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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORDER INSTITUTING INVESTIGATION to determine whether competition should be allowed in the provision of telecommunications transmission services within the state.	OII 83-06-01 (Filed June 29, 1983)
And Related Matters.	Application 82-12-21 (Filed December 9, 1982) Application 83-01-20 (Filed January 13, 1983) Application 83-05-15 (Filed May 6, 1983) Application 83-05-26 (Filed May 13, 1983) Application 83-05-40 (Filed May 18, 1983) Application 83-06-54 (Filed June 24, 1983) Application 83-07-21 (Filed July 11, 1983) Application 83-08-26 (Filed August 8, 1983) Application 83-09-37 (Filed September 19, 1983) Application 83-10-09 (Filed October 5, 1983) Application 83-11-07 (Filed November 3, 1983) Application 83-12-25 (Filed December 15, 1983)

	Application 84-01-01 (Filed January 3, 1984)
	Application 84-01-11 (Filed January 5, 1984)
	Application 84-01-33 (Filed January 13, 1984)
	Application 84-01-38 (Filed January 18, 1984)
	Application 84-01-61 (Filed January 27, 1984)
	Case 83-05-05 (Filed May 12, 1983)
	(I&S) Case 83-11-05 (Filed November 22, 1983)
	Application 84-02-01 (Filed February 2, 1984)
And Related Matters.	Application 84-02-13 (Filed February 6, 1984)
	Application 84-02-14 (Filed February 6, 1984)
	Application 84-02-19 (Filed February 7, 1984)
	Application 84-02-38 (Filed February 17, 1984)
	Application 84-02-45 (Filed February 22, 1984)
	Application 84-02-47 (Filed February 24, 1984)
	Application 84-02-59 (Filed February 29, 1984)
	Application 84-03-02 (Filed March 1, 1984)
	Application 84-03-26 (Filed March 6, 1984)

	Application 84-03-54 (Filed March 15, 1984)
	Application 84-03-61 (Filed March 19, 1984)
	Application 84-03-43 (Filed March 13, 1984)
	Application 84-03-78 (Filed March 26, 1984)
	Application 84-03-87 (Filed March 28, 1984)
	Application 84-03-88 (Filed March 28, 1984)
	Application 84-04-008 (Filed April 2, 1984)
And Related Matters.	Application 84-04-032 (Filed April 5, 1984)
	Application 84-04-046 (Filed April 9, 1984)
	Application 84-04-048 (Filed April 9, 1984)
	Application 84-03-70 (Filed March 21, 1984)
	Application 84-04-082 (Filed April 16, 1984)
	Application 84-04-105 (Filed April 19, 1984)
	Application 84-04-115 (Filed April 23, 1984)
	Application 84-04-118 (Filed April 25, 1984)
	Application 84-04-133 (Filed April 26, 1984)
	Application 84-04-136 (Filed April 27, 1984)

O P I N I O N

I. Introduction

This is one of several proceedings in which this Commission considers the effects of the Modified Final Judgment (MFJ), the antitrust consent decree between the U.S. Department of Justice (DOJ) and American Telephone and Telegraph Company (AT&T). Under the terms of the MFJ, exchange areas known as Local Access and Transport Areas (LATAs) are created. The LATAs provide the structural basis for the divestiture of the Bell Operating Companies (BOCs) from AT&T. California has been divided into ten LATAs. After divestiture (January 1, 1984), the BOCs can provide service only within LATA boundaries (intraLATA), while AT&T serves between the LATAs (interLATA), succeeding to the interstate and interLATA operating authority of the BOCs. Whether AT&T may also serve within the LATAs is one of the issues in this proceeding, although AT&T has not filed an application for such authority.

Anticipating an emerging competitive market, a number of parties have applied to this Commission for authority to provide intrastate telecommunications toll services, including the following:

A.82-12-21	MCI Telecommunications Company (MCI)
A.83-01-20	GTE Sprint Communications Company (Sprint)
A.83-05-16	U.S. Telephone of the West, Inc. (U.S. Telephone)
A.83-05-26	American Telephone Exchange (ATE)
A.83-05-40	Combined Network, Inc. (Allnet)
A.83-06-54	U.S. Ameri-Call, Inc
A.83.07-21	Telamarketing Communications, Inc.
A.83-08-26	Telesphere Network, Inc.
A.83-09-37	Call U.S.A., Inc.
A.83-10-09	Satellite Business Systems
A.83-11-07	Ameritel, Inc.
A.83-12-25	LD Communications
A.84-01-01	Com-Vest Telecommunications, Inc.
A.84-01-11	Creative Telecommunications, Inc. (Creative)
A.84-01-33	Republic Telecom Corporation - Pacific

