Computing Solution, incorporated a New York-based computer software company. Each of these acquisitions was a very strict part of our strategic plan in the non-utility area, and I'll go through that plan shortly.

Specifically, Computing Solutions was acquired to add an additional product line and an area of business to a subsidiary that already existed under Pacific Diversified -- that's Intergrated Information Systems. The company there had one product and one market and we felt that was too limited and, therefore, the reason for the acquisition of Computing Solutions. We do plan on additional acquisitions in a couple of areas that I'll go through and it's possible we may have an additional one completed this year.

As to our focus, San Diego Gas and Electric, and now through Pacific Diversified, has been in the acquisition business, has had non-utility operations, that is, for a number of years relatively small as they are today, but growing. Our goal is essentially to provide growth to the overall corporation through acquisitions and to improve the stability of the overall corporation. Our focus is two-pronged. The first, to look at companies that provide services to the utility industry, not necessarily San Diego Gas and Electric, but to the utility industry. Second, to look at companies that manufacture and/or distribute products to the utility industry, again, not necessarily San Diego Gas and Electric. We are looking for companies in the size range today of \$10 to \$100 million in sales and we expect in the next year or so to be looking at companies in the size range of \$25 to \$250 million in sales.

Our goal is to have 10 percent of consolidated earnings in non-utility operations by 1990; to have 25 percent of consolidated earnings in non-utility operations by 1990 -- 1995, excuse me. We have said all along that we are going to start small, learn our way through the business, and to do it in small steps. We've done that with the first two acquisitions, and we expect to continue on that path.

The panelists before me have made a number of statements regarding the level of ratepayer protection and the separation between non-utility operations and utility operations. And without me going through -- those are many of the same things that I would say to the panel. Specifically, what we've done, not only through Pacific

Diversified, is create a completely separate corporation with a separate identity, a separate staff, separate buildings, officers, everything away from the utility. We have very little contact with the utility, very little contact with utility employees, only to the extent necessary. For example, the parent company files consolidated tax returns, obviously we need to be sensitive to the tax issues and communicate that to them. The utility does not supply services at all to the non-utility operations unless it's for those very specific reasons I mentioned. Our policy is to act independent from the utility and to not provide services nor receive services.

We have said all along, as many of you know, in our application for a holding company before the California Public Utilities Commission, that we are open to and willing to and will pursue as much as possible allowing the Public Utilities Commission access to all necessary information to allow them to carry out and conduct their responsibilities to ensure the separation between the utility, and the non-utility, the ratepayers and the shareholders. And we continue to believe that and will continue to do that.

CHAIRMAN ROSENTHAL: I guess you went to the PUC and you asked them to form a holding company and they set out certain restrictions or...

MR. RASMUSSEN: Yes, that's...

CHAIRMAN ROSENTHAL: ...proposals for that to happen. But you've then decided to continue to diversify in lieu of a holding company structure, but to do it within the utility.

MR. RASMUSSEN: Outside of the utility and Pacific Diversified under a parent subsidiary structure.

CHAIRMAN ROSENTHAL: Okay. Then let me ask the same question that I asked earlier, what happens -- what are the guarantees that the bonding of the utility would not be affected if, in fact, something happened to one of your investments?

MR. RASMUSSEN: Given the size of our non-utility operations now, they are so small relative to the utility.

CHAIRMAN ROSENTHAL: But there -- you indicated that you want to walk before you run and that may not be the case by 1995, and what have we done to protect the ratepayers -- that's what I'm concerned about.

MR. RASMUSSEN: Under the existing parent-subsidiary structure, there is a well-defined separation in the corporations between San Diego Gas and Electric, Pacific Diversified which is a subsidiary of SDG&E and then the subsidiaries that are under Pacific Diversified. The separation of corporations and all the things one does to do that, are what help provide the insulation between the corporations. That doesn't guarantee necessarily that an action at a subsidiary level isn't going to have some impact back to its parent like Pacific Diversified, and theoretically it's possible that

it can go back to the parent company -- the utility. That's part of the reason why we felt so strongly about having a holding company structure to allow a further separation in utility and non-utility operations and the structure completely separated as Pacific Lighting indicated earlier.

CHAIRMAN ROSENTHAL: Do you plan to resubmit the proposal for a holding company?

MR. RASMUSSEN: We've not made a determination at this time.

CHAIRMAN ROSENTHAL: You also indicated that you are planning to establish, or you have begun to establish, some telecommunication services for your customers in competition with telephone companies?

MR. RASMUSSEN: We have not made a decision to supply any telecommunication services to our customers. The area of telecommunications is one which we think presents an opportunity for diversification. That probably doesn't mean it would be in our service territory; it may be something completely different, and we've not made any decisions in that area nor have we done anything in that area yet.

CHAIRMAN ROSENTHAL: And one final question that I have. How do you plan to keep one of your largest customers, the Navy, on the line?

MR. RASMUSSEN: Since I'm in the non-utility operations, it's difficult for me to answer that directly. What I think I can say is essentially what we've said already. And that's that by providing the lowest possible rate and the most appropriate cost base rate structure to our largest customers, we think that the incentive will be there for them to stay. It's a very difficult question and one I'm probably not well-versed enough to...

CHAIRMAN ROSENTHAL: Hopefully you are going to make money in these other ventures and then you won't have to go to the PUC and ask for a rate increase which would then force the Navy off the line, right?

MR. RASMUSSEN: Those are two separate events and...

CHAIRMAN ROSENTHAL: (laughter) ...All right.

Any ...Yes, Senator Morgan.

SENATOR MORGAN: Thank you. Mr. Rasmussen, is Pacific Diversified a separately listed company?

MR. RASMUSSEN: No, it's a wholly-owned subsidiary...

SENATOR MORGAN: It's wholly-owned. So, any bonding that you participate in there is a relationship then between you and San Diego Gas.

MR. RASMUSSEN: We don't participate in any bond structure right now.

SENATOR MORGAN: If you are just acquiring at this point I imagine not. But...

MR. RASMUSSEN: Only with equity in the company, yes.

SENATOR MORGAN: ...in Pacific Diversified.

MR. RASMUSSEN: In Pacific Diversified.

SENATOR MORGAN: Could you follow-up on Senator Rosenthal's question about making money in your acquisition -- with your acquisitions? Would that be a benefit to the ratepayers? As I understand...

MR. RASMUSSEN: We believe by providing a stronger company financially on a consolidated basis, not only through the utility but through non-utility operations, that has a direct and definite benefit to the ratepayer.

SENATOR MORGAN: I don't understand how money that Pacific Lighting makes isn't going to benefit the ratepayer because they have been so careful about keeping their company separate from Southern California, and yet when we get to San Diego Gas and Electric and Pacific Diversification, you feel that there could be a benefit because of, whether it's transfer of funds, or financial stability, or whatever. Seems to me you have parallel situations here, and you can't have it in one case and not the other, if in fact they are parallel.

MR. RASMUSSEN: I'll let Pacific Lighting speak to their part. I'm not sure they are quite parallel in terms of structures, but I think the underlying philosophy is that a stronger company financially is going to be in a better position over the long haul be it in the utility company, in the non-utility, etc. as opposed to a weaker company that's facing competition that may be on a declining basis over time.

CHAIRMAN ROSENTHAL: Senator Greene.

SENATOR LEROY GREENE: In this same area of questioning, it seems to me that the PUC with your various utilities other than the ones that are publicly owned, is saying, "Okay, there is a rate structure that's dependent upon, how much money it costs, what's the year investment, and so on and so forth, and the reason we turn on that investment and, therefore, we have, you know, very sketchily put, established a rate structure." What's that got to do with any subsidiary or any other company you own? Aren't they looking to your investment as your company, San Diego?

MR. RASMUSSEN: They are looking to the utility and its equity base and its return.

SENATOR GREENE: All right. Does that include income from other sources that have nothing to do with the utility, or, never mind the "or".

MR. RASMUSSEN: Looking at the utility separate, no, it should not.

SENATOR GREENE: All right. So, then the utility has a rate structure which is -- the perimeter of that is the utility...

MR. RASMUSSEN: Correct.

SENATOR GREEN: ...okay? And on the basis of that utility you have a rate structure. That utility is saying in effect, "We are making sufficient income that we want to take our income and invest it for greater profits by forming holding companies, by getting subsidiaries or whatever it is as additional sources of income that have nothing to do with our ratepayers." Isn't that correct?

MR. RASMUSSEN: Yes.

SENATOR GREENE: All right, so it has nothing to do with the ratepayers so there is no ratepayer benefit.

MR. RASMUSSEN: You are looking at the direct impact of the equity investment and rate structure in the utility and the non-utility equity investment earnings, etc. Imagine a situation where over time the utility company faced with competition, losing the Navy as a customer, for example, finds its earning base being eroded to the extent that non-utility operations provide earning growth and on a consolidated basis, the investment community looks at that consolidated entity -- all argue that they are going to look at that entity more favorably...

SENATOR GREENE: Why?

MR. RASMUSSEN: ...than a company that's having an earnings erosion or decline over time.

SENATOR GREENE: Why? You, as the utility -- speaking to you as the utility now, you know, as San Diego Gas, the utility says, "I have lost the Navy," okay, for example, "As a customer, and that's a very big loss to me. So, I go back to the PUC and I say again, this is the amount of investment I have here, this is what it cost to produce the commodity I'm selling, and in order to make a reasonable profit on behalf of my shareholders I need an increase in rates." Isn't that what you do?

MR. RASMUSSEN: Again, I can't speak to what the utility would or would not do under those circumstances.

SENATOR GREENE: Is there anybody here that can?

MR. RASMUSSEN: ...the utility company, but it's very plausible that the scenario can create what everyone has called the "death spiral" which results in higher rates, therefore, more incentive for other customers to leave the system, therefore, fewer sales over the...

SENATOR GREENE: Well, that may very well be, but isn't what you are describing right -- is typical U.S.A. at this point in time for public utilities? A public utility is a public utility; and it renders a certain service and it's paid by the customers for the rendering of that service. You are now talking about an expansion beyond the utility holding onto other areas, as you say, okay? There is a diversification. I am trying to find out from you what advantage or disadvantage there is to the ratepayer; and at this point in time, it may be simply that I'm too lacking in knowledge in this area, I find no connection between the two. Can you enlighten me?

MR. RASMUSSEN: Under the scenario that you mentioned earlier, imagine -- you came up with the scenario of the Navy leaving the system and rates being higher. I don't see how that would benefit all ratepayers by having to pay higher rates.

SENATOR GREENE: No, of course it would not. But I can't see anything about the

diversification that would benefit the ratepayer either. The fact that you benefit -- the fact that you are making scads of money someplace else, you would still go to PUC telling them about what your losses were because you -- all right, so the price of oil changes, okay? They get their act together over there in OPEC and the price of oil doubles, well, what do you know, I think a bunch of utilities around this country will be talking to the PUC, you know, in the various states. And I'm simply suggesting to you again, I do not see -- I'm simply looking for the connection. I'm one of your ratepayers. What is the advantage to me in your diversification? Because see, you, as a utility, you are a quasi-agent of government in the first place, you have guaranteed return on investment, you know much more about that than I do. You are not -- I don't think you are an equal among equals when you go out and compete to buy up some other country -- some other company -- maybe you are going to buy up a country for that matter, I don't know. I can suggest a couple for you now, can we start with Saudi Arabia? (laughter)

MR. RASMUSSEN: I think we'll pass on that.

SENATOR GREENE: Well, really, you know, you have a built-in area that's yours and nobody can compete with you in, and you have a certain source of income there. You take that income that you've arrived there and say, "Okay, I have a certain amount of money -- profit here and I've got the shareholders in this utility." Now, what I don't understand is when you diversify and you build, you take in some other company. What about that guy that owns a share of your stock? How does that affect -- does that affect the value of his share, or is this somebody else's share in this company that you bought in?

MR. RASMUSSEN: Again, in the way San Diego through Pacific Diversified is structured currently, since we have no publicly traded subsidiaries, the earnings flow on a consolidated basis back through into the parents financial statement, so the shareholder of San Diego Gas and Electric may or may not see an impact depending on the success and/or failure.

SENATOR GREENE: All right then, assuming success, then that means the shares are more valuable. Assuming failure, that means the shares are less valuable...

MR. RASMUSSEN: That's correct.

SENATOR GREENE: ...and that as the shareholder of San Diego Gas and Electric, okay? But isn't that all independent of what happens to San Diego Gas and Electric?

MR. RASMUSSEN: It's independent of the structural things you were talking about earlier but not independent of all of the issues surrounding the cost of acquiring money. Obviously...

SENATOR GREENE: But isn't it the same as if you or I -- if you owned two or three different businesses, and they are just different businesses, forget this utility thing, you own a couple of gasoline stations, at the same time you own a supermarket and you own

a department store. You are the owner of all three and whatever their combination of gains and losses are, you as the owner, you have it. But when something happens to any one of them, you are going to have to start shifting money around to protect -- from the other two to protect yourself or get out, okay? But is that true in your situation here as San Diego Gas and Electric? San Diego Gas and Electric, is it not compelled to stand on its own no matter who else you own?

MR. RASMUSSEN: The utility certainly is, yes.

SENATOR GREENE: All right. Thank you, Mr. Chairman.

SENATOR ALQUIST: Not so much a question as an observation -- I don't think the two situations are at all parallel or anywhere near the same. For Pacific Lighting to be the holding company and merely overseeing the operation of the So Cal Gas as overseeing management, their only concern is to see that the gas company produces all of the profits allowed by the PUC. And if that management doesn't perform in a satisfactory manner, why then that would change it. But for the utility itself to act as a holding company, I think creates an entirely different problem. Here management was going to be more concerned with diversifying with other acquisitions and looking for other sources of profit, and they aren't going to revert any of that to the gas operation to reduce the cost to the consumers. That's unbelievable; no utility has ever done anything like that, and knowing the management mind, I think it's quite apparent that they never will, and you not only would be faced with the hope for profit which, of course, you are doing it for, but also you're assuming a liability for some failures and costs that Pacific Lighting may become encumbered with through their acquisition of the Big 5. I would hope that the PUC would take a long hard look at this proposal.

CHAIRMAN ROSENTHAL: Senator Morgan, comment?

SENATOR MORGAN: I agree with Senator Alquist that they aren't parallel situations and I'm sure a lot more comfortable with the Pacific Lighting structure, if you look at it on an organizational chart where you have an entirely separate utility on the big board, separately managed than where you have the utility basically as the holding company; they are not parallel if you structure them out. And I would agree with Senator Alquist that the utility becoming a holding company of the diversifier, if you will, I think is going to be hard for us to track. And that's one of our responsibilities.

CHAIRMAN ROSENTHAL: Any further comments? Does anybody want to respond to the couple of questions that Senator Morgan raised earlier, not directly related but what you see for the energy field, the business for the future?

MR. COLE: I'll try to respond to a couple of them, Senator Morgan, and I'm sorry I'm not as prepared in this area as I should be and I, if I may, I'd like to -- I'll give you some off-the-cuff remarks and maybe your second question will check out with some of

our folks back home and see what their thinking is, but -- and I'll let Mr. Rawlings, if he wants, talk to the question about the PUC staff and the working relationship, because that's where that lies.

On the economy for '87, my understanding, but I really would like to check this out that -- of course we are very much interested in oil prices and where they are going -- and I think, I think we think they are going to remain about where they are right at the moment. Certainly there is not going to be a dramatic increase in '87. But again, if I may, I'd like to check that out. The one thing that I really don't have a feel for is what our land development people feel housing starts for '87 might be. I'm just not sure what their thinking is on that.

With respect -- but I will find out and I will get back in touch with you -- with respect to what we don't want to see happen, of course, we don't want to see national calamities or things like that, but we would hope that the economy as a whole simply wouldn't go in a tailspin, and we would hope that that doesn't happen. But if I may, let me check out the other things and get back to you.

CHAIRMAN ROSENTHAL: Mr. Rawlings, would you like to comment?

MR. RAWLINGS: Well, let me comment on two areas, one being the economic outlook, but as it relates to natural gas and for one, we don't see natural gas sales growing; they are to be pretty flat, with the exception of one. I'm sure all of you are aware of hotly contested area the enhanced oil recovery market in and around Bakersfield, and in that area, there is potential for a natural gas sales growth, depending in large respect upon the outcome of the proceedings now before the Federal Energy Regulatory Commission as well as the outcome of our successful efforts in order to attract those new markets.

Working relationships with the PUC, I haven't really been in this job very long, about six weeks, but let me give you some observations which may or may not be helpful. And I have, by the way, worked with the PUC staff off and on now for about the last five years in a slightly different capacity. But I think it's been generally good, they certainly have appeared to me to be open to listen to the issues and to try to understand them. I think you have to understand that in a hearing process which is a courtroom process there, it is a -- can become an adversarial situation, but I think on balance I've found, at least in the discussions I've had with them, the ability to communicate and talk about the issues openly.

SENATOR MORGAN: How would you feel if you were precluded from doing that, outside the courtroom environment?

MR. RAWLINGS: Well, my basic view is the California Public Utilities Commission is a body which does establish public policy, in the very fact of it's...

SENATOR MORGAN: Therefore...

MR. RAWLINGS: Therefore, it is, in my opinion, almost impossible to be able to do

that solely through a trial -- through a trial situation or a courtroom situation. I don't think you can do that, only within the context of a trial.

MR. GOLUB: Senator, Howard Golub...

CHAIRMAN ROSENTHAL: Yes, Mr. Golub.

MR. GOLUB: I'll try to address some of Senator Morgan's questions. I'll beg off on the question about the economy. We do have an economist in the company though who does evaluate the economy in our service area and if you are interested, I would have him get in contact with you later.

With regard to working with the PUC, I have worked for them for many years and actually, in many contexts I've worked with them as their very close ally. I don't think that it's generally understood that in many areas the utilities and the PUC work together to hold down costs to the state. And this is before the Federal Energy Regulatory Commission and also up in the Pacific Northwest with regard to purchases from Bonneville Power Administration -- a lot of that gets lost in the more dramatic stuff that the newspapers like to carry but there are very many millions of dollars that are at stake there and I've spent many nights working together with the PUC lawyers, and lawyers from the other utilities in Washington trying to think of a way to keep down a rate increase to all of us. So, in that sense, we've often worked quite closely. Another example of that was recently under federal hydro-relicensing legislation which was a difficult and controversial issue, but the PUC did what it thought was best and I think the results speak well for all of us. We've had our share of disagreements too, and I think that's just inherent when they are in a regulatory role and we don't always agree with their perceptions.

One last comment I'd like to make on staffing though, and maybe this isn't what you are interested in. I can personally attest that many of the attorneys and commissioners assistants -- those tend to be the people I work with -- work very long hours and the state is getting a very good deal from them. I know this because I'll often get a call from them asking for additional information and it will be well after 5:00 p.m. and it seems to me that I can usually get them in their offices those hours too. So, it's kind of a -- maybe a little recognition for some people who work awfully hard without much recognition, if I can put that in. I don't really know if that goes to the things you are interested in.