A.84-01-38	Executive of Sacramento
A.84-01-61	Southwest Interconnection Corporation
A.84-02-01	Lo-Call USA, Inc.
A.84-02-13	New American Phone Company, Inc.
A.84-02-14	Northwest Network, Inc.
A.84-02-19	United Telenetwork, Inc.
A.84-02-38	Amptelco, Inc.
A.84-02-45	CP National Network Services, Inc.
A.84-02-47	Budget-Tel Corporation
A.84-03-02	National Telephone Exchange, Central Coast, Inc.
A.84-03-26	America's Choice Telephone, Inc.
A.84-03-43	Americall Corporation
A.84-03-54	All-State Communications, Inc.
A.84-03-61	SaveNet, Inc.
A.84-03-70	NCR Telecommunication Services, Inc.
A.84-03-78	Tel-Toll, Inc.
A.84-03-87	Starnet Corporation
A.84-03-88	Toll Communications, Inc.
A.84-04-08	Nevada Communications Corp.
A.84-04-46	Westcom Datatel, Inc.
A.84-04-48	Westcoast Communications, Inc.
A.84-04-59	North American Telephone, Inc.
A.84-04-82	Standard Information Services, Inc.
A.84-04-105	American Communications Network
A.84-04-115	Napa Valley Telecom Services
A.84-04-118	United States Transmission Systems, Inc.
A.84-04-136	Associated Telecommunications Network, Inc.

Each of these applications has been consolidated with this investigation.

By complaint (Case (C.) 83-05-05) filed May 12, 1983, The Pacific Telephone and Telegraph Company (Pacific) alleges that MCI, Sprint, and Western Union Telegraph Company (WU) have unlawfully furnished intrastate telecommunications services. MCI and Sprint deny that they have operated unlawfully, while WU claims that it has authority to provide such service by virtue of its prior operations within the state, preceding the enactment of the Public Utilities Code. On November 7, 1983, WU filed tariff revisions that would establish the intrastate offering of WU's switched voice service. On November 22, 1983, the Commission suspended WU's tariff filing and instituted C.83-11-05 to examine WU's filing. The complaint

proceeding and the WU tariff suspension have been consolidated with this investigation. In the discussion that follows, applicants and WU together are generally identified as "Applicants" or OCCs (Other Common Carriers). Where appropriate, MCI, Sprint and WU together are identified as "Defendants," while other applicants together are identified as "Resellers." Of course, individual parties will be identified by name where necessary.

Pursuant to the schedule set in the order instituting this investigation, evidentiary hearings began on September 6, 1983, and concluded on October 28, 1983, after 37 days of hearing. These matters were submitted upon opening and reply briefs and oral argument before the Commission en banc . Briefs were received from Pacific, General Telephone Company of California (General), Continental Telephone Company of California (Continental), a group of 17 small independent telephone companies that serve in California (Small Independents), AT&T, the Cities of San Diego and San Francisco (Cities), Los Angeles, Toward Utility Rate Normalization (TURN), MCI, Sprint, WU, U.S. Telephone, Call U.S.A., Inc., the California Association of Long Distance Companies (Caltel), the California Cable Television Association (CABLE), the City of Mountain View, and the Commission staff (staff). Parties appearing at the oral argument who did not file briefs were Allnet, ATE, the California Independent Telephone Association (CITA), and the California Farm Bureau Federation (Farm Bureau).

By an interim decision in this matter, Decision (D.) 84-01-037, dated January 5, 1984, those Applicants filing before January 5 and WU were authorized to provide interLATA services, subject to the condition that each not hold out to the public the provision of intraLATA service. By D.84-02-012 dated February 1, 1984, D.84-03-058 dated March 21 1984, and D.84-05-008, dated May 2, 1984, the remaining applicants were certificated upon the same condition.

II. Issues

The purpose of this proceeding is to develop and apply the policy basis for deciding these various consolidated matters. In the order instituting this investigation we specified seven issues that we asked the parties to address. These issues are as follows:

1. Is any part of the telecommunications system a "natural monopoly?" Does the existence of a "natural monopoly" justify maintenance of a franchise permitting only a single firm to provide that service?
2. Does the rate flexibility provided in the existing structure enhance universal service goals? Should franchise monopolies be maintained to retain cross-subsidies and rate averaging?
3. To what extent will competition promote technological innovation and more efficient operations?
4. If competition is permitted, what terms and conditions should be imposed?
5. If competition is not permitted, what enforcement tools are available?
6. Should resale service be distinguished from independent transmission for purposes of establishing Commission policy?
7. Should the Commission grant certificates for interLATA service before deciding the intraLATA issues?

As stated above, interLATA entry was authorized by D.84-01-037, rendering the last issue moot.

As the proceeding progressed, these issues were distilled into two central questions:

1. Should intraLATA competition be authorized?
2. What form of rate regulation should be applied to AT&T and Applicants?

In addition, there are certain threshold jurisdictional issues that must be resolved in order to put these major issues and Pacific's complaint into their proper contexts. Before discussing this matter, a brief technical discussion of the telecommunications network configuration is helpful.

III. Network Configuration

This section generally describes the physical aspects of the telephone network, particularly those which will exist after the post-divestiture date of January 1, 1984. This information is important for several reasons. The specific network configuration strongly influences questions of enforcement, particularly "blocking" issues. The physical network also influences to a degree the competitive advantages and disadvantages of specific carriers, based on the type of interconnection they employ. This issue is strongly tied to "equal access," one of the crucial elements mandated by the MFJ.

In understanding the network, it is imperative to understand that one of its central characteristics is that it is a switched system. In order to permit each telephone in the country to connect with each other telephone in the company without using trillions of wires, a switching network has been developed. It is at switches that the OCC's interconnection occurs between the local telephone company, the OCC, and the customer.

Pacific's Exhibit 29 provides a good basic description of the network and the interconnections necessary to make it work. As discussed in that exhibit, "end offices" were created in order to provide switching capability, allowing the company to concentrate and redistribute traffic. An end office is the central switching office which is connected to the customer at each end of a conversation. End offices are connected to each other by "trunks."

A toll call may be switched through a number of different offices before it arrives at its intended destination. Large volumes of traffic between points are generally routed over direct trunks, while small volumes of traffic are usually switched from a central point. This is known as a "tandem" arrangement. Tandeming is used because it is more economical than direct trunking for small volumes of toll traffic.

After a call passes through an end office, it may be switched to progressively higher levels of tandem switching. A Class 5 switching function is performed at the end office. Class 4 switching is performed at toll center points. The switching concentrates and redistributes traffic. The next highest switching takes place at Class 3, 2, and 1 switches, also known as primary centers, sectional centers, and regional centers. There are two regional center offices in California, located in Sacramento and Anaheim, and 10 offices in other areas of the United States and Canada. After divestiture, AT&T will own and control Class 1, 2, 3 and 4 switches.

There are currently three types of interconnections between carriers and the local telephone operating companies. Those connections are ENFIA A, ENFIA B, and ENFIA C.

An ENFIA A connection is a "line-side" connection between the OCC customer, the local operating company, and the OCC. A line-side connection is a connection on the customer's side of an end office to interconnect the end office's switching equipment and the customer's line.

Virtually all OCC connections with local operating companies are ENFIA A connections. In order to make a call over an ENFIA A connection, an OCC customer a receives dial tone from the end office and dials a seven digit number to connect with the carrier switch. The customer next receives a second dial tone from the carrier switch, and then dials a personal identification number, sometimes also referred to as an authorization code, of six to eight digits. The customer lastly dials the desired telephone number.

There are a number of limitations associated with ENFIA A. Rotary dial telephones cannot be used with ENFIA A connections, without a separate tone generating device. Special features, such as answer supervision and automatic number identification ("ANI"), are also unavailable with this connection. ENFIA A inconveniences the OCC customer, who must dial an extra six to eight digits for an authorization code, as well as the seven digit number to access the OCC switch. There have also been allegations made that the ENFIA A connection causes the OCC's to suffer loss of transmission quality.

ENFIA B is a trunk-side connection between an OCC and an end office. Under ENFIA B, the customer dials 950-10XX in order to access the carrier. The carrier switch produces a second dial tone, and the customer then dials the telephone number. Trunk-side connections such as ENFIA B are capable of "answer supervision", or the ability of an originating toll switch receiving information from the terminating toll switch that the terminating party has picked up the telephone. ENFIA B connections also permit ANI, which aids in blocking and billing, and allows the customer to make a call and to be identified without the six- to eight-digit authorization code.

ENFIA B is possible only where the OCC customer is served by an originating end office utilizing #1 or 1A ESS switches. This currently limits ENFIA B service. Far fewer people can be called over an ENFIA B connection than over an ENFIA A connection.

ENFIA C connections are also trunk-side connections. They are routed through a tandem collection point, but unlike ENFIA B they connect directly from the carrier to the end office. The dialing is identical to that described for ENFIA B connections. The major difference between ENFIA B and C is that ENFIA C is not capable of ANI or rotary dialing. Some parties have also claimed that an ENFIA C connection does not provide "toll quality" calls, because it uses local trunking.

After January 1, 1984, connections will be offered as "feature groups." Feature Group A is merely a continuation of the existing ENFIA A connection, while Feature Group B continues the existing ENFIA B and C connections. Feature Group C is the existing connection between AT&T's long lines and PT&T. It is a transitory connection prior to equal access.