On the other thing I would like to address is what perhaps we're most concerned about happening in 1987 in the utility area. And I hadn't come prepared to address the question, but I thought about it after you raised it, and I think it really is pretty obvious to me what PG&E's concerned about. The utility industry is changing. Whether we like it or not is almost beside the point at this juncture. We do know we no longer have a situation where we are without competition in the energy field. And once again,

whether one likes it or not is irrelevant. What we are very, very concerned about at PG&E, is what may be a dramatic increase in cost to our utility customers as a result of the inability, rising out of regulatory and legal constraints, of the the utilities to compete effectively for those industrial loads. In other words, those loads that have the ability to shift, we must find a way to effectively keep them on the utility system so they will contribute to their share of the fixed cost. If we lose them, it's the San Diego Naval Station problem all over again. It's already occurring, and I think our projections indicate that 1987 could become a very, very painful process and I guess that would probably be our area of single greatest concern. We need the tools to be effective in competing in the marketplace for those customers. We're willing to accept the reality of competition, we need the tools, and the fact is, having been a traditional regulated utility for so many decades, all of us I think, are being a little slow, but I would say that the utilities and the regulators are being a little slow in realizing we are going to have to take some unusual steps and things that at first blush seem a little difficult to accept. So, that's our area I think of greatest concern for '87.

CHAIRMAN ROSENTHAL: Mr. Daniels.

MR. RONALD DANIELS: Ron Daniels from Southern California Edison. To follow on to Mr. Golub's comment about the loss of customers and the concern of maintaining those customers, one of the things that causes Edison to be mainly concerned with the electric utility side of the business is that we are basically not a high tech industry but rather one which has basic facilities with long-term life, and we are concerned about the length of life and the facilities that are out there, so, we are focusing our energies on the maintenance of our customers and the application of rates which will maintain the customers.

Responding to some of Senator Morgan's questions as far as the PUC interrelationship with the utilities, I've had a fair amount of experience over the last ten years. The commission staff spends a substantial amount of time during any rate case proceeding in reviewing and auditing the books of the company. As far as their ability to secure information, one of the things that has become quite apparent is that if the Public Utilities Commission staff is not receiving the information that they feel is necessary, they have means of pressing the company into being more cooperative. I've seen situations where cases have been -- are held up or have certainly had the potential of being held up if information wasn't provided to the staff. So, I think they do provide substantial information to the commission for their ability to act. I do believe that the staff spends an adequate -- certainly a substantial amount of time in review of both the electric operations as well as other operations that impact the electric operations. As far as the economy, I'm not an expert in that area other than to say that we expect to see a small growth over 1987 both in kilowatt-hour sales as well as customer growth.

Thank you.

CHAIRMAN ROSENTHAL: Any further comments from members or... Thank you very much gentlemen. We'll now hear from the response group. I thought we were going to have three, it appears that Sylvia Siegel cannot attend. This little note says that she is holding a press conference on the "Inside/Outside Wiring Issue." (laughter) And maybe we'll ask Mr. Vial to comment upon that at some point during his presentation. For those of you who are not familiar with what this is, the big thing going now concerns your responsibility and our responsibility in terms of who's responsible when the phone goes dead, and the cost involved in that and the concept of competition, etc., etc. Anyway.

Commissioner Donald Vial, President of the PUC.

MR. DONALD VIAL: Well, a lot of ground was covered this morning. I think what I would like to do is focus on the pressures that are developing on the utilities that we regulate for diversification and then comment on some of the problems that have been identified this morning in the context of the way our commission has looked at the situation and set down what we believe to be conditions necessary to protect the public in any diversification efforts.

I think all of us are well aware that the utilities that we regulate are undergoing vast changes at the present time, and much of this is related to the fact that the nation as a whole, is increasingly relying on market forces and entrepreneurial skills to develop the economy and to deal with our basic resources. And so, this is just to say opportunities. And this has some very specific kinds of applications in the energy field that I think contribute to the pressures for diversification. Now, to be energy specific, I think it has been clearly pointed out that many of our utilities, energy utilities today, are not -- especially in the electric side -- are not planning any major additions to their systems. We have developed and opted for in California, and I think very wisely, for a diversified energy base with alternative energy development in integrating that on a lease-cost basis for delivery of energy to the people. In doing so, we have an abundance of supply and alternatives and that means that the utilities are not as they bring on their major plants, mainly the nuclear plants, they are not going to be rushing out to invest anything in large facilities depending instead on independent energy development. So, they tend to become cash rich, in that sense, and I think perhaps San Diego, which is gas and electric, which has pretty much gone down the service route, and indicated that it will become increasingly a service company; therefore, being cash rich in that sense, is obviously looking for opportunities for investment.

The other is -- the other energy specific thrust comes from what has been identified generally, as the bypass issue in the energy field. In this, as energy prices have gone up and in today's oil market with fuel prices being so low, there are abundant opportunities for the large users who have market options to install their own systems

and leave the integrated utility system. And on that basis, the possibility exists, of course, that the margins to support the fixed-cost of the utility will shrink as those large users leave, putting increased burdens on those who remain, namely those who don't have market options. And, of course, this type of thing cuts across both the gas utilities and the energy utilities as a result of public policy to defer increasingly to market forces and to the entrepreneur.

So, with that kind of a background, you can see and can understand why, on the one hand, Senator Greene, is very concerned about the thrust toward diversification. No manager likes to preside over a shrinking company. If there are no places to invest in the utility business and there is cash on hand, the option is to give it back to the stockholders or to diversify and provide for some mutual fund opportunities within the utility and we talked about that at great length.

In our San Diego decision on what is the thrust behind diversification, and one of the major thrusts behind diversification in the present setting is management's interest in diversification; and that doesn't necessarily mean that is good or bad for the ratepayers. But I think it is important to focus on that, the reasons for diversification, and to also recognize what Senator Alquist was pointing out, that there is a world of difference between a diversification undertaken by a regulated utility and diversification undertaken by a holding company. And obviously, San Diego preferred the holding company to the regulated utility for diversification purposes, and recognizing that when you are going into non-utility fields, that perhaps the holding company could be the better option. At the same time, recognizing that we, as regulators, may have more problems in reaching the holding company to the extent that they interact with the regulated utilities, we then laid down in the San Diego order twenty conditions which we thought were essential to protect the ratepayers. The main point I want to make though is, there is a vast difference between a holding company seeking diversification opportunities and a regulated utility seeking those diversified opportunities. And where San Diego decided not to form a holding company, it is now -- it is diversifying through Pacific Diversified and it indicated to you this morning the areas in which they were seeking diversification.

Now, I would simply like to point out some of the things that our commission has been most concerned about and, of course, one of them is being able to deal with the cross-subsidies and whether you deal with this by accounting separations or physical separations; physical separation being through subsidiaries; subsidiaries of the holding company or subsidiaries of the operating company that we regulate. And these become very complex issues. And generally, we know that it's more difficult to deal with these potential cross-subsidies when the activities undertaken are those activities closely related to the business of the utility. And, therefore, in our order dealing with San

Diego, we specifically focused on that particular problem and indicated that we would, of course, want all the accounting separations that are necessary. But in addition, knowing that in many instances it's virtually impossible to prevent cross-subsidies, we also then discussed in that order the possibilities of royalties and affiliate payments to capture upfront what might be the negative cash flows or the negative benefits that might result to the ratepayers and the regulated utility in the formation of any enterprise that is related to the utility. So, we took these basic steps to indicate what we thought was critical.

Now, I should point out, and I think in many respects, we were saying we could do this on an individual basis. We asserted, the conditions that we laid down for San Diego, were conditions that we felt followed our authority to regulate the public utility. Some had quarreled that maybe we went too far, but we felt we had the authority to do so.

The other thing that I want to point out is that -- getting back to the issue of whether the diversification is undertaken by the utility, the regulating utility or by a holding company, and that is the issuance of debt to support the enterprise. Now, So Cal Gas this morning made it very clear that they interpret the law that you may not issue debt of the regulated company for non-utility purposes. San Diego in their discussions in the proceeding evolving around the formation of the holding company, indicated at that time that they also felt that a utility could not issue bonded indebtedness to support a non-utility enterprise. But most recently, and I think I should call this to your attention, Southwest Gas was before our commission seeking authority to purchase a Nevada S&L. And this is a purchase by a utility, a regulated utility, seeking our approval. And when I asked the question of our legal office whether, in fact, they could issue indebtedness under our present law for non-utility purpose, they came up with a long string of precedent cases where, in fact, that can be done in California. And I was a little bit surprised because all of us know what the policy was of the San Diego Gas and Electric Company in our proceeding, and also what the policy is of So Cal Gas that debt should not be used for that purpose. Maybe you might want to clarify the law to indicate that bonded indebtedness cannot be used for non-utility purposes.

SENATOR ALQUIST: Such an action could have a direct impact on the ratepayer?

MR. VIAL: Yes, it could if they did it. But we, in the case of Southwest, what we did because we didn't want this to be construed in any way to okaying the use of bonded indebtedness to support a non-utility purpose or acquisition, we pointed out that that was a diminuous situation, this was an out-of-state utility, very little of this jurisdiction is in California and on that basis, because it was diminuous, we allowed it to go through, but we stated very clearly, and all of us as commissioners indicated -- don't any one of you utilities think you can come in here and get our approval for

issuing a debt for a non-utility purpose. For example, San Diego Gas and Electric to go out through its diversified, Pacific Diversified, and purchase an S&L, I'm sure you would get very close scrutiny by our commission. So, that's the kind of thing that I want to clarify.

SENATOR ALQUIST: You are suggesting then a change in the law.

MR. VIAL: I'm suggesting that if you are not satisfied, I would be pleased to provide you with the case law that we have on this thing that indicates that it might be possible to do so. Now, there always can be overriding public policy on the part of the commission not to allow it, even though the law does permit it, you might want to close that possibility. You might want to look at it on that basis, and I'm just suggesting that's one area that's still cloudy. But beyond that, I think it's...

CHAIRMAN ROSENTHAL: Yes, Senator Morgan.

SENATOR MORGAN: Mr. Vial, is this, the present law, the result of omission or was it specifically allowed through some legislation?

MR. VIAL: I think it's primarily omission in not being in tune with today's pressures for diversification. It goes to an earlier era, the precedents relate to water companies primarily, where we did authorize in other cases issuance of a bonded indebtedness for a non-utility purpose by the regulated utility. And I think in today's context, no one would think of using that -- at least I hear our utilities saying that they wouldn't use it for that purpose. So that, I think it's just an omission and probably should be looked at from the purpose -- from the point of view of today's changing climate in the thrust for diversification.

CHAIRMAN ROSENTHAL: Excuse me. Senator Green, you want to comment on that?

SENATOR GREENE: Yes, a question. Mr. Vial, you indicated that some of these utilities are cash rich for some reason and, therefore, they want to make some use of this money and so on?

MR. VIAL: Yes.

SENATOR GREENE: What makes them cash rich?

MR. VIAL: What makes them cash rich is that the utilities no longer are looking at investing into facilities for the production of electricity. But if...

SENATOR GREENE: But wouldn't that -- you, through the system, they are guaranteed a certain profit on investment?

MR. VIAL: Yes.

SENATOR GREENE: Wouldn't you, on a rate-review case then say, "Well, the amount of profit being made is above that which we permit and, therefore, there will be a lowering of rate?"

MR. VIAL: Oh, yes, if in fact...

SENATOR GREENE: So where would they be cash rich? You know, wouldn't that balance

out?

MR. VIAL: They can be cash rich because they are not investing and reinvesting in plant. That doesn't mean that they are earning beyond the rate of return. They may, in fact, if they are earning beyond their rate of return, their authorized rate of return, that will be viewed very carefully in...

SENATOR ALQUIST: But doesn't the rate of return hypothesize certain growth on the part of the utility?

MR. VIAL: Yes. Every general rate case projects the growth of the utility. Every utility has a resource plan, and what I was really...

SENATOR GREENE: Is that determination a matter of law or a matter of regulation by your agency?

MR. VIAL: The utility, of course, and the energy commission that's involved in demand forecasts, and we tie into that energy commission forecast to require our utilities to develop resource plans. And the resource plans, they're 12-year's out, and they're specific as to the resource that they would develop to meet particular shortages, who do we then -- let me, it's important to understand this because then we, in turn, ask the utility to be specific on what resource they would develop to meet a specific need. And then we set the alternative energy price for both capacity and for energy so that it may be offered to an independent energy producer, and to the extent that increasing amounts of energy and the resource plan are to be met by alternative energy producers, it then takes away the incentive, of course, for the utility to develop plans which in turn tends to make them cash rich, especially as the construction of their nuclear plants comes to a close and they come into the rate base.

SENATOR GREENE: While we talk, however, of a rate of return, is the rate of return determined by your agency or by statute?

MR. VIAL: By us.

SENATOR GREENE: By you. Then you have some basis on which you compute these, and you have for a long time a rate of return?

MR. VIAL: Yes.

SENATOR GREENE: Does this hearing today suggest that there should be a review of the base of determining the rate of return?

MR. VIAL: It's constantly under review in all the great rate cases and in fact, we adjusted the return on equity just recently for the energy utilities because they were set too high with heavy changes in the money markets that had taken place subsequently, so, there was a stipulation agreed to by the public staff and the various energy utilities which we, in turn, adopted for reducing the return on equity for 1986 and 1987.

SENATOR GREENE: Well, is there a question here then of public policy where we are saying that here is a utility that when it started out 50 to 100 years ago, you know,

certain things happened over time and it expanded. the nuclear age came along and they decided to build a plant that cost \$1 billion, or whatever it was, and so, here is money and you have to, you know, and so on, and all that is part of the investment process. And now, now something happened where we've leveled off. We are not building greater capacity at this point in time in conventional power, we don't need it, you know, so there isn't the need for that reserve against future building.

MR. VIAL: ...there is deemed to be a general surplus.

SENATOR GREENE: Is this a matter where there should be a general review of what the whole structure is on rates now, or is that something for you when your agency was before the Legislature?

MR. VIAL: I think it's something where -- that goes to the core, the responsibility of the PUC, and I don't think that you can do it legislatively. You may want to develop some guidelines, but obviously, the job needs to be done by the assessment of the money market for both bonds and equity in the context of the changes that are taking place in each utility and the risk factors involved.

SENATOR GREENE: Is there nothing in statute then on the question of rate of return risk and so on?

MR. VIAL: Yes. I guess you should ask a lawyer specifically. But the general guideline that we have to deal with is to keep the utility healthy enough to deliver the services at the most reasonable rate possible. And we have to deal with the reality of the risk that's taking place within a utility and their access to money, either for debt or for equity. And we measure that very carefully, it's one of the most controversial aspects of every general rate case. PG&E, for example, has its general rate case before us. One of the issues will be in that proceeding as it comes before us, what should be the rate of return on equity.

SENATOR GREENE: Then, this is something that you need to ascertain within the PUC as a generalization as well as in specific cases; in other words, you need a general policy. What happens as you change from one era of time to another, you know, as to what the future is of utilities generally?

MR. VIAL: Yes.

SENATOR GREENE: ...then, some general guidelines there; then the specifics of each individual case.

MR. VIAL: Yes, but let me tell you why it's so important to give the PUC flexibility in dealing with this. On the third of December, the California Public Utilities Commission will be issuing a whole new framework for the regulation of natural gas, because of what I was identifying, the greater reliance of market forces in deregulation. We will be separating the core markets from the non-core markets for transmission and for procurement of gas, we'll be giving a lot more flexibility to the

utilities in dealing both in transmission charges and procurement for the non-core market that has market opportunities. But in exercising those market opportunities, there is tremendous pressure in problems presented for the core market where there are no opportunities. So, we have to look as we try to protect the core market and to give greater options to the gas companies to deal with a non-core market, you have to assess the risk factors. And we'll be -- one of the proposals will be to repeal the revenue adjustment mechanism to put the utility at greater risk for dealing for that non-core. So, if you are going to talk about what, you know, looking at the utility in the future and what the rate of return should be, you always have to look at it in the context of the regulatory climate and the kind of risk that we put into the operation.

The same thing is true on the electricity side. We have just issued through our public, our policy and planning unit, an OII, directing all of the electricity utilities to look at how they were going to deal with the bypass issue that was being identified in looking at competitive pricing of energy in terms of marketing practices and what this means for the attrition provision. And we have proposed that we eliminate the revenue adjustment mechanism and the attrition mechanism so the utilities can become more involved in dealing with the bypass problem on the electrical side. If we do that, obviously, you then have to assess the risk factor in setting the return on equity. It's really absolutely essential that you allow the flexibility for that kind of decision-making. So, I would urge you strongly not to put any constraints on the PUC that would really make it impossible and difficult for it to adjust to the changing conditions of the industries that we regulate.

SENATOR GREENE: Finally, I wouldn't consider myself knowledgeable enough to tell you what -- or anybody else what to do in this area. I just have some visceral feelings that a public utility is a unique organism...

MR. VIAL: Yes.

SENATOR GREENE: ...in that it's not that you build another department store or something or other, you know, that uniqueness about it. And so, it has certain customers that are there, take it or leave it, you know. There is only one post office, there is only one utility in this area, and that you are going to deal with them on their term. Now, we see that -- but there is a change in the scene here, and there is a change in the needs for that utility for cash. It has more cash, so it says, "I want to make greater use of this money by diversifying in a certain way, and that would be to the advantage of my stockholders." But on the other side of that table sits the customer facing the stockholder and from the customer's point of view, "Now, wait, we gave you a special privilege, and special means of conducting your business that no one else has, that if General Motors wants to diversify, or Ford or somebody or other, you know, or IBM, it's not a utility in this sense, and it does it under some other, you know, system."

MR. VIAL: Yes.

SENATOR GREENE: So that, where I -- as just one Senator, am at a loss because of lack of knowledge. But where these proper boundaries are and where we're limited to whatever you decide on our behalf for the people of the state but it seems -- it may be totally justified. There is nothing in me that tells me cut everybody's rate out there because they are making too much money. There is nothing that tells me that, but there is nothing at the same time that tells me you shouldn't do that, you know, I'm just not competent.

MR. VIAL: Well, you certainly indicated a great knowledge of what the problem is because you are...

SENATOR GREENE: Now give me some knowledge as to the solution.

MR. VIAL: Well, I wish I could tell you that there was a simple solution. Unfortunately, there is no simple solution to the kinds of problems that are taking place, that are upon us, and all I can say is that we are -- I think, doing our best to maintain what I would call the infrastructure of the utility system that we must depend upon to deliver the services with reliability and at the least cost possible. And what I've been trying to point out to you is, that market forces have been unleashed by public policy and by entrepreneurial opportunities which are beginning to challenge the infrastructure of the utility in a very basic way. And what we gave -- the way we have responded in our own regulatory decisions -- and I've taken the lead personally on this -- that when a utility looks at its diversification opportunities in today's climate, it better not do so at the expense of undermining the cost-effective investment base for least-cost services. Therefore, I put -- it was my doing primarily, with the support of the other commissioners, that we put into San Diego Gas and Electric order, that if you are going to diversify in areas that are related activities where there is a possibility of negative cash flow or benefits to the regulated utility, that we want you, as managers, to think carefully on what the impact is going to be on the regulated utility. And, therefore, we put in there the provision for royalties and possibility of affiliate payments and future hearings that would determine the bench marks for dealing with these non-affiliate -- the affiliate payments that would protect the erosion of the cost-effective investment base of the utility itself, and that's really what you are zeroing in on.