Feature Group D is the most important of the connections, as it embodies the MFJ's mandate of "equal access" to all carriers. The MFJ requires the operating companies to "provide to all interexchange carriers and information service providers exchange access, information access, and exchange services for such access...that is equal in type, quality, and price to that provided to AT&T and its Affiliates." Equal access is one of the most important features of the MFJ, as it is designed to provide OCCs with the quality of connection necessary to compete with AT&T on equal terms.

Under Feature Group D interconnections, the following characteristics will be available to OCC customers:

> "Feature Group D provides the arrangements which comprise equal access. These include the 10XX code for dialing each IEC, presubscription, the ability for the customer automatically to designate an IEC and eliminate the 10XX access code, and the ability for the customer to access the IEC from either a push button or rotary telephone. To access an IEC utilizing Feature Group D, a customer receives dial tone from the end office, dials the 10XX code of the chosen IEC (unless presubscribed) and then dials the called number. Feature Group D calls will route to the IEC either on a direct basis or tandem arrangement."

Pacific's witness Edrington further explained Feature Group D as follows:

> "Feature Group D is equal access.

"The key elements of Feature Group D are that it allows a customer to presubscribe to any interexchange carrier.

"It obviates the need to dial any special numbers to reach the carrier or to currently input any type of PIN, or that type of nature of thing.

"Simply put, you pick up your phone and you dial ten digits, and if as I do, you subscribe to perhaps a non-traditional carrier, you will simply be able to dial your ten digits and complete your call.

"It also has an option available in it which allows you to dial 10XX, the XX identifying a specific interexchange carrier and access that carrier to the completion of your call on an on demand basis, if you will."

Equal access cannot be instituted immediately. Equal access requires the BOCs to invest considerable time and money in modifying their facilities, and to do so without disrupting service to their own customers and those of AT&T. As mandated by the MFJ, equal access for interLATA service will be phased in over a two-year period starting on September 1, 1984. By September 1, 1985, the BOCs must provide equal access to 1/3 of their access lines, and by September 1, 1986, to all remaining access lines in conforming end offices. Local operating companies have raised questions as to their ability to meet these deadlines.

Equal access for intraLATA traffic, to the extent that state commissions permit intraLATA competition, will also be implemented by the BOCs. However, equal access for intraLATA traffic apparently does not encompass all the attributes of Feature Group D. Instead, intraLATA equal access means the embodiment of the 10XX plan to access carriers and is just an "overlay on the existing arrangements."

IV. Jurisdictional Issues

The question of this Commission's jurisdiction to consider the myriad issues presented by this case arises in two procedural contexts. First, there is the complaint filed by Pacific against MCI, Sprint, WU and others regarding the allegedly unlawful provision of intrastate services by the defendants. Pacific seeks both equitable relief and an accounting of allegedly ill-gotten gains. The defendants contend that we are without authority to consider the complaint.[1] Second, various parties assert that the Commission may not impose any restrictions on competition in telecommunications markets. It is essentially their position that such restrictions would interfere with the provision of interstate services authorized by the Federal Communications Commission (FCC).

This Commission has broad authority to regulate intrastate telecommunications. Our charter is set forth in the State Constitution and the extensive provisions of the Public Utilities Code. However, Public Utilities Code Section 202 recognizes that lawful state regulation by and large extends only to intrastate utility operations. Likewise, the FCC has broad authority to regulate interstate and foreign telecommunications under the federal Communications Act of 1934. See 47 U.S.C.§151, et seq. However, that enactment explicitly reserves to the states the regulation of intrastate telecommunications. Communications Act Sections 2(b) and 221(b), 47 U.S.C. §§152(b), 221(b).

Despite the mutuality of respect embodied in the state and federal statutes for the separate regulatory authority and interests of this Commission and the FCC, the advances of technology in the telecommunications industry have ignored, overrun and blurred that separation. Indeed, the courts have taken full cognizance of the

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[1] The complaint is discussed below in Part VII of this decision.

"technical and practical difficulties" of separating intrastate and interstate telecommunications. See, e.g., North Carolina Utilities Commission v. Federal Communications Commission, 537 F.2d 787, 791 (4th Cir., 1976) ("North Carolina I"), cert. denied, 429 U.S. 1027 (1976), and, California v. Federal Communications Commission, 567 F.2d 84, 86 (D.C. Cir., 1977), cert. denied, 434 U.S. 1010 (1978). The judicial response to these difficulties has been to create a federal primacy in order to protect the integrated national (and international) telecommunications network from the potentially disruptive and "frustrating" effects of state-by-state regulation of "the organic whole." North Carolina I, supra, at 793, 796.

Thus, FCC actions have received judicial approval despite the fact that those actions have affected facilities (1) located entirely within a single state, California, supra, at 86, or (2) used predominantly (97 percent) for intrastate communications, North Carolina Utilities Commission v. Federal Communications Commission, 552 F.2d 1036, 1046 (4th Cir., 1977), cert. denied, 434 U.S. 874 (1977) ("North Carolina II"). One court went so far as to hold that the FCC holds some residuum of authority to determine whether a state commission has discriminated against interstate services or subscribers and, if it finds this to be the case, to step in and regulate even the local exchange. See New York Tel. Co. v. Federal Communications Commission, 631 F.2d 1059, 1065 (2d Cir., 1980); compare Section 221(b) of the Communications Act of 1934, 47 U.S.C. §221(b).

Based upon these cases, several parties, notably MCI, Sprint and WU, argue that this Commission may not regulate their intrastate activities. It is essentially their position that intrastate traffic carried over their facilities as an incidence to lawfully provided interstate services are encompassed within their FCC certificates and that, consequently, this Commission may not bar the intrastate traffic which would otherwise fall plainly within our jurisdiction. Their analysis is incomplete and incorrect.

There remains in the face of the primacy of federal regulation a vital state jurisdiction. The cases only establish the proposition that this jurisdiction must be carefully exercised so as not to intrude on the interstate and foreign telecommunications over which the FCC presides. The FCC has noted on several occasions that it cannot certificate intrastate services. Re Competitive Common Carrier Services etc., 91 FCC2d 59, 62 note 8 (1982); Re MCI Telecommunications Corp., 70 FCC2d 666, 667 note 1 (1979). The full authority to certificate and supervise intrastate telecommunications is thus left to the states subject to the proviso that federally regulated services be neither burdened nor discriminated against. In our order, we take full cognizance of the "practical difficulties" of separating interstate from intrastate traffic and carefully weigh them so as not to "substantially encroach" upon the development of the integrated national network the courts seek to protect. See North Carolina I, supra, at 794 note 6.

We reject the notion posited by several parties that FCC certification inherently and as a matter of law precludes California from considering whether MCI and similarly situated carriers should be permitted to provide intrastate service. There are factual questions to be decided here, namely, whether Californians would be well-served by the free entry into intrastate communications markets and, if not, whether any prohibition may be crafted so as to avoid proscription of or interference with FCC-authorized services. We therefore conclude that we have full jurisdiction to consider the issues presented by the applications and complaints now before us.[2] Having previously decided to permit intrastate interLATA competition, we now turn to the issue of intraLATA services.

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[2] Several parties cite Southern Pacific Communications Co. v. Corporation Commission, 586 P.2d 327 (Sup. Ct. Okla., 1978) to the contrary. That case involved the use of foreign exchange facilities which the FCC had previously and specifically found to be in interstate service. Id., at 332. Moreover, the court found that the state commission's cease and desist order unavoidably intruded upon the FCC's prior orders. Id., at 329, 332.

In this case, we find the FCC to have specifically refrained from authorizing intrastate services, reserving that issue to the states. See, e.g., MCI Telecommunications, supra; accord, United States v. Western Electric Co., Inc., 569 F. Supp. 990, 1005, 1006 note 74 (D.D.C., 1983). Also, our order falls far short of the cease and desist order the Oklahoma Commission adopted. Finally, to the extent that the state court's opinion suggests that the state commission's authority was completely ousted by the FCC, we decline to follow the principle of comity and will make our own determination as to the breadth of our authority.

V. Argument of the Parties

In the order instituting this investigation, we stated our general policy that applicants for entry into intrastate markets must demonstrate identifiable benefits for consumers and a substantial probability that any adverse consequences from their entry will be outweighed by those benefits. The parties have directed their arguments regarding intraLATA competition toward this policy and have tried to respond to our specific issues within this context.

In reviewing this matter, we were confronted by two competing camps, one advocating free competition without regard to LATA boundaries and the other opposed to such competition. Following is a summary of the arguments of both camps.[3]

A. The Benefits of Competition

The parties asserting the benefits of competition are largely the applicants in this case. They seek authority to provide telecommunications services in California without regard to LATA boundaries. The most basic advantage of competition is that it reduces waste by visiting the negative consequences of inefficiency and waste (and the positive consequences of minimizing it) on those who cause (or avoid) it. Competition puts businesses on their mettle by applying the carrot of profitability to those who use resources shrewdly and carefully and the stick of unprofitability to those who do not.

A firm facing competitive entry is much more likely to produce and sell the maximum output at the minimum price. This benefit can be realized even without any substantial exodus of customers from the incumbent firm. Just as the possibility of

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[3] It should be kept in mind that the positions presented in this Section are not those of the Commission but those of the parties. The Commission's views on competition are found in in the ensuing discussion of Section VI.

transferring one's patronage to a grocery down the block from one that has priced too high or provided inferior or inattentive service tends to keep quality up, there is a value to the public in being able to choose, for whatever reason, an alternative intraLATA provider. The benefit is not only in the exercise of the choice, but in consumers and the telephone company being mindful that the choice is there.