SENATOR GREENE: Commissioner Vial, it's just -- something just occurred to me while you are speaking here, just an interesting question in my mind. We are talking about the diversification of a public utility, wherein a public utility is going to buy into other businesses?

MR. VIAL: Yes.

SENATOR GREENE: Can it be the other way around? Can the XYZ Corporation out there

buy up a utility?

MR. VIAL: Well...

SENATOR GREENE: Has that ever been done or can it be done? Will the law permit it?

MR. VIAL: Well, the Wall -- you read the financial journals, there is talk of takeovers and some of them may be friendly, some of them hostile, but there are these movements nationally.

SENATOR GREENE: Would that take, isn't that takeover a matter of getting control of a certain amount of the stock and thereby the other company?

MR. VIAL: Yes.

SENATOR GREENE: ...and I guess, that's it, I guess that's what I'm talking about, you know, if the XYZ Corporation says, "I want to buy So Cal, or Edison or whatever."

MR. VIAL: Well, when a takeover artist decides that the utility is cash rich, and that his stock is undervalued, and there is a possibility of finding some company that will issue junk bonds, to allow them to take over the utility and may very well occur.

SENATOR GREENE: But do you play any role in that?

MR. VIAL: Well, myself, I would resist. I would look very hard at any effort of these takeover artists to take over one of our utilities because I don't like what's going on nationally.

CHAIRMAN ROSENTHAL: Do you want to continue with your...

MR. VIAL: Well, I don't know that I have anything more to add. I think I've indicated a lot of my values. I think that our commission has really approached this realistically. We have certainly looked at diversification with considerable doubt as to whether it's going to benefit the ratepayers and, therefore, we've asked for the -- we've exercised, I think, the requirements that are necessary to protect the ratepayers. All I can do is, I can comment as you want, if you want me to on the telephone situation.

CHAIRMAN ROSENTHAL: Well, let me -- we are going to do that. Now, San Diego rejected the conditions that you applied on them for a holding company status...

MR. VIAL: Yes.

CHAIRMAN ROSENTHAL: ...and then, they moved in another direction. They said, "Well, we won't establish a holding company, we will then do it within the utility."

MR. VIAL: Right.

CHAIRMAN ROSENTHAL: Now, under that set of circumstances, are they now obligated on these royalty payments, or was that under the holding company?

MR. VIAL: Well, listening to the utility this morning, they talked about Pacific Diversified moving in the direction of acquisitions that tend to be suppliers of services or products to the utilities. They are not looking at services that are directly related to the utility function. For example, they are not seeking to go into independent energy

development to sell it within the jurisdiction in competition with the regulated utility. They are not proposing anything like that at this point. So, I think what my answer to you would be, we would watch very carefully the type of enterprises they go into. Now, obviously, if they are going to go into those types of enterprises that are really totally unrelated - they are not quite doing that - if they were going into enterprises that are totally unrelated -- a holding company would be the better vehicle generally to protect the ratepayers. If they are going to go into activities that are increasingly related to the utility, then we have the strongest possibility of dealing with the cross-subsidies by working with the regulated utility. Now this becomes important, I don't want to really cross over into telecommunications, but, in fact, that's the central issue in dealing with telecommunications and diversification through a holding company; it's a network of the future and what it may be and whether the network is going to be -- the services are going to be offered through affiliates of the holding company, affiliates of the operating company, and on what basis and whether those services are price elastic and competitive and so forth, there are just all kinds of issues where we have to have authority to deal with them.

CHAIRMAN ROSENTHAL: Well, since you may not be here for the other portion, on this wire ruling -- telephone wire ruling, in terms of competition, is that going to go into effect January the 1?

MR. VIAL: Well, the FCC in its wisdom has mandated that it go into effect. The FCC has in effect said that the repair, the maintenance of inside wiring come January 1, shall be detariffed and it shall be provided -- not only did they say that it shall be detariffed, but FCC decided that it will be detariffed, and to the extent that the operating company wants to provide the maintenance services in competition with other entrepreneurs that may want to provide the same service, that they would do so only by accounting separations. They have taken away our authority to decide whether it should be by physical separation through a subsidiary or whether it should be done by accounting separations. The FCC has mandated that there be this kind of detariffing of what has heretofore been considered by ratepayers to be a service that goes with the telephone service. Most people, unfortunately, don't realize the extent to which the FCC will go to create entrepreneurial opportunities for competition against the regulated utility. Here, they have indicated that in order to provide opportunities for someone else to provide that maintenance, they then in turn instructed the deregulation of this kind of service and in a specific way. I think the decision of FCC is an outrage but it's behind us, and I wish there were something we can do about it.

CHAIRMAN ROSENTHAL: Could the utility -- could the telephone company postpone on their own?

MR. VIAL: No, the utility is -- doesn't have a clean shot at it. And maybe it's

easier to work by way of example. If you have a problem in your phone system, you don't know where it is, because right now there is a separation between the company line, the utility line and your line that is a protector. But that protector, unless it's been a new house or something, has no basis for deciding what side -- you can't tell what side the problem may be. If you have a modern detector, you can do it from the utility office. If you have another type of system, you can just plug in at the connection and decide where it is. But lacking that, someone is going to have to come out. You are going to call, that's tariffed. So, that visit is free to the point of deciding where the problem is, but if they come out and look at it and say, "Well, Senator, we are sorry, but your problem is in your inside wiring, not ours," then they'll say, "We can repair it, but we can repair it on unregulated basis, our fee is \$65, or you can," as a company is saying, "You can take out this 50-cent insurance policy and we'll continue to provide the service," or you can go out and get an entrepreneur that is going to come out and provide the service. Now, obviously, the problem that the people that are out there providing the service, are going to say, "Well, the utility is already there, therefore, we can't compete because it's unfair, because it's not a free-standing service, there is a cross-subsidy issue and the FCC has mandated that we do that by accounting separations." But the FCC in its wisdom hasn't set out the guidelines on how you are going to provide this separation. It just took the decision to detariff the services. So we are right here in limbo right now on what to do about it. Basically, I feel that there are economies of scale for a regulated utility company that's providing the service to determine where the problem is, to be able to repair it. That's my view on it; but the FCC said, "Thou shall have separation and there shall be competition in it." So, we are looking at our options at the present time on how we can deal with it frankly, and...

CHAIRMAN ROSENTHAL: Is it possible that the PUC can delay for some period of time?

MR. VIAL: Well, we -- I had a long meeting with our staff of lawyers and others on last Friday, and they are going to be looking at the possibility of a final appeal to the FCC to give us more time on how to do it. The other thing is that we don't want to be putting the utility in the middle of this problem in exercising what we think might be our authority. My inclination is to look very carefully at the revenues that might be pulled into the system that is being proposed and make it above the line rather than below the line, so that the ratepayers are not hurt by the change. But, the problem is who is going to be paying; you know, the people that don't have confidence that their whole inside wiring is going to hold up will take out the insurance plan. Now, I live in a pretty good neighborhood in San Rafael and the chances are of myself -- my wiring going bad, I think they are very slim, therefore, I'm not going to take out the insurance, I'll say that openly. But on the other hand, if you live in a rat-infested slum, you might very well be just the type of person who is going to have the problem of an inside wiring

and they are the least ones that can afford the 50 cents. That's the kind of problem that upsets me when the FCC mandates that inside wiring just go deregulated.

CHAIRMAN ROSENTHAL: Well, now, regardless of whether people go for the insurance portion or whether they are going to pay the 65 or 80 or whatever number of dollars it is for somebody to come out and fix whatever needs to be fixed, there are going to be some tremendous profits from this service. Is that going to go back to the rate base?

MR. VIAL: Well, that's one of the options we are looking at. You see, you have a number of people that are now providing the service, on the average it's about once in 12 years that you have an inside wiring problem, but there are a body of people that provide for maintenance services on inside wiring. Now, one of the things that can be done is to completely remove those people from the regulated base and reduce rates for that purpose and then go into a totally independent system of providing service for maintenance. Then, you have to deal with the fact that there aren't these devices to detect where the problem is, and if you are going to use those devices, it will cost a billion dollars. So, you wonder about the cost effectiveness of a billion dollars going into the rate base so that the FCC can deregulate and create more entrepreneurial opportunities. But, you know, these kinds of things aside, what we could do is -- one possibility is allow the people to say where they are, allow the utility as best it can to maintain a service out there and any money that they make from that service, goes above the line into the revenues to offset the cost of it. But, as I said earlier, the problem with that is, that who pays for it are those people that buy the insurance. See, no longer do we have the capacity as a utility to socialize, if I may use the term, the cost of maintaining the inside wiring.

Now, the other thing you have to bear in mind is that inside wiring is now part of the consumer premises and their equipment when the new house is built. So, it's clear when you are buying a new house that the inside wiring is like the electrical wiring in your house. You are responsible for it. I should take that back. Right now you own it, but the utility is servicing it. Now, we also have all the other inside wiring there that's been expensed or amortized and not all that has been amortized, but eventually, it will be all amortized. But we have always maintained the authority of the utility to maintain the inside wiring even though it may be owned by the subscriber. And this is what is being deregulated; it's the service.

CHAIRMAN ROSENTHAL: Let me ask you a question moving back into this whole... Is there a clear difference between how energy and telecommunication utilities diversify into unregulated businesses?

MR. VIAL: Is there... I'm sorry.

CHAIRMAN ROSENTHAL: Is there a difference between how energy and telecommunication utilities diversify into unregulated businesses?

MR. VIAL: Well, there could be substantial differences.

CHAIRMAN ROSENTHAL: Should there be?

MR. VIAL: Well, look at it from this point of view. If you are a utility that now has in its resource plant a great deal of dependence on independent energy development and you are not going to be developing any resources on your own but you know that independent energy development is going forward, you can form a holding company within your regulated utility to go into diversified energy development under PURPA. Then the question is, would you do that in competition with other independent producers within your own jurisdiction, or would you go outside and do it outside of your jurisdiction. That's primarily the Southern California Edison model of approaching this issue.

PG&E has indicated with the bypass issue that they are not going to go into diversification. They are not going to go out to the bypassers and join them, or propose a holding company or rather an affiliate or a subsidiary to go out and join others in producing independent energy below the line. They've not indicated that. Instead, they have on file with us now an application for approval of a contract that they have negotiated with three hospitals in -- down the Peninsula where they are seeking to provide discount rates to keep them in system and some contribution to the margin so that the rates won't have to go up for the residential. But, of course, if you are going to negotiate these kinds of contracts, you are going to shrink the margin and there is going to be some shifting of fixed cost from the commercial, or the industrial to the residential. So, then, you know, you get all of these different pressures that work on you toward diversification and what your response may be and it's going to vary by utility. And in telecommunications, much depends upon national policy.

Now, at the present time the FCC has indicated that in dealing with a network of the future that any enhanced service under Computer III, shall be provided by the regulated telephone company, the operating company by accounting separations. They have taken away and preempted our authority at the State to determine whether they should be offered on an affiliate basis or an accounting separation basis. And we have complained about that and we had that decision on appeal.

You have the Dole Bill before Congress which is suggesting that the MFJ is now tremendously complex. Way beyond what anybody anticipated, the courts can't administer, therefore, let's shift it over to the regulators. And the FCC is now saying, "We'll regulate, we'll preempt and tell you that every enhanced service under Computer III has to be offered in a package with basic services. And every basic service shall be offered an enhanced service through open architecture," which means you have to tear apart the existing structure of the network and rebuild it in the vision of the entrepreneur who may want to offer some services of enhanced services on an unbundled basis. So, if you look at that and the potential for deregulation, it's just tremendous. And that's

exactly what the FCC is proposing, to make the regulatory process so complex that you deregulate.

So, if you are going to deregulate, you'll see all kinds of opportunities for diversification. And as you know, we penalized Telesis, or we penalized Pacific Bell because we've been having trouble getting timely information out of Pacific Telesis; they are cooperating more now, but our staff now in the general rate case is looking at the conditions that we laid down in the general rate case -- I mean in the diversification case for SDG&E and they are applying that as an independent advocate for the ratepayers in the Pacific Telesis case. I can't go beyond that, the Pacific Bell case, because I'm the assigned commissioner to comment on it. But, that's in controversy now and our staff is proposing that we look at the relationships, the cross-subsidies and affiliate payments.

CHAIRMAN ROSENTHAL: Is there a difference in the audits between the utility -- I mean the holding company holding the utility and then the utility diversifying? Is there a difference in the kinds of audits...

MR. VIAL: Well, our auditors are looking at that in the context of Pacific Bell and Pacific Telesis and I can -- I think Terry Murray, who is going to be here has an update of the investigation that our staff is providing and that _____, and I have a copy of it here that I'll leave with you. But to tell you what our staff is doing, now, that's our public staff which is totally independent of the commission and looking after the interests of the ratepayers. They are looking at the auditing problems in a relationship of PacBell to Telesis. And those are the same kind of problems that you are dealing with in any kind of diversified relationship. And all -- the point I want to make is that the auditing problems tend to become more difficult -- I'm not an auditor so -- they tend to become more difficult when you are dealing with related activities to the regulated activities when it's in a holding company instead of an operating company.

So, for example, if we were looking at the network of the future in Pacific Bell and the enhanced services to the extent that we didn't want to put the investment in the rate base, we would probably look at a related service being offered through a subsidiary of the operating company before we would go to the holding company if it's an activity that is closely related to the regulated activity. But the more you remove -- you go away from that regulated activity, then the holding company becomes a little more attractive in terms of insulating the utility from the operations in non-utility areas.

CHAIRMAN ROSENTHAL: I'm just reading -- at the Federal level, it seems that California Senator Pete Wilson, has proposed an amendment to the Dole Bill to move jurisdiction from the FCC to the PUC, I guess.

MR. VIAL: Yes.

CHAIRMAN ROSENTHAL: The amendment would have imposed a system of cost-of-

regulation fees to be paid by telephone companies to fund required audits by the FCC of diversifying utility companies.

Any comments on that?

MR. VIAL: Well...

CHAIRMAN ROSENTHAL: Do you think, for example, we are going to be seeing the Dole Bill given the composition of the new Senate?

MR. VIAL: We have submitted a lengthy statement on the Dole Bill where we indicated -- number one, yes, the administration of the break-up is tremendously complex, the courts can't do it well, and that regulators ought to be stepping in to do so. However, to give the authority to the FCC and assume that they have the competence -- I'm emphasizing the competence -- to do the regulatory job, is with substance, without any evidence that that's the case. The FCC does not have the competence to deal with the kinds of issues that PUC's are established to deal with around the country. There is more competence in our (void in tape) the FCC is dealing with the network of the future and how it might be pieced together. And, therefore, we have said very clearly in the Dole Bill that now is the time to deal with the fact that the FCC has been trying to preempt the authority of the state utilities in every respect and particularly in connection with Computer III. And, therefore, if there is going to be any transfer from MFJ to the regulators it should be with a clear understanding of what the roles of the State must be in dealing with the network of the future and how those investments might take place.

CHAIRMAN ROSENTHAL: Okay. We have one other from the response group. William Marcus, consulting economist representing Independent Energy Producers Association.

MR. WILLIAM MARCUS: Thank you, Senator Rosenthal. I'm with the consulting firm of GBS Engineering, and I've been doing work for IEP over a long period of time. Dr. Harrison had another commitment today so, she wasn't able to be here.

I think our major concern has been as a potential competitor to some of the utilities' unregulated activities in terms of the diversification of utilities into independent energy production.

When I was here last year, I think the issue was a little hotter than it is at the moment because at the moment we've seen some movement from the utilities away from doing business in the independent energy field in their own service territories with themselves. The Public Utilities Commission put a condition on San Diego Gas and Electric Company in its holding company application, that they could not provide independent energy production to themselves and we think that is a very good decision by the commission. We had advocated that in the hearings on the diversification bill.

From looking at Southern California Edison Company, it appears that they are at least slowing or stopping their activities in their own service area with what they've

already got on their plate, and don't seem to be pushing forward heavily into adding additional projects in their own area although I think they are still thinking about doing some work in other service territory.

With respect to PG&E, we've seen very little activity. At one point, they were talking about being a joint venture participant in the Shell Martinez project when they were thinking about bypass, but it's our understanding that that's not going forward at the moment. So, I think our main concern on this issue has been twofold. Which is when a utility is involved in its own service territory as a monopoly buyer of power -- monopoly seller of power, that it should not be able to take an unregulated stake in its own service territory. I think that we would welcome competition from utility affiliates in the independent energy business as long as they are operating in somebody else's service territory. We would also welcome competition from utilities putting together alternative energy projects on a cost of service basis in their own service territories as a regulated utility with any profits falling above the line for the ratepayers. Pacific Gas and Electric had that in their resource plan in about 1981 and dropped it out at that point, that type of involvement. But we would see that as being a reasonable thing to do. But where we draw the line is at the point of utilities selling power to themselves in their own service territories through unregulated subsidiaries. We've seen some difficulties on this nationally, we've seen some examples in several other states where the utilities looked like they were going to cut themselves a better deal than they would cut other people similarly situated.

There has been quite a bit of controversy in front of the PUC on the Applied Energy Incorporated, subsidiary of San Diego Gas and Electric. I think the commission essentially required a repayment of certain funds to the ratepayers and reformed a couple of their contracts upon the recommendations of the consumer group, Utility Consumers Action Network in San Diego. And, I think at that point, San Diego has since sold its interest in energy factors. But there was still this problem left over from the days when they were involved in it on an unregulated basis that the commission had to take a look at. So...

CHAIRMAN ROSENTHAL: So all of your problems has disappeared?

MR. MARCUS: They are getting smaller. I think -- I wish I could say they've disappeared, but things are definitely becoming a little bit smaller around here. And we appreciate the opportunity to offer you some brief comments this morning and would reiterate that this is our major concern although at the moment due to utility activities, not due to legislative activities, it seems to be diminishing a little bit.

CHAIRMAN ROSENTHAL: Well, maybe it came about as a result of our interim hearings.

MR. MARCUS: It could of been your interim hearings, it could have been the PUC's decision in the San Diego case as well. Thank you.

CHAIRMAN ROSENTHAL: Any comments from the members? Very good. That completes our first panel, we will break until 1:30 p.m. -- come back at 1:30 p.m. and then within two hours, we will complete the second panel. Thank you very much.

-- Lunch Recess --

CHAIRMAN ROSENTHAL: We will begin this afternoon session; I was waiting a couple of minutes to see if we could get a couple of the Senators back here, I'm sure they are coming but will be a little bit late. And now I have the second panel, Telecommunication Utilities. Elliot Maxwell, Executive Director of Strategic Planning for Pacific Telesis Group; Jenny Wong, Regulatory Manager, General Telephone Company; and Harry Baker, President at Sierra Telephone Company representing California Telephone Association.

If you'll just turn those nameplates so that we can see the names. Mr. Maxwell, if you would.

MR. ELLIOT MAXWELL: Thank you, Mr. Chairman. I'm Elliot Maxwell representing Pacific Telesis, I'm Executive Director for Strategic Planning for Pacific Telesis. I'd like to thank you for the opportunity to testify today. I wanted to talk a little bit about our diversification versus diversification by other utilities within California of our plans for diversification, and finally, the safeguards that exist for the activities that we've engaged in under diversification.

Let me start off by saying what the commitments by the Pacific Telesis Group are in the area of diversification. The first is that we are committed to the provision of proficient, reliable, basic service at affordable rates, and that commitment is not waived at all as we move into other areas of business. The vehicle for doing that is Pacific Bell which is by far the largest part of Pacific Telesis Group. It's about 95 percent of the assets and about 95 percent of the revenues of Pacific Telesis Group. And it is a part of Pacific Telesis Group that has the highest priority within the Group because for us to maintain the strength of the Group, overall, we must maintain the health and welfare of Pacific Bell.

Over the years since divestiture in January of 1984, we've reinvested about \$800 million into Pacific Bell. And we continue to raise new equity to provide support for Pacific Bell and we hope to continue to provide new services for our customers throughout Pacific Bell.

Finally, there is a commitment on our part in diversification, to make sure that the ratepayer, the customer of Pacific Bell, is not impacted negatively by the diversification efforts and that there will be no cross-subsidies from Pacific Bell and the utility to other members of Pacific Telesis Group and that no member of Pacific Telesis Group will engage in anticompetitive conduct.

Those pledges are really at the core of the diversification activities that we've undertaken and the safeguards that we've erected. We think that the most important test about diversification is that it not harm the ratepayer. And I will describe the safeguards later to make sure that does not happen. But we see that there are some potential benefits to the ratepayer and I don't want to exaggerate those, but we think that they do exist.

The first is that the utility, Pacific Bell in this case, has somewhat reduced common costs like treasury functions that it can now share with other affiliates within Pacific Telesis Group. There is a second benefit, in fact, that there is profit made by sales to the affiliates; and when I talk a little bit later about the transfer pricing, that possibility for profit and for efficient access to services in Pacific Bell we think reduces cost to ratepayers and also provides more services which count against the revenue requirement in Pacific Bell.

There are two other benefits that I think exist, and that we believe are part of the diversification program. The first is that the opportunities to participate in an extended range of activities helps us attract and maintain and retain the kind of people we would like to have within the enterprise.

Finally, and one that I think will be particularly important to you and I think echoes some of the comments this morning, is that many of the customers of Pacific Telesis Group and particularly at Pacific Bell, now have the option of providing -- of obtaining service from different providers other than Pacific Bell. And we believe that it is important that we can, if we are able to, maintain those people as users of the Pacific Bell network. If we don't, if, in fact, the bypass activities that we see already accelerate, then the fixed cost that exists in Pacific Bell will be borne by the ratepayers and the ratepayers will face higher rates.

There is a second set of benefits that we think exists because of diversification. It's tied to that last point. And that is that we are now able to offer a broader range of services than Pacific Bell could offer because of the restrictions that exist in the Modified Final Judgment and because of FCC regulations. Without that, we find it much less likely that those customers would stay on the Pacific Bell network or that those services would be available to customers in California.

Finally, we think that we help contribute to a strong California economy. The diversified business within Pacific Telesis Group employ about 2,000 people now and have generated about \$40 million in salary and the like in California. The diversification efforts in Pacific Bell and Pacific Telesis Group, are somewhat different than the diversification efforts that exist in the other utilities in California. The most important difference is that we face a very extensive set of regulations at the Federal level and a set of controls on our business and a set of protections against cross-

subsidy.

Let me try to go through some of those to give you some idea of the activities that are undertaken at the Federal level. As you know from the divestiture, Pacific Bell is restricted in the kinds of services it can provide, and that's restricted because of provisions in the Modified Final Judgment and in the FCC regulations. The Modified Final Judgment now requires us to seek waivers from the court if we choose to enter any new business. And those waivers have brought with them certain conditions. The most important test of the waiver is that there is no opportunity, no substantial possibility that the utility would be able to use its power to impede competition. A second part of that is that they'd be engaged in through structurally separated entities. A third is that the earnings of that new line of business, not exceed 10 percent of the net earnings of the holding company. That holding company was not chosen by Pacific Bell or by Pacific Telesis Group, it was mandated as part of the Modified Final Judgment; and it was not a choice that we made but a choice that was imposed upon Pacific Telesis Group.

Finally, as another part of the conditions on the MFJ, it's impossible for any of those new lines of businesses to be funded with recourse to the assets of the underlying utility. So, the separation that was talked about this morning, the ability to protect the ratepayer by not allowing any new business to have recourse to the assets of the utility, is part of the Modified Final Judgment conditions. It is also true through FCC regulations that the separate subsidies that are required on the FCC's part, also prevent recourse to the underlying utility assets.

So, at the Federal level you have the Modified Final Judgment with a set of conditions that I just described, the FCC has the conditions with respect to access to the underlying utility assets. The set of controls on structural separation the county controls to make sure that there is no cross-subsidy, and the same rights to audit and visit as it is true through the Department of Justice.

At the state level, clearly there is the range of regulation that was described this morning, the right to disallow transactions to investigate any transactions and because of the legislation passed last year, the right to engage in efforts to examine the records of any of the parts of the utility that might effect the -- any of the parts of the holding company that might effect the utility's operations.

In addition to these provisions in regulation at the Federal level and at the state level, we have committed to a series of internal policies to try to make sure that there is no cross-subsidy from the utility to the other affiliates and no anticompetitive behavior.

In the testimony that we distributed, we included copies of the internal policies and those established safeguards or guidelines for affiliate transactions with respect to tariffed and non-tariffed goods and services, equipment, real property, leasing property,

disclosure of proprietary information, and the like. And the corporate guidelines that include this will be reviewed with our personnel on a regular basis. These guidelines allow us to tract internally and externally the kinds of transactions that lead to concerns about cross-subsidy or anticompetitive behavior.

One of the things that we do want to say is that we have been in the process of starting up these subsidiaries over the last several years. And we have found problems both internally, and we have moved to fix those, and we have had certain kinds of problems discovered by the CPUC in their audits. We are committed to making sure that those things are fixed. And when we sort of take a look at the scale of it though, we find ourselves not persuaded that the threats are as grave as people have, in fact, tried to point out.

In the '84-'85 period of time, the public staff looked at about 1,200 transactions that existed. And as part of the discussions in the audit proceeding now going on, we have identified about 11 of those transactions that seemed to us to be a real problem and we have moved to fix those. So, the scale is about 1 percent of the transactions have seemed to indicate a problem. But regardless of the source of discovery, we are committed as an institution to fixing those problems and to making sure they don't recur.

Since divestiture there have been a number of acquisitions, which I thought I would simply review quickly for you; they are included in the testimony that we distributed. Most recently we bought the -- from Northern Telecom the installed base for their Integrated Office Systems Western Region Sales and Service Operations; and that's located in PacTel Info Systems. On the Bell subsidiary, we bought a small percentage, under a quarter of the percentage, of a company called Integrated Technology Incorporated, which provides advance network service software. We bought through the PacTel Mobile Companies Communications Industries, which has a number of cellular and paging assets through the Pacific Telesis International a consulting firm called Teleconsult through Info Systems; a computer retailer in the northwest; an electronic mail organization called One to One, operated by Pacific Telesis International in the UK; and a directory publisher of national directories JWJ, which is operated by PacTel Publishing. All of these are subject to the cross-subsidiary protections that I described earlier and many of those we had either to obtain waivers or to get additional regulatory approval either through CPUC here or the Public Utilities Commissions in other states.

With respect to the future, there is really no rush to diversify; what we are trying to do is look carefully at our business and to see what kind of extensions of the basic businesses that we have now can be extended either horizontally or geographically or vertically. But as I said earlier, the health and welfare of Pacific Bell and Nevada Bell remain the number one priority for the corporation and it would be foolish for it to be otherwise, given the size of our investment and the percentage of assets that that

represents.

Finally, in conclusion, we think that there are good reasons for us to diversify. And reasons that relate not only to meeting the customer needs of people in California, but being able to keep on the network customers who because of the inability of Pacific Bell to provide certain kinds of services, whether the customer is promised equipment or enhanced services, might desert the network. And I think that that is something that we think given the increasing likelihood of bypass and the increasing provision in California of services by integrated network CPE providers, like AT&T or like IBM, RHOM and MCI, something we need to be concerned about for the underlying strength of Pacific Bell. We certainly hope that diversification efforts aid those customers and aid California in general, but we recognize that none of that can be accomplished without strengthening and continuing to be concerned about the health and welfare of Pacific Bell.

Finally, we think that there are sufficient controls, in fact, there are multiple controls both at the Federal, state and internal level to prevent cross-subsidies and anticompetitive behavior, but if we discover problems, we are committed to fixing them. Thank you.

CHAIRMAN ROSENTHAL: Let me tell you my bias. A year ago, I heard a similar kind of presentation and then the PUC hits you with a large fine for doing things that you had said you were not doing. Why should I believe you now? That's my personal bias. In other words, you got blasted for diversification procedures at PacTel, for example, and Pacific Telesis, being the worst of all of the BOC's compared to Nevada Bell for example, who received a good report. Can you respond to that?

MR. MAXWELL: Sure. I think the quotation -- just to deal in part with the quotation then to deal with the substance of the issue. The quotation that you -- as I understand it -- is a quotation from NARUC committee report. And that NARUC committee essentially picked up this public staff division report of the audit of Pacific Telesis Group and reprinted it without any independent verification of that audit. Now, clearly we don't feel comfortable about that kind of accusation, and in the testimony we've attached a letter from the Executive Vice President, External Affairs for Pacific Telesis Group, addressing that.

The underlying, and clearly I think, the underlying issue is the important issue. At the moment, we are engaged in a process with the public staff division to take a look at the charges that they made in their audit and our response to those. And that litigation has been going on for quite some time. Al Borough of Pacific Bell, is here in case you want to deal with the specifics, but the concern I think is one that is important to address. We believe, in fact, that the charges in that audit are really grossly overstated, and we think that we have demonstrated through the testimony that we

filed and the witnesses that we've brought forward, that there are inaccuracies in that report, that there is incomplete information in that report and that, in fact, the charges that were made are not sustainable, with some very small exceptions. And those exceptions we taken to heart and we have committed to fix. But that right now, it's not the CPUC that has done that, and I think that it's important to draw that distinction. It is as if an independent intervener had come before the CPUC and said, "These are the charges." What's important about the litigation right now is we can test those charges in front of an ALJ and then the CPUC can, in fact, make a determination independently. But I don't take those charges at the moment as charges that the CPUC has validated. They are like any other intervener with the right to go smack-dab through all of our subsidiaries, through every transaction, through every business plan, through every record. So, I think that you are right to raise the point, and I'm not trying to diminish the concern because I think we have to come back at the end of that audit -- at the end of the review by the ALJ and say, "What did they find and what have you done about it?" And we commit to that.

CHAIRMAN ROSENTHAL: Okay. So, then I'll wait to see what happens on that, because if, in fact, after that the PUC now slaps you with some fine, then I've got double questions. In other words, you know, once I begin thinking along a certain line...

MR. MAXWELL: I think that's absolutely fair and what we find very distressing about the auditing and about statements like the NARUC statement, is that you sort of run after them and say, "But by the way, this is not the CPUC, this is an independent staff that's set up to challenge that," and finds, and it's reported that the testimony was, they were saying, "We don't need to say what was right, all we need to say is what's wrong because we are an advocate."

CHAIRMAN ROSENTHAL: You supported the Dole Bill which, as I understand, was moving from the court to the FCC in terms of getting new authority to go into enhanced services. Where are you now? In my personal opinion the Dole Bill is dead. Okay? ...given the new composition of the Senate.

MR. MAXWELL: Well, unfortunately where it places us is in a situation where we have multiple jurisdictions having authority over us and saying potentially and often explicitly, contrary things. And we have, in fact, little way of reconciling those things. We have the FCC that says one thing about enhanced services; we have Judge Greene saying another thing about enhanced services; we have the CPUC potentially saying another thing.

What we did in the the Dole Bill was to say, that with respect to regulatory jurisdiction, it doesn't make sense for the court that oversees the Modified Final Judgment to be making regulatory decisions. But essentially, that court has responsibility for enforcing an antitrust decree. But to look at the impact of these

services on customers, to look at the impact of these services on bypass, to look at the impact of these services on international trade, it's not equipped to do that. And we tempered our support for the Dole Bill by saying that we believe that it should, in fact, ensure that the jurisdictions of the states remain as they are, that it not be a sweeping attempt to ensure Federal jurisdiction over these issues. But to have a multilevel, multipart jurisdictional structure that doesn't recognize the changes that customers have, that the technology has, the regulation has, seems to us to be a recipe for disaster for either the operating utility or the other businesses.

CHAIRMAN ROSENTHAL: The FCC's position to require competition on the services has been somewhat confused and I'm getting lots of calls in my district office and I'm sure every Senator and every legislator is going to be getting calls about what to do about this -- the lines in my house and the lines outside my house, and I think it raises a few unfair competitive issues.

MR. MAXWELL: I would like to call, if I might.

CHAIRMAN ROSENTHAL: Fine.

MR. MAXWELL: Mr. Chairman, George Schmidt, who is a Vice President of Pacific Bell who might want to talk a little about what we are proposing in inside wire and the impact with the FCC and what CPUC has done.

CHAIRMAN ROSENTHAL: Okay.

MR. MAXWELL: Because I don't think you are the only one who is confused, really.

MR. GEORGE SCHMIDT: Good afternoon, Senator. I'm George Schmidt, I'm Vice President - Regulatory for Pacific Bell. I appreciate having the opportunity to talk a few minutes about inside wire, what's happened with it, and where we think it's going.

First of all, inside wire has been maintained by the telephone company since the beginning of time, at least from telephone time, if you will, and only when the Modified Final Judgment came in, did we begin to not maintain all inside wire, and certain large customers had options of maintaining their own and we were taken out of business. But as a business, Pacific Bell has opposed the whole deregulation of inside wire from the beginning. We filed with the Federal Communications Commission last July a request to defer in California the implementation of the deregulation of inside wire throughout next year.

Unfortunately, nobody else in California chose to support us in that filing, and last week the FCC denied our petition for a waiver from that and ordered us to go forward in California with deregulation next year. I was pleased this morning to hear Commissioner Vial indicate that he felt that we should do something different here in California; we continue to support that. Part of that order gave Pacific Bell an option to not get into that business, to just drop out of the inside wire business altogether. We chose not to do that, not because there is tremendous profits there, but because we

care about our customers. At the time that order was issued from the FCC last February, I was the Operating Vice President for Pacific Bell in Northern California, the rural areas of California.

In my area, there were virtually no providers of inside wire maintenance and not very many of inside wire installation. We made a very strong argument in our office deliberations about this, about making sure that we didn't leave our customers out in the cold, if you will, at the time that inside wire was deregulated, and so we went in the business.

In the last three weeks, we've begun to tell our customers what inside wire deregulation meant. It's a very difficult and complex process, not the least bit impacted by what customers already think about divestiture, particularly our smaller customers, and we are very concerned about that. But we felt with the FCC order in hand and no support coming from anywhere, that we needed to get forward with getting ourselves ready and our customers ready for what they surely are going to face January 1, in the event of nobody else is helping us get actions changed at the FCC.

I feel that you should know and, so should our customers, that this is not something that Pacific Bell or Pacific Telesis either one foisted onto our customers or on the State of California or even wanted to have happen. We are really attempting to take care of our customers because we know better than anyone else that those customers blame us, not the Federal regulators, state regulators, or you for what happens to them with their telephone service. And if Commissioner Vial can figure out a way to do something else with the FCC, which we think will be very difficult now because they've closed the case, we would certainly refile our petition that we filed last July in support of not deregulating in California.

CHAIRMAN ROSENTHAL: Where will the profits go?

MR. SCHMIDT: Senator, the profits from inside wire if it goes the way the FCC has it stated are below the line along with the investment. In California, we have long held with the Utilities Commission and in our own business that it's the right of our regulators to determine what deregulated services go above the line and below the line on our books. If our commission chose to put the risk and the regard above the line, that is in the rate base and shared by all ratepayers, profit wire/investment wise, we wouldn't oppose that. That's their right, we've long maintained that. If they chose to put inside wire above the line and were allowed to do so in spite of the orders that are currently out of the FCC, we wouldn't care; in fact, it would make our lives a lot easier instead of having to go through accounting separations than what we have that we are looking at right now, going into place in January. So, I'd encourage whatever actions can be taken to straighten the mess out.

CHAIRMAN ROSENTHAL: Right now, _____. Just as it took almost two

years for people to become aware of what happened to their telephone, we are now coming to January the 1st, which is a short time from now, _____ nobody really understands, and as on radio, for example, they say, you know, buy this insurance for 50 cents a month, or else if we come out it's going to cost you, and I heard that it's going to cost \$80 minimum, you and we are all going to have a lot of people jumping up and down.

MR. SCHMIDT: Senator, in the event that we cannot get out of deregulating inside wire, we'll have a number of proposals that we'll put forward to the Public Utilities Commission to allow us to do other things to try to help customers through this. For example, an opportunity during this first winter when most inside wire troubles happen, to retroactively sign up for the maintenance charge instead of having to pay the \$65 charge. It's not clear if they are going to allow us to do that, but we believe that we need to do something to help our customers through this if we have to go forward with it the way it currently looks.

CHAIRMAN ROSENTHAL: Well now, since the idea was to create competition, is this unfair?

MR. SCHMIDT: I suppose, Senator, that there are people who would say that's very unfair advertising. We are more concerned about our customers' welfare than anything else in this issue right now. We feel like our customers are going to have a devil of a time understanding this whole thing. We need to do the very best job we can to tell them what they are up against. Frankly, at 50 cents a month, even though the numbers look real big, when you add them up by all of our customers, all of our customers are not going to sign up for it, many will not. We just think that, particularly in the areas where we have people that don't understand English well, that they generally don't read their junk mail, if you will, because that does come across to some people looking like junk mail, we just need to help them through this period, that's a very difficult time for us as well as for you.

CHAIRMAN ROSENTHAL: How will we handle, for example, Lifeline?

MR. SCHMIDT: What we have proposed is that Lifeline customers be credited at 25 cents on their bill and they can choose to either take the 50-cent option or not, so they get it for half-price. I believe though, that we would need to deal with the Legislature to determine whether or not they wanted to have that funded out of the Universal Service fund that was established a couple of years ago.

CHAIRMAN ROSENTHAL: How would you deal, for example, with the local units?

MR. SCHMIDT: Those are very, very difficult, Senator. I've been in the operation side of our business for a number of years, I know how we wired up apartment houses. There will be an awful lot of disputes between apartment owners and tenants about who owns inside wire, who is responsible for it. It's my belief that there are two bad

alternatives to that. One is to say to the utility that keeping the rate base even though there's no money for it, the connection is up to the first point on a customer's apartment premise and treat that like it was cable plant. That can be done, but most ratepayers would have to share in the cost of that. The second alternative would be for, somehow, for landlords to pick up the cost of that, and I believe that they'll generally be very reluctant to do that. So, it is not apartment houses in particular very difficult to -- no good devices available to put in for this so-called "serving network interface" that you've heard discussed earlier this morning. I get particularly concerned about accessibility to those interfaces by other customers who they can plug into somebody else's line and use it for making calls if they are not totally protected on a customer's premise and I think that if, as we go forward, they will be the most difficult customers for us to deal with.