Competition is also viewed as encouraging and fostering increased choices of service and price/quality options. Allowing intraLATA entry will permit potential competitors to offer services which the enfranchised monopolist might never make available. Because consumers will "vote" with their dollars, it is less likely that telephone companies will produce products and services which will enhance their regulated rate of return profit picture, but which ignore consumer preferences and priorities. A firm protected from competitive entry knows it is "the only game in town." It can afford to adopt a "take it or leave it" approach. In contrast, a competitor seeking to win customers is motivated to offer innovative services or to satisfy a discrete clientele with particularized needs. Thus, it is argued, free entry will provide California consumers with a wider variety of price/quality trade-offs. New price/quality variations will stimulate new toll demand, which is relatively price-elastic.

It is also contended that competitive firms are much more likely to invent or adapt new technologies to maximize their cost advantages and increase their market. It is an article of faith in a free enterprise system that more competition means more technological innovation. Competition reduces the likelihood that an incumbent firm will use technologies that fail to address consumer preferences for a range of services. A firm that does not face competitive entry has little incentive to employ even existing technologies which can reduce costs. Instead the regulated franchised monopolist also is likely to choose from the range of currently available technologies the one that will maximize profits--even if it is not the most efficient technology.

Indeed, an enfranchised monopolist may be affirmatively hostile to such innovation, which may only enhance the incentives of its customers to find alternatives for its services, thereby "stranding" its investments in outmoded equipment. The early introduction of new technology can result in substantial savings and contribute to innovation in any one of a number of other areas which depend upon or employ the telecommunications network. This in turn discourages system bypass.

With regard to intraLATA entry in particular, it is argued that there is every indication that the shorthaul toll market is precisely where the advantages of competition and additional incentives for new technological innovation are most needed. New developments in shorthaul microwave may bring costs down and increase capacities. Such shorthaul technology will be introduced significantly sooner if intraLATA competition is permitted. IntraLATA entry will also encourage lower cost rural communications services based upon spectrum radio systems well suited for, but currently underutilized in, rural areas. Authorizing intraLATA entry is also likely to stimulate technological innovation from sources other than the telephone companies or the OCCs. For example, competition in the customer premises equipment market has led to lower prices for all consumers and has brought about a broader range of product choices and a much more rapid introduction of technological change than had occurred previously. As a further example, Sprint was the first interstate carrier to introduce an access code which made it possible for customers to call from any station in the nation served by Sprint and bill the call automatically to their home or business number. This feature combined toll and credit card billing in a manner later emulated by the Bell System's credit card offering.

The importance to universal service goals of enforcing efficient operations in the short run and encouraging technological change in the long run, it is argued, cannot be overstated. Continued use of outmoded and inefficient technology will result in unnecessarily high telephone company costs. These higher costs will lead in turn to requests for future rate increases which would not be necessary if more efficient technologies were employed. Implementation of more efficient communications technologies also will result in important productivity gains throughout the economy. All this redounds to the benefit of those least able to subsidize inefficiencies and the price of waste.

The applicants assert that regulation itself would benefit from the introduction of intraLATA competition. They state that resort to regulation is predicated upon special circumstances that prevent the effective operation of market forces and require public intervention to simulate the benefits of competition. For all of the efforts of regulators, regulation is an imperfect substitute for competitive incentives.

It is difficult to force a monopolist to be efficient, or technologically innovative. A major limitation is that virtually all of the information about cost, revenues, technology, and the like are obtained by the regulators from the regulated company itself.

Regulation necessarily fosters a battle of wits between regulators seeking to impose restraints and regulated companies trying to avoid them. It encourages the companies to invest resources in persuasion and rationalization, instead of production. MCI quotes Pacific's witness Harris commenting on Pacific's own relationship with the Commission in his report to Pacific for its internal use:

> "Though not necessarily deliberate (or even conscious), the Company's posture toward the

> P.U.C. has been generally uncooperative, sometimes even hostile. This is, to a certain degree, understandable: regulation is an adversarial process by legislative design. Nowhere has this posture been more evident than in the submissions to the Commission in rate proceedings; the sheer volume of documents and details cannot be justified solely in terms of the requirements of the regulatory process. Whether intentionally or not, one effect of this approach is to overwhelm the Commission staff."

The disadvantage of this adversarial game is that the regulated company's ingenuity is not harnessed to provide benefits to consumers--and indeed may be consciously aimed at minimizing regulatory obligations to furnish such benefits. In a competitive market, firms devote resources to outsmarting their adversaries--other firms. The key difference is that if they succeed, consumers win rather than lose.

In this vein, the advocates of competition note that regulatory resources are scarce. Using them effectively is not easy. Wherever possible, regulators should look for opportunities to use the competitive process for furthering consumer welfare, preserving regulatory resources for the special cases that competition cannot address.