CHAIRMAN ROSENTHAL: Senator Morgan.

SENATOR MORGAN: I have a question. In this ruling, were there any guidelines as to what you would charge when you do set up this service?

MR. SCHMIDT: No, there were not, Senator Morgan. The FCC said it's totally competitive service charge which you want; let the market bear whatever prices you choose to charge. We have chosen to price these services now at what we believe will cover our cost.

SENATOR MORGAN: The \$65 that is in your circular.

MR. SCHMIDT: The \$65 or the 50 cents a month. If we were to achieve 80 percent market penetration at the 50 cents a month, it would balance out the amount of money that will be coming out of the regulated rate base in our expenses, as best we can tell it right now.

SENATOR MORGAN: Well, I'm going to assume you did a good job.

MR. SCHMIDT: We did the best we could. The accounting on that small part of our plant is very, very difficult to have accuracy.

SENATOR MORGAN: But I'm assuming that your wiring was put in right _____.

MR. SCHMIDT: Oh, it was.

SENATOR MORGAN: ...the need for a service...

MR. SCHMIDT: It was, but they are very many -- a great many different ages in that wire. There is wire that's still in place that was put in 60 years ago, and that is susceptible to problems as were some of the earlier inside wires that we put in in the 60's around California.

SENATOR MORGAN: But as I'm hearing it from you and Mr. Vial and others, there is little likelihood that there is anything that we can do to change the FCC ruling. And so, it's a matter of educating the public. If that's the case, how do you think the Legislature can help or is there something that we are overlooking?

MR. SCHMIDT: I guess I don't -- I think that we shouldn't give up on the FCC yet. I don't know what the commission is planning to do. In the case of New York State, the New York Commission and the NYNEX Corporation both went to the FCC together in July or last spring and asked for a waiver in New York of implementation of the inside wire policies. Because there were support for that from both the public bodies and the company, the FCC did grant them a waiver. Now, it looks to me like the case is closed and it's going to have to do on appeal and I certainly can't speak for the commission, but I know that our company's position has not changed and if there is a way for us to do business back there to get a similar waiver to what New York got, I'm sure that we'd be happy, and you'd be happy, and so would the Utilities Commission because clearly, all of us are going to hear from our customers on this one.

SENATOR MORGAN: Is there any parallel with electricity and how you can handle it in apartments? Is this a problem you anticipate?

MR. SCHMIDT: In a way the circuit breaker box for electricity is similar to the serving network interface concept for telephone service. The difference is when apartments were wired for electricity in the regulated world, that interface was put in there in a way that it's not too obnoxious to customers from the viewpoint of having to look at it and do business with it. We would have to be retrofitting apartments for that and it won't be nearly as esthetically pleasing to customers although it is not undoable. The problem is with the accounting for the piece of wire that runs through the building before it hits the customer's apartment itself, that's the piece of wire that really causes the problem in the apartment houses, because that one is owned by the customer, so to speak, and covered in this maintenance agreement for the customer and not covered in the regulated rate base after January 1. And that's really where the difference exists and it is almost impossible, I believe, for us to explain that in a way that's understandable to apartment customers or at least in a way that's believable to them, that you own the piece of wire that runs from the garage up to your house or your apartment.

CHAIRMAN ROSENTHAL: The condo is a whole different thing, isn't it?

MR. SCHMIDT: Yeah, it is. Condos, particularly those that have adjoining walls, are very much like apartment houses. Now, customers understand they own a lot of that, or people who buy condos understand they own a lot of things, but I don't think very many of them think they are going to own the telephone wire that might run through two or three other people's condo, depending on how it was wired.

CHAIRMAN ROSENTHAL: Let me ask you -- you've indicated what the utility's first priority is, _____ but was your recent proposal to the PUC to freeze local rates in return for new _____ freedoms a signal that you'd rather not spend much time with utility matters as opposed to new unregulated ventures?

MR. MAXWELL: Not at all. I might also ask Mr. Schmidt to comment on that, but it clearly was a desire on our part to try to move away from a situation in which regulation focused retrospectively on issues of transactions or modernization to one in which the incentives of regulation would do two things. One, it would make sure that the rates that resident customers in particular faced were stable and predictable over the long term; and secondly, with the incentives of the managers of the utility which is separate management from the management of the unregulated businesses, were given the appropriate incentives to manage their part of the business, the utility part, most efficiently. But I'd like to turn it to Mr. Schmidt for comment as well as the Vice President for regulation for Pacific Bell.

MR. SCHMIDT: Thank you, Senator. I guess that I do know a little bit more than Mr. Maxwell about this. I was a witness in the rate stability plan as we laid it down to the commission, and our underlying concerns are that we are not sure what's really going to happen in the world of regulation as we go forward. We believe that resident customers in this state, given our current political climate, should -- will continue to expect that basic access to the network will be subsidized. We have substantial subsidies flowing today from many sources, primarily from the Interexchange Carriers, and from IntraLATA Toll which we'll be talking about tomorrow morning. It was our desire to stabilize the residence rates so that we could direct subsidy toward them and move other prices closer to cost in the event that something cause shock in the competitive environment that we have here in California.

I don't believe that'll come from our State Commission, but it would come from the FCC unless what we support, which is the state has the right to determine what goes in the network and what doesn't as we do. We are concerned about what will happen to customers' rates, particularly the smaller customers. We think that we should also continue to have a former regulation that doesn't result in three-year rate cases. We think that what's been going on with the Public Utilities Commission for the last 30 months or so, since we laid down our NOI, serves neither us well, you will, or the public well, and that we need to get out of the contentious rate case process. Part of that filing indicated, on our part, that we were willing to give up annual attrition cases and rate cases to try to get to the point where we understood that public policy in California said, "We want universal service and low basic rates," and it's our job, as a utility, to provide those at a price that's valued by our customers and let us manage the rest of our business from the viewpoint of which prices need to go up and down and where the subsidies flow from. Not that we don't want the commission to continue overseeing what we are doing, but we believe that we need to do plenty of things on our own part to be ready for whatever eventualities may occur in the 90's. And we'll talk about that -- talk about that more tomorrow morning.

CHAIRMAN ROSENTHAL: Next? Jenny Wong, Regulatory Manager, General Telephone Company of California.

MS. WONG: Good afternoon. My name is Jenny Wong, I'm here this afternoon representing General Telephone Company of California.

General Telephone Company of California is a telephone company and is a wholly-owned subsidiary of GTE. We consider our diversification effort as a little bit more unique and different from the other utilities because both of our short-term and long-term planning efforts primarily focus on our customers needs for telecommunication services and products. We do have a subsidiary -- a wholly-owned separate subsidiary called GTEL. And GTEL was established as a result of a California Public Utility Commission order in our 1984 rate case.

The commission at that time had directed the company to establish a separate corporate subsidiary in order to market and maintain new customer premises equipment if the company wishes to remain in that business, and we did. In its 1984 order, the commission was quite explicit with regard to -- as far as how GTC, the regulated utility, and GTEL, the separate subsidiary, account for their respective expenses. There is a complete separation of expenses with respect to the sale and maintenance of new CPE. With the exception of corporate oversight and a sharing of very limited resources over a short period of time, all the GTEL's expenses are properly identified and accounted for separately from our regulated books. And since the establishment of GTEL, the commission has been very diligently, and spending a lot of time auditing our transaction with GTEL, making sure that all their expenses are properly identified and properly booked in a separate set of books, and so that they could adequately protect the California ratepayer from cross-subsidization.

Now, as far as our future, current and future diversification efforts, I'll say that our company at this point in time does not have any plan to get into any unrelated market -- unrelated telecommunication market. Our primary emphasis would be to continue what we've been doing well, that is, to provide high quality telecommunication services at reasonable prices. And to develop our core network, to enhance our products and services and to continue to improve the quality of our products and services available to our customers either through GTC, the regulated utility or through GTEL, the separate sub.

Now, with the constant scrutiny of the California Commission's professional staff, whether it is in the context of a general rate case or as a matter of general surveillance -- like they've been doing for the last two years for us -- and as a regulated utility, we always keep the commission informed as to what our operations and what our future plans are in this area. So, our company really does not feel that any additional statute at this time is necessary to protect the California ratepayer.

CHAIRMAN ROSENTHAL: Let me ask you a question. You just indicated that all of your activities present and as you see the future, are in telecommunications. What is automatic teller program...

MS. WONG: Okay...

CHAIRMAN ROSENTHAL: ...automatic teller machines, right? Located in retail stores. Do you consider that telecommunications?

MS. WONG: We consider that as an enhanced services of the telephone network. Okay. Let me explain a little bit about that business..

In March of this year, we acquired the assets of a company as a joint venture, we -- I'm speaking as GTEL, the separate sub -- as a joint venture with a FTE electronic fund transfer services, who has the expertise in the automatic teller machine business. And it is basically a network that connects the financial institutions to the automatic business, automatic teller business machines through a regular telephone private line, so that allowing the customers to access and use their bank accounts. About locating them at a convenient locations throughout California, such as the Seven-Eleven stores and their grocery stores, they benefit not only the retailers, the financial institutions, the customers, as well as efficient use of the telephone network.

CHAIRMAN ROSENTHAL: So that it's really -- it's not the kind where I walk up and put a card in, it's the use of the telephone to activate that service.

MS. WONG: I'm not quite familiar with exactly how it operates, but it would be similar. But the connection from that machine to the bank's is through a private line network. It would be just like a card, yeah.

CHAIRMAN ROSENTHAL: I see. All right. Because I didn't quite understand your first statement with what you just said. In other words, it was my understanding that you had indicated that you had a limited diversification agenda which has included cellular telephone franchising, and then when I heard about this automatic teller program, it seemed to be outside of that particular agenda.

MS. WONG: Well, it has a limited... -- well, it really increased the utilization of the network by having the telephone -- by having a unit such as GTEL to provide that connection.

CHAIRMAN ROSENTHAL: I guess it's a definition problem... Another question, it's pretty well-known that U.S. SPRINT has had losses.

MS. WONG: That's correct.

CHAIRMAN ROSENTHAL: And I would like to know if, in fact, any of the local telephone service provided by General, is at all affected in any way literally or potentially?

MS. WONG: It does not. We are not affiliated with U.S. SPRINT, the General Telephone Company of California. And there was a consent decree signed by the Department

of Justice and GTE when we acquired SPRINT. All the expenses and all of their investments associated with SPRINT is accounted for in GTE separately, having nothing to do with any telephone operating companies.

CHAIRMAN ROSENTHAL: So that if SPRINT has a bad interest rate for floating of a bond, it would not affect General Tel?

MS. WONG: No, it would not.

CHAIRMAN ROSENTHAL: Okay.

SENATOR MORGAN: So, that GTE is the parent company. It owns General Telephone and it owns GTE SPRINT. There is not a connection between the two?

MS. WONG: That's correct. GTE, the Corporation, has been in a diversified business for over 25 years and they are in a lot of different business _____ telephone.

SENATOR MORGAN: As I hear your testimony read here, what has happened is that you've stayed within the related business of telephones. And that was the GTEL subsidiary.

MS. WONG: That's correct. GTEL is the General Telephone Company of California subsidiary.

SENATOR MORGAN: And do you anticipate any more purchases or developments of that kind of business within General Telephone as opposed to GTE?

MS. WONG: When you say that kind of business, you mean the telecommunications?

SENATOR MORGAN: Yeah, what do you call it, GTC -- GTEL.

MS. WONG: GTEL. No, we do not have any plans at this time.

SENATOR MORGAN: So you'd anticipate that as far as General is concerned as of today, GTEL would be your only subsidiary.

MS. WONG: That's right.

CHAIRMAN ROSENTHAL: Okay. Mr. Harry Baker, President, Sierra Telephone Company representing California Telephone Association.

MR. HARRY BAKER: Good afternoon. My name again is Harry Baker, I'm President, General Manager of Sierra Telephone Company. Sierra Telephone is among the small group of companies here in California. There are 16 of us at the lower end of the size spectrum. My company has something less than 12,000 customers and the other 15 companies have somewhat less than that.

For the most part, they are family-owned companies to some degree that have grown in the last many years to be more than just a little mom and pop operations that they were after the close of World War II. Taken collectively we 16 small companies serve less than one-half of 1 percent of the telephone customers in the State of California. In my company's case in the mid-1970's, purely for estate planning purposes and for no other reason, we formed a holding company to minimize some estate problems. That holding

company ultimately turned out to be a good vehicle to be able to continue to offer our customers some of the services that were being forced into the unregulated environment. We don't have a subsidiary as such, we've arranged to do that through the holding company that was there and a vehicle that we could use and it's worked rather well.

To respond specifically to your questions, what makes each utility's diversification effort unique from another? I'm not sure that the diversification efforts of the small companies have any particular uniqueness about them and, to a considerable degree, we aren't diversified that much. In our area, and in most of the other rural areas, there are not -- they don't lend themselves to much of an onslaught by competitors. There is not much out there that would appeal to someone to come in and make an effort to give services in those small communities, and to some extent we're least vulnerable to competition in that respect than those companies in the larger urban-serving areas. In our current mode of operations, Sierra and most of the other smaller companies, continue to provide our customers with services which were provided prior to divestiture, either through the telephone company per se or through some holding company or a subsidiary company.

We have long felt a strong responsibility, as I know my other friends in the industry do, toward providing service. You might be interested to know, Senator Rosenthal, that in my younger days I wore out three pairs of snow shoes going back and forth to fish camps. We provided end-to-end service, we were not precluded by the Modified Final Judgment from providing telephone service and in a while that's going through another change now at least with the Modified Final Judgment, we were not precluded from providing our customers with a telephone.

Our non-regulated activities are pretty limited. We presently repair inside wiring and jacks; we do all testing of customer premise equipment; and we make available to our customers a good quality telephone should they choose to avail themselves of it. We advise our customers where it's appropriate, and when they want our advice on the acquisition of specialized equipment; and we sell and we repair business telephone systems and security alarms. You might be interested to know that through our holding company's subsidiary, but it's not, in fact, a subsidiary, we did venture outside of our service area to sell business telephone systems. We've decided now to withdraw from that market and as of the end of the year we are going to confine our efforts entirely to our serving area and not attempt to sell business systems outside of our area. And that was the only venture we made outside of our serving area.

Another one of your questions, what recent acquisitions have you pursued and/or achieved? It's my belief that the small companies seldom make acquisitions of other businesses to enhance their diversification goals. They may embark on a new non-regulated telecommunications activity to fill a need of their users. The single

acquisition which my company has made through its holding company, was the acquisition of a piece of property adjacent to our headquarters building which we foresee a strong need for down the road a few years, and it was more reasonable to do it in the unregulated environment rather than the regulated environment.

What measures have been undertaken to prevent cross-subsidizations? Even though it's kind of a small town, _____ you might say, "We do take that very seriously," and I'll give you some of the details of the things that we do do. The unregulated -- incidentally, the name of our unregulated company is SIERRATEL Tronics -- no magic to the name, it's just ties in with the name of our company, Sierra Telephone. The unregulated is a separate company and has separate accounting records. Vehicles are leased on a mileage basis to the unregulated by the regulated. The mileage is monitored on a monthly basis. Space in the regulated company is allocated to the unregulated based on the square footage of use. We have a long history of separations because for many, many years the Division of Revenue with the Bell System was based on an allocation of space. So, this isn't anything that's new to us and we can do that pretty effectively, we believe. So, that space is allocated on the basis of square footage of use.

All work is covered by time sheets and quoted to the regulated or unregulated as appropriate and this is monitored at two-week intervals. Separate invoices are used for the unregulated. The maintenance of station equipment is done by the unregulated and billed to the regulated. All activity, the unregulated is reviewed monthly to ensure that no undocumented charges are submitted to the regulated.

At what way should the Legislature be acting to protect ratepayers against the threat of cross-subsidization? The current method of separate accounting with appropriate cost and overheads, with Public Utilities Commission oversight, protects the ratepayers against the threat of cross-subsidization. And in my judgment, they should be continued.

And one of your final questions, what are your future diversification goals and plans? Senator and Committee, our goal is to continue to do that which we think we do best and that is render telephone service to our customers and we have no particular -- I have to be -- make that stronger -- we have no plans for any diversification now or in the foreseeable future. Thank you for the opportunity to be here.

CHAIRMAN ROSENTHAL: Thank you, Mr. Baker.

All right. We will now hear from the response group. Yes, Senator Morgan.

SENATOR MORGAN: Mr. Baker, how do you get affected by the FCC ruling on inside wire, and does that change anything for you?

MR. BAKER: Well, like many of these things that were supposed to be transparent to the independent portion of the industry, we're swept up in the tidal wave too. We are doing essentially what Pacific does in this regard; we are offering our customers the

50-cent charge for maintaining the inside wiring and through our unregulated company we are also offering, should they choose to use us, to come out and make repairs to the inside wire. We've chosen initially to start out with what appears to be a relatively modest charge compared with what some of the other companies are making. We are charging \$20 for the first 30 minutes, \$10 for each 15 minutes thereafter. Now, of course, that's subject to change, we don't know if we'll break even at that price or not, but if we do, that's all we want to do.

SENATOR MORGAN: In General Tel, what are your plans in that, in light of this ruling?

MS. WONG: We are being affected just the same way as Pacific Bell. And we are also offering a maintenance program starting now, and giving the customer a 120 days to consider signing up for the maintenance plan and they could drop out at any time during this 120 days and we will refund all the money that they had put in.

SENATOR MORGAN: This is different from the 50-cent insurance program, so to speak?

MS. WONG: (cross-talking) ...similar, yeah, it's the same program, at a slightly different charge.

SENATOR MORGAN: How much different?

MS. WONG: I think that we've been notifying the customers since the last month, and this month we are formally notifying the customer as far as the charge of the maintenance plans. And our charge will be 95 cents a month for the residential customer. It is a little higher, but we have just completed a cost study which we filed with the commission identifying the cost of maintaining inside wire on a 1985 level and it came out to be somewhere close to 60 cents, just for maintaining the wire, not including the installation cost which is also being deregulated. So, our feeling is instead of coming in low, we want to make sure that it is a worthwhile business for us to get into because we do have the option of not getting into the business and we have the same concern as Pacific Bell. We do have a customer in the rural area that, come 1-1-87, if something goes wrong with their wire, they don't have any place to turn to because the other independent operator may turn down their request for repairing the wire because the cost involved.

SENATOR MORGAN: And what is your visit charge going to be?

MS. WONG: There will be no visit charge. Oh, you mean if the customer does not...

SENATOR MORGAN: ...if the customer does not go on the insurance plan, or the maintenance plan and needs to pay a service call?

MS. WONG: It will be \$85.

SENATOR MORGAN: So, if my people from Los Gatos call me and say, "How come I'm paying more than my friends in Saratoga," I can refer them to you?

MS. WONG: It will always be that case, but, you know, instead of -- our feeling is

we should come up with a price that is good for at least a long period of time so then we won't be constantly changing prices once we get into the operation and found out that that particular business is in the red, then we would have to automatically increase the price on a customer, so...

CHAIRMAN ROSENTHAL: So, you are talking about my district now, of course, are you not?

MR. SCHMIDT: Senator Rosenthal, I'm sorry. I neglected to address something that I would like just a second to address, if I can squeeze...