It is contended that competition would provide the Commission with a useful regulatory tool. Authorizing intraLATA competition would allegedly enhance the Commission's decision-making ability by improving the quality of the information provided to the Commission. It is claimed that for many years the Commission and civic parties have been frustrated by the poor quality of costing information provided by Pacific. This need also has been shown in numerous other cases in the recent past, such as D.83-04-012, in which the Commission ordered new cost studies to replace Pacific's GE-

100 studies. The introduction of competition and the possible participation by competitors in Pacific rate proceedings would force Pacific to calculate its cost of service carefully and would thereby assist the Commission in its scrutiny of Pacific's rates. Moreover, with additional providers of services in the market, the Commission would no longer be required to look to the single telephone company for information. The Commission would be able to compare data from a number of carriers in order to test the accuracy of data and the validity of its underlying assumptions. The Commission also could look to the new carriers for innovative ideas on meeting traditional public interest goals, such as universal service.

In addition to improving cost data submission, competition in intraLATA markets also would assist in the difficult task of identifying subsidies built into the rate structure and thus in determining whether such subsidies do indeed promote the public interest. Sprint claims that in this case, for example, the potential entrants have called attention to the significance of the fact that Pacific's evidence shows that private line and other business users are receiving greater subsidies than residential customers.

It has been pointed out that the U.S. Department of Justice has recognized that intraLATA entry might be appropriate. In a letter from William F. Baxter, Assistant Attorney General, Antitrust Division of the United States Department of Justice, addressed to Administrative Law Judge Patrick J. Power and dated October 20, 1983, Baxter stated that:

> "...the Department fully expected that state regulatory commissions might allow intraLATA competition and require equal access arrangements for all interLATA carriers. See November 23, 1982 Response at 6-8. Indeed, the Department expressly assumed that appropriate policy choice was to permit the consolidation and to rely on

> competition over time between the technology of the new entrant versus the potential efficiencies of the existing distribution mechanism to determine the appropriate mix of traffic between the BOC and its competitors...."

November 23 Response at 22 (referring to the Response of the United States to comments received on the BOC LATA Proposals, United States v Western Electric, Civil Action No. 82-0192, November 23, 1982). See also pages 23-24:

> "...competitive interests might better be served by a market test between the interexchange competitor and the transport of traffic by the BOC. In sum, where a LATA contains multiple SMSAs of significant population, or where significant distances are involved between population centers, a regulatory environment based on the presumption of monopoly service between such population centers 'would be alien' to the analytic approach used by the Department in making its LATA recommendations."

In addition to agreeing with the above arguments, WU asserts that it needs no additional operating authority prior to offering intraLATA telecommunications services. WU began its telecommunications service in California under statewide authority enacted long before the provisions of the Public Utilities Act requiring certificates of public convenience and necessity were adopted. WU claims that under its preexisting authority, it is not required to obtain a certificate of public convenience and necessity to offer its switched voice MetroFone service.

According to WU, its MetroFone service offering does not involve an expansion of its franchise authority nor of its service area. It has the right to hold itself out to perform this service at rates which the Commission finds fair, reasonable, and non-discriminatory. It argues that there is no support for Pacific's assertion that these rights may be denied.

Certain of the parties advocating competition are essentially resellers and assert that competition is peculiarly necessary for their businesses. Their operations, as described by counsel for American Telephone Exchange, are as follows:

> "They are essentially investing their own money in switching equipment and computer processing equipment to provide at a very close level of contact with the end user community, a form of enhanced, maybe not value added, but at least enhanced long distance service.
>
> "They are taking the WATS service of Pacific Telephone, soon AT&T Communications, and offering, reoffering that bulk-priced service to the small and medium size users, residential and business alike, who individually and by themselves could not be good candidates for those bulk-priced services.
>
> "To resellers, the concept of universal service is, of course, important. They want their customers to be able to call throughout the state, but there is another concept of interpretation of universal service that is important to them, and to the viability of their business. And that is the ability to offer these small and medium size business customers or residential customers the ability to call anywhere.
>
> "They can't compete effectively in that smaller market where their customer base usually has a much smaller telephone bill to deal with if they can only provide them partial calling capability.
>
> "Right now that partial calling capability is limited to interstate calling only. That makes it difficult for them to penetrate a small user or a small business and convince them of the effective savings that they can achieve when they can only save money for them on an interstate call.
>
> "Hopefully with the expected order of this Commission, they will soon be able to provide at least some form of intrastate calling, thereby further improving the savings that they can offer to their customers.

"But truthfully, when they are dealing with customers whose total telephone bill might be no more than 20 or 25 dollars, or in the case of a small business it might be 100 to 150 dollars, they really need to offer that customer a truly universal calling both within the LATA and without the LATA or outside the LATA.