CHAIRMAN ROSENTHAL: Let me, let me... \$85 that's the figure that I have heard and then I heard you give it 65 and 50 cents as against 95 cents, what's all this about competition?

MS. WONG: Well, I would imagine the customer has the freedom of choice. They don't have to sign up for the maintenance plan.

CHAIRMAN ROSENTHAL: Now, wait a minute. I don't have a choice to go to Pacific, do I?

CHAIRMAN ROSENTHAL: _____ (laughter)

MR. SCHMIDT: We have not decided to do anything but maintain our own residents and small business customers wire. Clearly, that's an option that we have, but we have enough problems dealing with our own and taking care of our own to even consider getting into somebody else's business right now.

As an illustration of what would have to happen if you chose to get into the position. There would have to be a whole series of waivers at the Federal level, a whole series of activities at the state level. Clearly, there is a contemplation that all these people will rush into the business. It's not at all clear that that will be true. And we have taken the position through Pacific Bell, we hope to serve our customers and make sure that they are not placed in a position of not having any place to turn.

CHAIRMAN ROSENTHAL: Yes, Mr. Baker.

MR. BAKER: Senator Rosenthal, I neglected to mention that I am not aware of anybody in our service area that is ready to install inside wire or maintain inside wire, that's one reason we are most anxious to continue to do that. Additionally, the only people that we know of in the area who are ready to sell telephone instruments or have been ready to sell telephone instruments, is Sears Roebuck and Radio Shack, and that's why we have continued to make telephone available. Thank you.

CHAIRMAN ROSENTHAL: Okay. Anything further from the utilities? All right. We will now hear from the response group.

Okay. Peter Arth, General Counsel for the PUC.

Would you turn your cards so we can see them? Thank you.

MR. PETER ARTH: Good afternoon, Mr. Chairman and members; so I don't appear under

false pretenses in case there is a record of this proceeding, I am a general counsel with the commission but not the General Counsel.

CHAIRMAN ROSENTHAL: Okay.

MR. ARTH: Okay. I'm sort of sandwiched between tough company, with President Vial appearing this morning and Terry Murray here beside me. And so, what I would like to do is simply toss a bouquet to the committee for their thoughtful work in the last session. I think as much as the diversification issues can be boiled down to the fundamentals, there are fundamental concerns regarding the risk issue, that is, whether any of the risk of the non-regulated ventures can go back to the utility ratepayers; there is the concern with the cross-subsidy issue inasmuch as these entities deal amongst themselves. The one message that we tried to present to the committee last year was that the irreducible minimum is the need for the commission and its staff to be able to effectively audit these transactions. And I think you really put in yeoman's work in fashioning the compromise between the differences of the parties in getting Senator McCorquodale's 2331 enacted. And I think that will serve us well as the committee and the commission goes forward in dealing with the real time forward looking aspects of the diversification story. I was to sort of paint an overview on the telecommunications related aspects of diversification; I think President Vial has done that in terms of is there a difference energy vs. telecommunications; I don't think there is, in term of those two fundamental concerns. There certainly are in terms of the speed with which telecommunication entities are competing with one another with the changes in Federal policy that promote competition and the safeguards that used to be relied on by the commission that are now in jeopardy at the FCC level. And so, with regard to those and what's going on with the PacBell rate case and the specific problems, I'd like to turn it over to Terry Murray.

CHAIRMAN ROSENTHAL: All right. Terry Murray is Advisor to PUC Commissioner Victor Calvo.

MS. TERRY MURRAY: Yes. Thank you Senator.

I'd like to pick up on the theme that Commissioner Vial and now Pete Arth has brough forth about differences and similarities between telephone company and energy company diversification, and then offer a few other observations on the basic problems before the commission, some specific responses to Mr. Maxwell and some observations about our continuing staff audit in the Pacific Bell rate case.

But first, with regard to the differences or similarities between telephone and energy diversification, I think as Pete has pointed out, it's really basically the same problem, but there is one important difference in the motivating force behind the diversification efforts. In the case of the energy companies as Commissioner Vial pointed out this morning, we've got a situation in which the companies themselves in large part due to the diminishing need for investment in central station generation

plants, are building up cash reserves, not so much, I think, to pick up on Senator Greene's point of this morning because of an excess return on their investment, but simply through the depreciation process we are returning the investment that the shareholders made and we don't need to reinvest those dollars in new plants, so there is an issue as to where that cash goes. So, for the energy companies the motivation seems to be more a financial one. You've got dollars sitting there, what are you going to do with them? For the telephone companies, it's a little bit different. What they are looking at is a physical asset, the telecommunications network that has been built up to serve local customers, and a body of experience gained through providing that business, that's the asset that they are seeking to maximize. It's not so much a financial asset, but a physical and experiential asset that they no longer can develop solely through the regulated companies because of actions on the Federal level and the divestiture in the case of AT&T and Pacific Telesis. So, I think there is a really different sort of motivation there that's driving the two businesses and that leads to some of the other differences and problems that we are experiencing at the commission level, and...

SENATOR KEENE: Question.

MS. MURRAY: Sure.

CHAIRMAN ROSENTHAL: Senator Keene.

SENATOR KEENE: I understand the situation you just described with respect to telecommunications but not with respect to energy, could you simplify it a little so that...

MS. MURRAY: Okay. In the energy case, I mean it's really a matter of dollars. It's not that the energy companies are necessarily trying to do anything that relates to their current lines of business. They've got cash reserves built up from depreciation, and depreciation is usually intended to return the dollars you've invested in a plant to make it possible to replace that plant, but if you don't need to do that, you've got all these dollars sitting there and you've got to decide what to do with them. Now, one option obviously is to return it to your shareholders as dividends. There are tax reasons why that may not be as attractive as reinvesting the dollars within the company in other lines of business. And the energy utilities, as San Diego Gas and Electric said to us in their application for a holding company, do not see the opportunity for investment being within their regulated business; they feel that the competition from independent energy producers that reduce growth and demand for electricity and so on, precludes them from having opportunities to reinvest those dollars in their traditional regulated businesses.

SENATOR KEENE: Okay. Is that a temporary situation, the surplus dollars, or is that going to continue into the indefinite future?

MS. MURRAY: I think that will be a very difficult thing to assess on a company by

company basis it will probably differ; for example, the San Diego service territory, I think, is one line which growth is still fairly substantial; that's not as true in PG&E's service territory. Then you have other issues -- PG&E in its rate case has indicated to us a need for a substantial replacement of its transmission and distribution plants, so they have need for reinvestment of those dollars in other kinds of facilities whereas SDG&E does not seem to have those same needs. So, some utilities such as SDG&E may for a long time have these excess cash reserves. Others may have investment sources within their regulated business that they need to turn these dollars over anew. It's not easy to generalize, and until we get the picture on demand with the oil prices having gone down and so on, we really don't know where the demand for energy is going in the next five, ten, fifteen years. We have excess capacity now and probably into the 1990's, but what we will need after that is anyone's guess, and where we will get it from, remains to be seen.

SENATOR KEENE: So, the potential for more diverse diversification is with the energy companies and, therefore, the range of problems -- potential problems -- is greater.

MS. MURRAY: I wouldn't necessarily say the range of potential problems is greater, and I was about to get to how the different kinds of diversification relate to the problems we experience as regulators. The problems are different. You won't experience the same kinds of cross-subsidization problems if you are going into very unrelated businesses, just by the nature of the diversification. You are not sharing the same facilities or the same personnel. You may have other kinds of problems just related to how the cash flows back and forth between the entities. You want to make sure that that's being done in a fair way, but they are different kinds of problems.

SENATOR KEENE: Okay. Let me listen for a while. Thank you.

MS. MURRAY: Sure. As I was about to state, the telecommunications companies differ from the energy utilities in the nature of the diversification they pursued. In telecommunications we've mostly seen the companies moving into closely related businesses. You heard from Ms. Wong that GT of California intends to stay totally within telecommunications. Certainly to date our experience with telesis has been that virtually all of their diversification is into closely related businesses. PG&E on the other hand, considered the conglomerate diversification route when they proposed to acquire Nutrasweet from Seale; certainly the pattern we've seen with SDG&E and Pacific Lighting, the Thrifty Drug thing, the real estate development, is more of a conglomerate kind of diversification into unrelated activities. And I think, as I mentioned in responding to Senator Keene, that creates real differences in the cross-subsidization problem -- I'll get back to those in a moment. I would want to observe here that there is an interesting tension in our San Diego Gas and Electric holding company order, we

noted that diversifying into closely related businesses, makes a lot of sense if you are just a manager or maybe a student doing a case study at Harvard Business School. It's where your profit opportunities are greatest it's what you know how to do, it's where you have a reputation, so for the shareholders in the company that makes a lot of sense. And we were concerned to some degree with the San Diego application that if the company were to diversify into very unrelated businesses, their chances of success in those businesses were not necessarily all that great. What they had to offer was really just dollars, not expertise. So, on the one hand, it enhances this cross-subsidization problem and it really makes our regulatory controls more difficult for us, as I'll describe when I get to our auditors report.

The second issue, of course, is the structure, and you've heard a lot about that this morning, holding company vs. utility/parent subsidiary structure. As you've all noted very correctly, the holding company structure has real advantages in terms of protection of the financial security of the utility subsidiary. If you have that kind of structure, it does protect your bond ratings, not 100 percent, there is always a devastating loss that the holding company level could affect the financial security of the utility subsidiary. But the utility parent subsidiary structure has other kinds of advantages. In the San Diego case again our public staff was opposed to the formation of that holding company even with conditions, it was their second choice because they felt it would diminish our regulatory control, and this has been the subject of a lot of debate, and the legislation passed last year certainly helps by improving the access to books and records on the holding company level; but I think you can't write off those problems by giving access to books and records, and that's where I'd like to get into some specific responses to what Mr. Maxwell brought up today.

He noted that our auditors have been looking closely at the transactions -- of course, you are very aware of the audit report last year and the penalty adopted by the commission because of what we perceived to be insufficient access to affiliate books and records. Mr. Maxwell noted that only 1 percent of the transactions have been found to have problems. Well, from what I hear from our auditors it would take an army of accountants to monitor closely much more than 1 percent of the transactions. So, I don't know whether that reflects the level of problem or whether it reflects just what you are able to monitor. This is an enormous problem looking at all the different transfers that go back and forth. It's not something that you can just pick up and do very simply. He also noted concerns about the public staff's report as it was picked up by NARUC and the NRRI study, and said, "Well, people hadn't gone down to look at the record, there were inaccuracies and there was an incomplete information." That phrase "incomplete information," I think, summarizes it all; of course, there is incomplete information. We can audit this company for the next decade and not have a complete picture of what's

going on.

Our auditors have discovered a real problem in dealing with all of these companies. The most cooperative companies will respond to the date of the request Southern California Gas described you this morning in the rate case process with literally thousands of pages of information. Now, you can say that's cooperation, and helpful; you can also say, how in the world does a team of public staff division auditors supposed to shift through those thousands of pages in the time allowed for processing a rate case application and come down to the bottom line. It's not a simple process, we don't have all the answers. Regulatory controls are extremely difficult. That's why Tom Lew, the Chief of our telecommunications auditing branch in the public staff in issuing an update on the staff audits investigation on November 14, described the guidelines, noted by Mr. Maxwell this morning in the following words; he said, "The audit team's initial assessment in that these guidelines lack implementation procedures and further that the implementation of these guidelines or any guidelines, for that matter, will not provide the satisfactory solution to the problems created when the holding company corporate structure is used in the environment of regulated utilities."

The guidelines are an important first step; I don't think the guidelines would be in place today if it hadn't been for last year's staff audit report that noted so many improprieties and questions in the transactions occurring between Pacific Bell and its affiliates within the Pacific Telesis. But the guidelines are not self-enforcing, and it's really very difficult to imagine ever having enough personnel to make sure that they were being applied strictly to every transaction that occurred. So, when you are going into closely related activities, you simply cannot expect to prevent any and all possible cross-subsidies. And that's where our staff auditors have come up with a recommendation that we pick up on the commission's order and the holding company decision for San Diego and impose a 5 percent across-the-board royalty payment on all Pacific Telesis affiliates. That is intended to pick up on the fact that you can't find everything that goes on, you can't measure every benefit received by an affiliate of a regulated utility especially when that affiliate is in a closely related business. You simply cannot make sure that proper activities and compensation to ratepayers are taking place across the board. Some of the specific problems that our auditors are still complaining about -- and I stress, as Mr. Maxwell noted that the commission has not yet made findings on these, these are in the hearing process -- but there are concerns about interlocking directorate and common offices...

CHAIRMAN ROSENTHAL: Wait, wait, wait!

MS. MURRAY: Certainly.

CHAIRMAN ROSENTHAL: I thought that they were completely separate. They're not?

MS. MURRAY: I think Mr. Maxwell can address that more specifically than I, but I

understand that until April of 1985, for example, Mr. Guinn, who is the CEO of Telesis was also on the PacBell Board of Directors. He has since stepped down, but I am told by our auditors that he still attends strategic planning meetings of the Pacific Bell Board. Obviously, when you have personnel that are used in both areas whether they are management personnel or operating personnel at a minimum, there is proprietary information that becomes accessible to the competitive side of the business on the Telesis side that would not be available to other competitors out in the world. And you get into real problems here. There is a "synergy value" as the term has been used to the connection between Pacific Bell and these unregulated ventures. It may have potential for returning things to PacBell's ratepayers, but you've got to question whether the returns are coming back adequately and whether competition is being adequately protected with these kinds of relationships. So, those are the sorts of observations our auditors are making, they are very concerned about practices with respect to these intangibles even more so perhaps than the tangibles, the actual physical goods being sent back and forth. I think some progress has been made on things like property held by Pacific Bell being transferred to affiliates at less than market price. Those are the kinds of things where we can put guidelines into place and monitor fairly directly whether things are being done correctly.

These other kinds of problems, however, the information transfers, you are never going to be able to tie down completely, and certainly you'll never be able to eliminate the affiliates benefiting from the name and reputation of the utility when they go out into related ventures on the unregulated side, the simple fact that a company can come up to a customer and say, "I represent Pacific Telesis, you know us, we are the guys who have been providing your phone service for the last 100 years." There is nothing that you can do short of some kind of payment from the affiliate to the regulated entity to recognize the benefit of that association, because the name itself does the job without any other kind of association whatsoever, on any improper activity on the part of the competitive business.

CHAIRMAN ROSENTHAL: Question, Senator Keene?

SENATOR KEENE: Yeah. Obviously, someone is going to ask the question, "How do you arrive at the 5 percent?" But maybe more importantly, what is intended by the imposition of a royalty? Is it intended to deter those kinds of relationships or limit them or is it intended to impose an equalizing burden on the relationship or -- I mean how does all this work? Or is it just the sort of, "We are throwing up our arms at the difficulties of auditing and we are just going to do what we can to try to redress an imbalance."

MS. MURRAY: First, let me stress that the 5 percent number is a recommendation from our public staff in a proceeding that is ongoing and it's not something adopted by the commission. As I understand that recommendation, it picks up on the philosophy

expressed in our holding company decision last March that there are certain non-quantifiable benefits of association, so the number is in some sense inherently arbitrary.

SENATOR KEENE: What does it have to do to the quantifiable benefits?

MS. MURRAY: It has nothing to do with quantifiable benefits. The affiliates' payment as was proposed in the San Diego Gas and Electric Company holding company decision, was intended to address only the more general aspects of association, where there were specific properties being transferred and so on, those would be judged by specific market tests. So, this royalty recommendation would do two things. It would, to some extent as you've mentioned, levelize the playing field for competitors; it would say to an affiliate of a regulated utility, that if you are engaged in a business closely related to the utility's business and you are going to benefit from the expertise, the name and the reputation of the utility, you have to do two things. You have to play fair with competitors by paying the value that the competitor would have to pay to get that kind of name recognition and customer referrals, because one of the problems our auditors have brought up, problems of referrals from Pacific Bell to Telesis affiliates. That sort of thing is hard to buy in the open market. So, it pays for that and also, most important to the commission, make sure that the ratepayers are compensated for the value of the expertise and the reputation of the utility that has been built up at ratepayer expense over the years. So, it's really that that we are trying to capture with these concepts, in fact, the alleged benefits of diversification to ratepayers can only exist if there is some payment of this sort. Otherwise, nothing comes back to the regulated utility.

SENATOR KEENE: Okay. So you are going to seek the tangibles that you can find...

MS. MURRAY: The tangibles... Yes.

SENATOR KEENE: ...and these are the less tangibles or intangibles?

MS. MURRAY: That's right. And whether 5 percent is the right number or anything, that's before us in hearings and I don't have an obvious answer to that one.

SENATOR KEENE: Thank you.

MS. MURRAY: That really concludes the direct remarks I wanted to make. I'll answer any questions.

CHAIRMAN ROSENTHAL: Senator Morgan.

SENATOR MORGAN: I know that you are not the staff person that developed this 5 percent but can you give us any insight into how this percentage has been arrived at or what you think will ensue in arriving at a figure? What's going into that calculation?

MS. MURRAY: I think the 5 percent, and here I'm a little bit hesitant to speak for the staff auditors who have developed this recommendation, but as I understand it, it represents their informed judgment based on the nature of the transactions that they have

observed in their auditing, the kinds of transfers of intellectual properties, loaning or use of personnel back and forth between the regulated entity and its affiliates and so on. I really don't know how the record is going to shape up, hearings are still ongoing in this proceeding, and of course, Pacific Bell has some very specific responses to the 5 percent as to its propriety and level. That record will be assessed by the administrative law judge and the recommendation will be before the commission probably some time early next year. So, I don't have many more specific observation to offer you at this time.

SENATOR MORGAN: Maybe it's premature of me to venture an opinion. But I don't have any trouble with our insistence that we keep the records clean, that there is an audit trail, and your track expenditures and you are not given advantage for having been in the business a long time by allowing funds and expertise to flow back and forth unattended. But I think to try to start putting a dollar value or a percentage value on the value of a name, you'll get really -- I question why you feel you can regulate that kind of thing or should.

MS. MURRAY: Although it's certainly true in private enterprise that there is a market for things like trade names and associations, whether the process that's been gone through in this proceedings has correctly quantified that, I think you might find, if Pacific Bell were to put up to auction the right to affiliate with it and offer these kinds of businesses, the competitors of Pacific Telesis affiliates would be willing to offer some dollar value for the right to be affiliate with Pacific Bell in offering these services.

SENATOR MORGAN: But you are going to treat Pacific Bell as a utility and you are going to say that they can't absorb any losses from Pacific Telesis nor should they have to -- but you'd like them to have the benefits from it.

MS. MURRAY: I think when you say, "...have the benefits from Telesis," what we are talking about is only capturing those benefits that Telesis is receiving from Bell, not taking any other benefits generated solely by the activities of the Telesis affiliates. So, for example, the commission indicated in its holding company order that it does not believe the cost of capital to the regulated utility should be somehow subsidized by earnings from the affiliates. And if the affiliates have high positive earnings, that doesn't detract from our obligation to provide an adequate opportunity to earn a full rate of return on the utility investment, that I think would be an example of trying to benefit from the diversification without being willing to absorb the losses. We are talking here about a difficult to quantify problem but one that is still directly analogous to paying for what you get. I don't know whether the commission will find that it is possible to put a realistic dollar value, but conceptually, it's certainly the same thing. It is paying Bell for services rendered, not trying to benefit from the

affiliates.

SENATOR MORGAN: But I'm hearing you say, "The service rendered is the use of the prestige of Pacific Telesis."

MS. MURRAY: It would also be the access to information gained from the flow of employees back and forth.

SENATOR MORGAN: And that's where I can understand your need to put in a good tracking system, preferably, not to have that happen. But you are saying that Pacific Bell, you know, should -- Pacific Telesis, as I hear should pay a percentage for the quality of their name to the utility to benefit the ratepayer. But what happens if Businessland becomes so successful they put PacTelesis with their equipment and so on out of business? You are going to expect the utility to help cover that loss?

MS. MURRAY: That certainly would get to the point that the commission raised in its holding company order in which had it indicated it wanted to have hearings as to how to set such payments and how to review the appropriateness of them at any point in time. I would agree with you that it's difficult to say one figure for all lines of business at all points in time is an appropriate number. That is simply the public staff division's recommendation at this time.

CHAIRMAN ROSENTHAL: Of course, it seems to me that one of the things she indicated that staff had a hard time because they didn't really receive from Pacific Telesis all the information that they wanted. Now, there is disagreement as to whether they gave all that information or not, but there is a question, at least in the minds of those who are doing the auditing, that there were bits of information that was not available to them. Now, I don't know how you...

SENATOR MORGAN: What's a fair amount of time though, the divestiture took place two years ago? That to some people seems like a long time, to other people -- what's a fair period of time to sort these things out?

MS. MURRAY: Again, I don't have an easy answer for you. I think the point the staff is making is really a relatively simple one. You can't get an answer to a question you don't know how to ask, and unless you had people dogging the trail of every single employee of Bell and Telesis every day, you wouldn't know what kinds of things might be going on within the company. It's one thing to say you are going to look at specific transfers of physical assets, but these other sorts of things are very difficult to get hold of. I think that's the kind of concern that we are talking about here and it may be, as you say, that this isn't the right club to go after it with, but it's certainly one proposal that the staff is pursuing vigorously.

SENATOR MORGAN: Fair enough to explore all possible... I just tell you I think that's...

CHAIRMAN ROSENTHAL: Well, okay. Spencer Kaitz, President; Michael Morris, the

Director of Regulatory Affairs for the California Cable Television Association.

MR. MICHAEL MORRIS: Thank you, Senator. I think I'll start out; I'm Michael Morris from the California Cable Television Association. I appreciate the opportunity to address you this afternoon. I want to start out by applauding you Senator, and your committee for continuing to study this issue of utility diversification which I think is one of the most important and certainly one of the most difficult issues facing the Legislature in the coming years.

It's very clear from this morning's discussion and now from the discussion that's ensued this afternoon, that this committee is well aware of many of the problems of utility diversification, and also is quite concerned about them. So, I'm going to dispense with the beginning part of my presentation which was another review of those problems and instead turn to some examples of these problems which have arisen in the past year in the cable context, and give you an idea of why we in the cable industry, are so concerned about this diversification issue.

I'll give you several recent examples. The first is in Ohio where there is a lease-back cable system that's been proposed by the local telephone company, I think, in Cleveland. Remember a lease-back system is where the local telephone company builds the cable facilities and doesn't operate the cable system but leases that capacity to a cable operator or some third party that provides the programming and markets the services. It's a kind of system that Pacific Bell is constructing in Palo Alto that's a lease-back system.

The telephone company, the Telephone Company of Ohio has applied to the FCC for authority to build this system and it's been challenged by a competitor there. Now, this is not a cable operator who is the competitor, but what we call an MDS operator, someone who provides through microwave systems the same kind of competing video programming that we provide on cable systems. Now, they've charged one of the bases of their complaint is something that ties into some of the concerns you were talking about this morning that has to do with the financing of these activities, these diversified activities. You were talking about the bonding of problems and how you separate out the financial impacts and so forth. And evidently, in this situation in Ohio, one-fifth of the cost of the payments that this lessee was supposed to be making to fully compensate the telephone company for the construction cost of this system, are being deferred to some other date and the competitor there is charging that this is actually a loan by the telephone ratepayers to this lessee, and is an improper kind of cross-subsidization. That's an example of the kind of financing problems that we saw that were raised this morning.

Another situation -- two other situations actually are in Florida; one is a proposal by Southern Bell in a part of Orlando to build a lease-back cable system there. And this is actually something that the FCC has already granted this authority to do,

although it's a great deal of concern because this is a small system — some 1,500 subscribers. In its application, Southern Bell says, "This isn't really financially justified," and if you work through the numbers, they are going to sustain operating losses every year to very near to \$1 million. This is only a system that passes 1,500 subscribers. Now clearly, the telephone ratepayers are going to pick up the tab for the \$1 million a year loss; and this is the kind of example of a diversification into the cable business that we are concerned about.

Another example in Florida involves a subsidiary of Florida Power and Light, which has entered the cable business in Florida. Now, it's done in kind of a different way than we see people in the cable business normally operate. It's adopted a very aggressive policy of overbuilding existing cable systems. Now, it's possible that it's financially viable to overbuild an existing cable operation. But yet, I think if you are going to go into the business of operating cable systems, you would probably not start off that way. You'd probably get experience operating a cable system; you'd see that you are very low cost provider; you'd expand maybe into contiguous areas if you were going to overbuild and so forth. And be very discriminating about overbuilding in areas where the existing operator is doing a very bad job, price is too high, the customers are dissatisfied, and so forth. That isn't the situation that we see in Florida with this Florida Power and Light subsidiary; we see very aggressive overbuilding, which to me raises a concern that there is a cross-subsidy that's likely to be happening there or it just would not be financially viable to go into the business in that fashion.

The other thing is, we see this activity and this interest in this Florida Power and Light subsidiary in going into the cable business in this overbuilding sense, only within its own service area. And this ties in to some of the concerns that were raised here earlier and this morning, that when you get involved in a business that's very closely related with your core utility business, and then you engage in this business only in your utility service area, you really maximizing the potential for abusing your utility ratepayers.

SENATOR KEENE: Question.

CHAIRMAN ROSENTHAL: Yes, Senator Keene.

SENATOR KEENE: What occurs to me is that whatever we may do legislatively to try to prohibit cross-subsidization in order to protect ratepayers that what we will do, to use Peter Arth's word, would be so general that it might not be effective. Wouldn't better recourse be either through the courts where you can in a specific instance document cross-subsidization and injury to yourself as a competitor, or somehow through the administrative process through the commission? I mean, isn't it eventually going to come to that anyway, that we can pass laws dealing with the subject, but ultimately, you've got specific cases before you in which either cross-subsidization has or has not

occured?

MR. MORRIS: Well, I think what you are saying is possible. You really need to have some way of the aggrieved party of addressing the situation more. Now through the administrative process there is a problem, as has been explained, that it just -- in an accounting sense, it's so expensive and so overwhelming to go in and track down these specific sources of cross-subsidy, that it's just a remendous burden. It's perhaps possible, but it may not be the most effective way of addressing the situation. We have suggested another approach over the years, and that has to do with the private remedy. Currently, the utilities are immune from the state unfair competition laws to the extent that any of -- that their prices for these services are generally under tarrif. Some of these, for instance, these lease-back systems, would be a tarrified service, so they would be protected from the laws of the state which allows aggrieved parties to pursue a competitor who is engaging in predatory pricing. One thing that we have suggested is an amendment to that law which would allow competitors to, in a judicial sense, go after that problem.

SENATOR KEENE: But your problem is not competition from the regulated utility. Your problem is competition from the unregulated subsidiary, isn't it? And if it is, they certainly wouldn't be exempt under the Unfair Competition Act; why can't you go after them?

MR. MORRIS: Well, Senator, I think there is two things that are going on. In certain circumstances it's unfair competition by an unregulated subsidiary. For instance, in this Florida Power case that I'm talking about, the cable business is being provided by an unregulated subsidiary of FP&L which is the holding company. In many of these other cases in which we are talking about these lease-back arrangements, those, although they are competitive activities and they compete with others bidding to get into the cable business in those markets, those services are being provided as regulated services by the utility within the core of its business. And that's what makes the cross-subsidy problem so difficult. You are dealing with a business that is totally intertwined with the provision of ordinary telephone service. You're sharing the same linesmen, you are sharing engineers, you are sharing plants, center office plants where you propose to house both your telephone switches and perhaps the head-in for the cable system, and you are just engaging in business in a way that absolutely maximizes the potential entity the potential for these problems arising.

SENATOR KEENE: And if you sue the unregulated entity that was in competition, you think that they would be protected by the umbrella of exemption from unfair competition laws that affect regulated utilities?

MR. MORRIS: As to suit under the Cartwright (?) Act, yes.

SENATOR KEENE: Well, you know, I haven't delved into the area at all, but that

surprises me. If it is, maybe, you know, maybe that is an area that we could look at.

I think Ms. Murray has some comment on that.

MS. MURRAY: I'm not a lawyer and no expert on the states unfair competition laws, the one point I would make is that to the extent we are talking about tariffed services offered by the regulated. Utility an additional remedy is to intervene in the process of the tariff setting or to file protest if the tariffs are set by what we call an advice letter process. Those are public documents and there is a period before those tariffs are allowed to go into effect. So, there is that sort of remedy available as well.

SENATOR KEENE: But if they are unable to develop the information that your auditors can't -- you know, have difficulty developing, they are really at a disadvantage.

MS. MURRAY: They are at a disadvantage there, they would be at the same disadvantage in the courts and everywhere whenever you are talking about so-called "joint and commons costs." An economist will tell you that there is no absolute correct way to allocate those costs, so any provisions of the service at a cost above the incremental cost of providing that service, can be deemed in some sense to be a fair and nonpredatory price. You get into very difficult definitional problems there.

CHAIRMAN ROSENTHAL: Would you -- you mentioned, for example, something happening in San Jose, and because this is California, I'm interested in what's happening in California.

MR. MORRIS: In Palo Alto?

CHAIRMAN ROSENTHAL: In Palo Alto, I'm sorry.

MR. MORRIS: On Palo Alto, this is a kind of franchising situation that's gone on for quite a number of years now, but...

SENATOR MORGAN: Would you believe since 1969?

MR. MORRIS: 1984 is where I'll start (laughter). But the city had a Request for Proposal. Several entities responded; one of whom was Pacific Telephone, I think at the time, and proposed to the city that Pacific Telephone simply build a cable system and lease it to the city. We had significant problems with that approach, and in the end that's not what happened. Pacific now has contracted with the cable operator who was selected by the city -- franchised by the city of Palo Alto, and Pacific Bell has contracted with the cable operator to construct a cable system and lease those facilities to that cable operator. [It] continues to be a concern of ours to whatever way for us is possible and for the PUC and for the Legislature to watch these relationships develop to make sure that those lease-back facilities aren't being provided on a subsidized basis. But the examples I gave you were examples of problems, when utilities get involved in the cable area, and I did want to contrast that, I don't think that this in every case across the board has presented problems. SANTEL Telephone Company, which is very active I think

in the midwest area, is also in the cable television business and has been for many years, and we have never had a problem with the way in which SANTEL engages in the cable business. Primarily because their cable operations are outside of their telephone service areas. They are very careful to do that to avoid any questions of cross-subsidy; they have totally separate subsidiaries which provide the cable service, totally separate management of those companies, separate financing, separate financial reports and so forth. We think that's a responsible way for utilities that want to be in the cable business to go about doing it.

The examples I gave were outside of California. Quickly within California, I will just mention that we were recently involved in a dispute with Pacific Bell, this is over an application that Pacific had filed -- an advice letter showing intent to build a cable television system in the city of San Francisco which would be leased to a customer that would serve 18 hotels in the city; and I've provided a copy of our protest to that earlier to your office, Senator.

We had some problems with this. It did not propose any of the kinds of cross-subsidy protections that have been talked about today, not even to the extent of having separate books or any kinds of financial separation that would be at a minimum appropriate. In addition, it was done in a way that failed to protect legitimate franchising interests of the city. This entity that was to lease the facilities, had not received the cable franchise; no franchise fees were being paid to the city which the Legislature and the Congress have deemed to be a legitimate interest, and the city, therefore, didn't get any input into other needs of the subscribers such as governmental access, public access and so forth. Now, we did object through the advice letter process at the PUC to that and Pacific, after our protest was filed did withdraw its proposal to offer that service. Of course, we mentioned the ongoing situation in Palo Alto that bears watching.

Finally, in California as I understand it, General Telephone of California is interested in pursuing the possibility of building a lease-back cable system in the city of Cerritos. I think that will be an interesting situation to watch for a couple of reasons. When General Telephone of California submitted its proposal to the city, it explained that this was possible but that it would have to be subsidized by the city because there was no way that the system would be financially viable and that the Public Utilities Commission wouldn't let them get involved in a project that would lose money and result in the risk being shifted to their ratepayers.

It's also a system, as I understand it, that's being proposed that raises some other concerns and difficult accounting concerns because it involves building a large capacity system and leasing only part of that capacity on the one cable to the franchise cable operator in Cerritos, but utilizing the other capacity in that cable for the

telephone company's own telecommunication purposes. And I think that raises additional very difficult cost allocation problems when you are not only talking about, you know, installer's time, pole attachment questions, and so forth, but you are actually talking about allocating the cost of capacity on one wire.

CHAIRMAN ROSENTHAL: How do you deal with that?

MS. MURRAY: Not very well. There aren't -- this is a problem that runs through the utility business and it's a constant tension in antitrust law. You want to use what you have efficiently, so you don't want to build duplicative systems and so on. There are not any rules. The separations manuals that you've heard referred to -- tend to go to relative usage factors like that to allocate costs. You can do that obviously retrospectively. You can look at how the line was used to the extent that you keep that kind of data and you don't always on a communications system, especially a so-called "private line." But you -- that isn't necessarily an economic principle of cost causation. I can't give you a simple answer because there isn't a right answer theoretically.

SENATOR MORGAN: Can I ask you then, Ms. Murray or Mr. Arth, do you feel as representing PUC, you can track the cost and the expenditures that have gone in, for instance, in Palo Alto to PacBell's activities with the cable TV?

MS. MURRAY: I can't answer you specifically on the Palo Alto situation. I haven't looked at that. We have had several applications before us recently to put in fiber-optic systems for private systems and have added to our approvals of those requirements that the ratepayers be made whole over the life of the contract. Pacific Bell has agreed to these requirements; we do have internal concerns as to what teeth a requirement like that can have, how you can actually go back through the records and make sure that all costs have been properly allocated to those contracts. We think we can probably do that as well or better than anyone else, we've got the staff that's been working with this kind of equipment and looking at it over time. I think the answer is that no one can do it perfectly and that's why we are nervous.

SENATOR MORGAN: And so that it's not like the separate subsidiary coming into work with the city in setting up the cable TV?

MS. MURRAY: Again, I'm not familiar with that example. But no, typically, it's not like that and there are good reasons of economic efficiency for not doing it that way. But then you have the potential for cross-subsidization in spades.

SENATOR MORGAN: And the fibre-optics is not a -- it could be of general benefit to all the ratepayers within that location?

MS. MURRAY: It certainly could. It's a high capacity system and unless the user that wants the system needs the full capacity, it would be foolish in a sense not to make it available to others.

SENATOR MORGAN: So, you are dealing with a very different issue really when you are talking about fiber-optics and a telephone company, and talking about a telephone company buying real estate.

MS. MURRAY: Exactly. We are talking about a telephone company using its central office equipment to provide an enhanced service. This is the problem we were discussing earlier.

MR. MORRIS: Mr. Chairman, just one thought as I close here. In your introduction this morning, you mentioned your concerns about the deregulation of inside wire and you mentioned that you saw concerns both as to the anticompetitive facts on other providers of wiring services and to the competitive risks which might befall the monopoly telephone ratepayers as the phone company would get into this in a competitive sense. Similarly, Pacific Bell has recently asked the PUC for authority to detariff its billing services, and that request raises these same public policy questions and, in fact, TURN has protested the Pacific application on these same public policy grounds. And what the TURN protest and what your -- and all of our discussion this morning I think raises, is the key question: It is -- does the ratepayer have any possible benefit to be gained from this diversification activity? That's the question that has to be answered. If the answer is yes, then it's necessary to weigh that possible benefit with the risks that the ratepayer faces from shifting of costs and risks from the competitive activity to the ratepayer. That concludes my presentation. I think Spencer has some thoughts on that last issue and if there are no questions, I'll turn it over to him.

MR. SPENCER KAITZ: Thank you. Spencer Kaitz, President of the California Cable Television Association.

Our view on the fundamental question as to whether there are benefits from diversification to the consumer is that that case has by no means been demonstrated. The benefits to the consumer raised by Mr. Maxwell, his testimony, for example had to do with common costs; yet 95 percent of the revenue at this point is from the regulated utility. Profit from sales to affiliates was mentioned but Senator Morgan is already troubled from the efforts the PUC is having in trying to deal with what, in fact, is owned the ratepayer.

From then -- the regulatory difficulties I think have been adequately covered, although I note that Mr. Maxwell in his enthusiasm to emphasize that by regulation, these issues could be dealt with said that the CPUC has the right to go through and I quote, "...every transaction, every subsidiary, every record." What we are finding out is that the burden of going through every transaction, every subsidiary, every record with multibillion dollar a year corporations is enormous and probably impossible. So, our view, frankly is that the policy that -- the policy direction that has utilities going into diversified businesses, is wrong from the start and a better way to approach it

probably would have been at the outset to say, utilities ought to serve customers, and the utilities where they, as PacBell, have been traditionally and primarily in that business. However, it's clear at the same time and we have to concede as well that to some extent PacBell and others have been forced into some diversification efforts by FCC rulings. And, I would like to clearly distinguish in my comments those businesses from the situations where they are venturing forth into completely different businesses. I think that we all agree that it's important for PacBell to continue to have a facility available or service available to keep wires in place for customers for a variety of reasons. So, they have to be in diversified businesses and you have as policy representatives, decision makers have to wrest with that issue. But that's very different from their going into the cable television business and into the computer business, into the real estate business. And those are the areas of our concern where they are moving beyond businesses that they're forced into by policy decisions by the FCC into areas that are not traditionally their business and essentially represent an effort to move money from utility dollar money into unrelated businesses.

The only way we see of solving those problems if you decide that is either to say, they shouldn't do it at all, or if they do do it, to do it in a way that deals with the problems that Senator Morgan was getting at and I think also Senator Keene, and that is the impossibility frankly of ultimately going through each of those transactions. On the one hand none of us want to see the telephone company, the Public Utility Commission quadrupling their personnel and dealing endlessly with each of these transactions. And yet on the other hand, there is a very real possibility of damage to the consumer and damage to other businesses. The way we've looked at solving that is when our board sat down and brainstormed this issue two or three years ago, was to say, "What kind of outside marketplace forces can you establish to help the PUC with that?" And what we came up with as our thinking in it was to have a requirement of fully separated subsidiaries with separate auditors and separate shareholders and a change in the antitrust laws that permit those separate entities to be dealt with as if they were unrelated to a utility business. Now, this isn't a well-thought-out plan, I'm simply giving you our thoughts in terms of how far you have to go to try and get away from the problem, and I think we've been struggling with -- I know Senator Morgan, you are very worried about Senator Rosenthal's bills because of the complexity of them and the extent to which the PUC had to intrude into private businesses to deal with that, and I think that's a legitimate problem. On the other hand, I think it's fair to say that we feel strongly that Senator Rosenthal is dealing with a very serious problem and that there has to be -- you either have to get into that kind of scrutiny or you have to look at a completely different mechanism. The example I would give and the one that's been thought of highly in our own board context is, "CBS was required for regulatory purposes to spin

off a subsidiary some years ago called VIACOM. And what happened in that spin off was that they gave the company a new name, new shareholders, new auditors, and accomplished in effect a complete separation, which is not, frankly, what we are seeing happen at least in the PacBell case which is the only one I've -- really been studying. When the names Telesis, continues to be used on subsidiaries raising the kinds of problems we were talking about earlier, and there clearly isn't that desire to completely separate it out; it's not simply an investment in a different corporation that will have a life of its own and has its own shareholders, so you have people with a vested interest in making sure there aren't -- there isn't money flowing one way or the other.

CHAIRMAN ROSENTHAL: Okay. Keith Askew, Vice President of California Teleconnect Association.

MR. ASKEW: Thank you, Mr. Chairman, Senators. I'm Keith Askew, Chairman of the California Teleconnect Association, and we, as an Association, appreciate the opportunity to address this committee as it regards the need for additional legislation to protect ratepayers and deter anticompetitive conduct as a result of utility diversification. The CTA is a trade association of manufacturers, distributors, and contractors of telephone equipment, primarily key systems and PBX's, to the business community of California.

First, I would like to thank the committee again for its efforts last year and your legislation which opened the books and records to the subsidiaries and affiliates of Pacific Bell and other utilities to inspection by PUC. The need for this becomes more obvious when you look at some of the facts. In 1985, in addition to the two utilities, there were 19 subsidiaries providing competitive operations. All of these were subsidiaries of the Pacific Telesis Holding Group. Pacific Telesis diversified into numerous other competitive ventures in 1986, including the Provision of Financial Services and now to Region Cellular and Paging Services. They just obtained approval from the _____ court to enter the property casualty insurance business and foreign manufacturing international telecom and non-telecom business. Also, pending before the court is a request for authorization to enter the Vehicle and Equipment Fleet Services businesses. I think that's sufficient to look at the extent of their effort to diversify. And we've already heard several times today the problems that the PUC itself is having in identifying the costs associated with that. There are several studies out which indicate that they, as separate subsidiaries, in total lost a substantial amount last year, as did all of the seven Bell operating companies that have diversified at this point in time.

We would like to commend the PUC though for their monitoring of the transfer of assets for tangible/intangible and the personnel from Pacific Bell to its numerous affiliates. The staff's June 3rd report says, "Pacific Bell has made transfers to its affiliates without receiving adequate compensation." And they, in fact, fined them, as

we've heard many times, \$17 million. It's clear that their accounting practices, and despite Mr. Maxwell's comments of cooperation, have not been sufficient for the PUC to feel comfortable that there is not some abuse of the ratepayer and these efforts to diversify. And again, our question is not some abuse of the ratepayer and these efforts to diversify. And again, our question is what is the benefit to the ratepayer, not the stockholder, but the ratepayer of their efforts? I think as Mr. Morris said, most of the rest of my prepared remarks on that issue, have already been discussed. But there is one other area that Pacific Bell has not taken up on and that's another means to check cross-subsidiary to promote the use of public switch network and equal access to the network. [It] can save ratepayers money, and it's a sales agency. The sales agency was instituted as a nonstructural safeguard when the FCC granted a waiver in the Computer II rules to permit the BOC's subsidiaries to jointly market network services with their CPE arms. BOC's, engaged in joint marketing, are required to authorize a reasonable number of unaffiliated agents to market network services, for a commission on the same terms and conditions as a CPE subsidiary. BOC's and five of their operating companies have established sales agencies. Pacific Telesis is one of the two that have not done so yet. There are approximately 300 sales agencies...

CHAIRMAN ROSENTHAL: I guess I -- would you explain that last procedure because I'm not familiar with that.

MR. ASKEW: Okay. It's a procedure whereby Pacific Bell can authorize other vendors or agents to market their services in jointly with non-Pacific Telesis equipment. Pacific Tel -- PacTel Information Systems, under the new regulations will be allowed to shortly joint market Pacific Bell services along with their own CPE equipment. And we are suggesting that there is some cost savings involved in Pacific Bell would look at letting other vendors do that jointly. We are out there talking to customers all the time. We are selling them CPE equipment; we could easily sell them access to the Pacific Bell network and we can do that without Pacific Bell providing their own marketing on -- we can do it for them, all we ask is allow us to do what your own subsidiary can do and we will provide the revenues to you, just pay us a fair sales commission. It allows the PUC to take a second look at what those costs truly are. What would they pay me as a separate subsidiary, separate vendor to market their services. I know they're truly allocating those kinds of costs to their own subsidiary. Have you heard of that?

MS. MURRAY: Yes, I have.

MR. ASKEW: Okay. So, there's another area, as I say. Recently, of course, with the FCC decision to, let me see -- is expected to eliminate the requirement that BOC's provided when one of these competitive products, namely CPE, which is predominately our business through a separate subsidiary. That's where this becomes very important. If they do as the FCC is going to allow them and allow joint marketing of both network

services and CPE equipment, then they should at least make that available to competitors in the same field. And they have not so far offered to do that. And there are many benefits to it and as I said, those are documented by a particular -- I think a case in Oregon was recently, when Oregon instituted such things and whensome quantified results as to the savings to the ratepayer of allowing their services to be offered, the operating company services to be offered through this method.

I think in closing, as so much of my comments have already been made, I'd like to say that we believe that a case can be made that any relaxation of regulatory overview, or either removal of separate subsidiaries as the FCC would do, would only increase the risk of a return to what would become a virtual monopoly. That virtual monopoly could be re-achieved at the expense of the ratepayer if cross-subsidization is not very closely monitored. The results of that return to such a situation, will lessen the ratepayers options from the service point of view, and leave a good portion of these new virtual monopoly revenues on a non-regulated basis, subject only to the board of directors of Pacific Telesis Group. I don't think -- certainly, we don't want to see that, and I don't think that the ratepayers of California would like to go back to that noncompetitive situation. We are very concerned that unless adequate safeguards are put in place to prevent the cross-subsidization today of not only the more obvious sources which is funding on a capitalization level and going into a completely separate sort of business that is relatively easy to check according to the PUC. But when you go into a very similar business, not only do we get into a joint use of cables, joint use of information, and if you were to call people, businesses out there today, less than a half of 1 percent would be interested in buying a new telephone system. If, however, that customer is moving his premises for whatever reason, more than 50 percent are seriously considering changing that business.

Pacific Bell has knowledge of every single customer that is going to move their lines. If any of that information is transferred to the Pacific Telesis Info Systems Group, they can concentrate their efforts. There are innumerable instances of very subtle information transfer, technology transfer, nonpower informal expertise transfer request, a telephone call to an old buddy, innumerable examples. I feel that the PUC idea for a surcharge, if they are going to be allowed to continue in very closely associated businesses, and the PUC idea to -- not to enable continued competition in those areas, something has to be done in that area, or there is a very real risk that a situation will regress to one that I don't think is very beneficial to the ratepayer.

CHAIRMAN ROSENTHAL: Senator Morgan.

SENATOR MORGAN: Mr. Askew, based on your listing of the product areas that you and I sensed that probably you compete with IBM and ROLHM for some of your products as well, _____ PacBell.

MR. ASKEW: ROME more than IBM, yes.

SENATOR MORGAN: Do you find the same problems in that competitive relationship? They have a pretty well-known name.

MR. ASKEW: Not really, because it's not the name I am concerned about. The name is important, don't misunderstand me, Pacific Telesis, PacTel, there are very few people today that really understand the difference with AT&T and PacTel when you get down to it and on the street level, let alone PacTel Information Systems, PacTel Connections, Pacific Bell, they are very confused. And the general consumer in California is very confused and the name can be important; but more than that are the very difficult to quantify but very real assets of having access just to the thinking of a utility, let alone some of the records and some of the information that they have to know on account of responding to customers' needs.

SENATOR MORGAN: And I know, you know, PUC is responsible for a utility and not, you know for IBM and ROME, but I'm just trying to see if there are any parallels here in your experience in competing with those kinds of companies and competing with the utility company.

MR. ASKEW: I would say no -- very, very limited...

SENATOR MORGAN: ...it's a whole new different environment?

MR. ASKEW: Yes.

SENATOR MORGAN: Anything we can learn from it?

MR. ASKEW: Not that I can suggest at this time. I'm sure there might be -- I will give it some thought.

SENATOR MORGAN: Let me ask another question. Have you ever tried to bid for your products with the State of California?

MR. ASKEW: Yes, we have.

SENATOR MORGAN: And have you been able to succeed?

MR. ASKEW: Yes. We've won some, we've lost some. It would depend on the situation and on the terms of the bid. The State of California still has certain entities that don't go out through the normal GSA bid process, some of them are still going direct; and depends on the limitations as to what do they have to take, a responsible low bid? We were not involved in the Senate or the Assembly as a company, but our members were, yes. Our members, in fact, won both of those accounts.

SENATOR MORGAN: I was asking for -- not that problem, but also whether or not you foresee any improvements in the competitive bidding process as a result of setting up within general services as specialized planning unit.

MR. ASKEW: I would -- I think we are going into another area, but I would very much like to see a considerable change in the state's practicing methods and the responsibilities for determining those. I think there is considerable confusion and some

friction between departments and considerable lack of a consensus as to what the State is looking for and what it hopes to achieve by it. I'd like to see some considerable improvement.

SENATOR MORGAN: You are right. It is unrelated, I just think while we are dealing with utilities and improving competitive opportunities, you know, it was a somewhat related question.

CHAIRMAN ROSENTHAL: The PUC will be there tomorrow. (laughter) Okay. Thank you. We'll move on now to Mark Ostrau, an attorney respenting Businessland.

MR. MARK OSTRAU: Good afternoon. I am Mark Ostrau, I'm an attorney with Wilson, Sonsini, Goodright and Rosati, a law firm in Palo Alto and I'm here on behalf of Businessland. Dave Norman, the Chairman of Businessland regrets he cannot be here today, but he's asked me to come here in order to emphasize Businessland's continuing concerns in this area.

Mr. Norman spoke briefly and submitted an outline of his testimony at the last interim hearings last November at UCLA, so I won't repeat those points. Moreover, much of the theoretical concerns and the recent developments that create an underpinning for the concerns that many of the panelists have here have already been explored and in the sake of brevity, I'll just incorporate those by reference.

What I want to focus on is that the point here is not whether the utility companies are intentionally engaging in or intend to engage in activities that are particularly harmful to the public -- any by public I mean, ratepayers, competitors and consumers. Rather it's the risk of the harm in the present situation where we have a huge entity controlling vast resources in a market that is quite unique and characterized by a rapidly changing overlapping technology. It creates a risk that's very substantial, and that risk should be minimized through what we believe should be increased public scrutiny. I think what I'd like to do rather than go through a specific testimony, is first address some of the issues that Mr. Maxwell raised, and perhaps that way I can just incorporate our ideas.

Mr. Maxwell first discussed that their continuing investments in Pacific Bell and I just -- I suppose that one of those would be the "Project Victoria" multiplexer. The "Project Victoria" multiplexer and a lot of the other investments like that really just serve to emphasize the fact that there is a blurring distinction here between the regulated and unregulated activities. And that's really the basis of the whole concern here. Mr. Maxwell later on was talking about the regulatory atmosphere and why there is little need for concern. He mentioned Federal regulations, state regulations and internal policy.

First of all, the Federal regulations, I suppose, is embodied in first the Modified Final Judgment and the FCC regulations. In the Modified Final Judgment we've seen an

active amount of activity by the Regional Holding Companies, in fact, over 60 applications for line of business restrictions waivers have been made, and most of those have been approved and this success rate applies to Pacific Telesis as well.

The FCC -- we can't look to for much continuing regulation in this area as well as we've seen from some of the testimony as well as Chairman Mark Fowler comments regarding deregulating the entire telephone industry. The precise issue then is that the decreasing Federal regulation increases a need for increased state regulation. And the regulation at present, given what I've heard today, seems to be problematic and not quite sufficient. That's where we would suggest that in addition to Senator McCorquodale's bill that was passed, and we think that's a step in the right direction, and the solutions embodied in Senator Rosenthal's bills that were introduced last term, we'd like to see a chance for a adequate forum for competitors and the public. The specific details of that forum we haven't quite worked out, but the problem remains that there isn't an adequate forum. If we are left to the courts, that is both an after-the-fact remedy and a very prohibitive one. I'm not at liberty to discuss the details of -- under a settlement agreement that we made, but suffice it to say that just this summer, Businessland felt the necessity to bring an action for unfair competition against PacTel Info Systems and incurred substantial costs, in excess of a \$100,000, in prosecuting that action.

What we'd like to see is some before-the-facts public scrutiny of the activities and the intended diversification activities in light of both the potential impact on the cost and quality of telephone service, and the potential impact on competition, and some means of allowing the public of airing its views. The Public Utility Commission could be that forum, but it requires more enabling legislation in order to do that.

I think that the last point I want to make -- every time I look down in my outline, I see something that's already been discussed and I don't want to belabor the points, but the last point I want to make is that the recent developments that we've seen, the acquisitions of Northern Telecom and Communications Industries, the merging of PacTel Info Systems and PacTel Communications subsidiaries, and the "Project Victoria" multiplexer increased attention to the ISDN, all show that in this area there is an increasing overlap that's making a clean cut regulatory break between regulated activities and unregulated activities very difficult. And it appears to us that in order to aid this, the approach to remedy this, is to allow the public to get more involved in it and to -- and in that respect part of Senator Rosenthal's bill that suggested a compensation for substantive contributions to the PUC, is along that line, and we commend that.

I think that's all I want to say. I'd like to open up for questions if you have any.

CHAIRMAN ROSENTHAL: Senator Keene.

SENATOR KEENE: Let me play what may be a devil's advocate position for me because I'm not sure where I stand on such issues, but other than causing reduction in competition and a concentration of corporate power, something which this society seems to be no longer concerned with -- if a regulated entity is able to invest financial capital in the private sector, what is wrong with that same entity investing its expertise, the use of a name that's been developed over a period of time, those kinds of advantages that it may have and how does that differ from someone who may compete with you or with Mr. Askew which is simply a larger entity with a very deep pocket -- deep capital pocket? You know, it's broad, philosophic and very general, but what's your response to that whole thing, other than the fact that it's more competition for you?

MR. MARK OSTRU: Well, the antitrust laws have no problem with a large integrated company using those benefits to aid it in other ventures.

SENATOR KEENE: They used to, they used to.

MR. OSTRU: Right, well...

SENATOR KEENE: Previous generations, they used to have problems with...

MR. OSTRU: Previous generations -- I suppose, previous generations, but the problem here is that's not the case here. Here we have a regulated, vertical -- we have a regulated monopoly and we have vertical attachments to that monopoly in the unregulated sector, so, that the advantages of which you speak, are coming from -- essentially coming from ratepayers.

SENATOR KEENE: But the capital that generates those industries to begin with, comes from a regulated entity. So, why distinguish between the financial capital that comes from a regulated entity -- my terms may not be very precise -- and the other kinds of advantages that the regulated entity has built up?

MR. OSTRU: Maybe I'm not understanding this, maybe Mr. Askew can...

MR. ASKEW: I'll try to give you a response and -- our concerns are not from the true capitalization point of view, you know. Certainly Pacific Telesis in answering to its stockholders has every right to invest its accrued profit in whatever business it sees fit. Our concerns are more on the more subtle forms of cross-subsidization, intentional or otherwise, whereby costs which are being attributed to ratepayer services and therefore, built into the calculated rate of return in allowing them to come in for rate increases, are not being totally used for ratepayer services. They are being used to enhance the opportunities of the separate subsidiaries performing very similar functions. But the ratepayer is paying for that, is paying for services which are not being used in the ratepayers' benefit. At the same time, the separate subsidiary, gets a considerable cost reduction which allows them to be more than competitive, not only from the name point of view, but because of cost reductions which are being picked up by every

single owner of a telphone line out there in California.

SENATOR KEENE: What is the distinction between profits which have been generated by originally the contributions of ratepayers and these other items that are generated ultimately by people who pay rates for services that are provided?

MR. ASKEW: Okay. I would say there that again -- I would like to see the profits generated by ratepayers, reinvested into services for the ratepayer. But that's not a requirement by any moral standard -- by any law that I know of.

SENATOR KEENE: No, because if they are returned into the pockets of stockholders, they're money can be used in any way.

MR. ASKEW: I agree, and I'm saying that from the calculation point of view, I have a lot less problem with that side of it. That becomes, as I do from the ratepayer abuse and somewhat anticompetitive behavior of the fact that services, expertise, information, transfer of knowledge, and in some cases hard physical assets, are going across to the separate subsidiaries without being documented are being left on the Pacific Bell operating company books, and are being charged into the base for rate increases which the ratepayers are picking up. So, I agree there are two completely different problems and one of which -- that's why I say, I have far less problem with diversification into nonsimilar industries. Because the calculation angle, as I think, Ms. Murray was commenting on, is somewhat easier to track, it's there; it's a hard buck value and if the entity -- I'm not saying that again, that's a stockholder risk to me that's not the ratepayer abuse or risk, it's a stockholder risk and they should be concerned about it. But when you go into very similar industries, then I think the ability of the PUC or any other entity, within a reasonable amount of time and finances to truly identify what should be applied to the operating company and the ratepayer and what should be applied to the separate subsidiary is all but impossible to determine.

Given today's technology and the ability to share so many fundamental aspects of the operating company's business, it has to be somewhat on a judgment basis.

SENATOR KEENE: Well, the distinction is very clear to me, but the difference is less clear to me.

MR. ASKEW: Okay. I'm sorry.

SENATOR KEENE: No, I don't think it's necessarily your fault, I just don't -- either I'm not getting it or maybe there isn't one. Maybe there isn't much of a difference.

CHAIRMAN ROSENTHAL: Okay. That -- does anybody feel compelled to add anything further?

MS. MURRAY: Just one thing. I have copies of the statement that Commissioner Vial eluded to this morning (cross talking).

CHAIRMAN ROSENTHAL: Oh! Fine, thank you. In summation, there is indeed a

blurring of definitions of telecommunication services and responsibilities among regulated and non-regulated entities which I'm certain the committee will continue to monitor with hearings and legislation possibly, so that we can protect against subsidization which affects ratepayers which is my major concern. I'm all in favor of competition, I think it's fine. I must indicate that sometimes the unregulated entities that are now being competed against, we might be able to solve some of these problems if they let us regulate them. That's another (laughter) -- that's another way to go perhaps, but (laughter)...

I want to thank everybody for input today. I have found this personally very interesting and we'll now adjourn; we have another hearing tomorrow morning about 9:30.