"So intraLATA calling is important to that market, and since they will be reselling a service that you will have jurisdiction over in the form of Pacific Telephone's WATS service, or AT&T's intrastate WATS service, we submit to you that the risk of exposing that bulk-priced service to the smaller or medium sized customer is really non-existent, that you can't afford not to do it, and that is the only fair way to give all customers the benefit of potential competition.

"You can't really reach down to them if you make available to them only MCI or only Sprint or carriers of that caliber. The resale carriers in contrast to those entities need that universal offering capability.

"And finally, I would express to you that the final practical reason or pragmatic reason for extending the resale concept and eliminating these resale restrictions in the tariff has to do with the fact that while there has been probably no testimony throughout this hearing to this point, and those LATAs of Los Angeles, San Francisco, Sacramento, there are very large corporate companies out there reselling that service, reoffering it through their PBXs, through their tandem networks to their employees and to their customers in this state which you don't have any knowledge of and you probably never will have any knowledge of.

"As a practical matter you are never going to get to the bottom of that, probably never going to be a good reason to try to interfere on that.

"There is (sic) benefits and advantages accruing to the customers and the companies alike. It is going on now, it has been going on for a year, and going to go on regardless of what this Commission does.

> "So I think you've got to take a practical approach to this and recognize the real world and that is going on out there. And make that practice acceptable and credible. And do it whether through resale certification or through an acknowledgment in PT&T's tariff or AT&T's tariff, the resale shall be permitted or maybe perhaps should be limits on the price or whatever that it might be reoffered at."

As stated above, AT&T has not applied for intraLATA authority. However, AT&T supports competition in the provision of both interLATA and intraLATA services, claiming that the expansion of competition in the telecommunication marketplace is driven by the convergence of two inexorable market developments: (1) a burgeoning customer demand for sophisticated communications and information options, and (2) the rapid development of new technology capable not only of constantly improving engineering efficiencies in basic transmission services, but also of providing the means for introducing innovative new services which enhance the utility of the telecommunications network.

Several parties also suggest that unfettered competition is not likely to dramatically affect the California telecommunications market. According to the proponents of competition, after well over five years of competition in interstate telecommunications services, the Bell System's competitors have an aggregate market share of approximately five percent. The arrival of these competitors has assertedly had no effect on basic local exchange service rates or universal service penetration. Instead, the interstate experience demonstrates the handicaps under which the OCCs are operating. It is argued that the Commission has little to fear if the past five years of "contrived competition" at the interstate level is any guide. AT&T, with its superior interconnections, access to rotary phones, simple dialing requirements and obvious "presubscription" advantage, retained 95% of that market. AT&T's total volume of and revenues from long distance traffic has continued to grow.

These parties also claim that data from the state of Texas, where intrastate competition has been authorized since 1974, confirm that intraLATA competition in California will not jeopardize affordable telephone service. OCC aggregate market share in Texas has gone from zero in 1975 to 1-1/2% in 1979 to 4% or 5% currently. Over that period, local exchange rates in Texas have not changed any faster than local exchange rates throughout the nation. Residential service rates in Texas have not increased any faster than such rates in the neighboring states, also served by Southwestern Bell, in which toll service has not been offered on a competitive basis. Since 1974, Texas has experienced an improvement in universal service penetration, both in absolute terms and in comparison to the surrounding states served by Southwestern Bell.

Thus, the applicants conclude, the facts concerning trends in local exchange rates and universal service penetration in Texas during the era of competition are undisputed: universal service penetration has increased.

It is argued by various parties that the alleged subsidy from toll to local exchange is absurdly overbroad if its real purpose is preservation of universal service. The existing rate design delivers a massive "general" subsidy which does not in any way target the recipient class. This indiscriminate scattering of benefits is an unconscionable extravagance in a cost-conscious society.

According to this argument, the existing subsidy depicted by Pacific's rate design is so radically overbroad that its ultimate beneficiaries and benefactors simply cannot be identified at all. If a subsidy does exist from toll to local service, it is in essence a "tax" of random incidence. Just as the magnitude of the subsidy is unknown, so is the identity of the socioeconomic groups that benefit from it.

So, the argument continues, preservation of "universal service" is unrelated not only to the indiscriminate toll-to-local subsidy, but also to other subsidy elements in the existing rate design. Preservation of universal service means the maintenance of high levels of residential telephone access. Private line and business customers are substantial beneficiaries of any so-called "subsidy" from toll. The "subsidy" to business exchange access projected for 1984 is $219 million; the "subsidy" for business service connections is $144 million; the "subsidy" for business local usage is $125 million; and the "subsidy" for Pacific private line service is projected to be $704 million. The total "subsidy" to business and private line is $1.182 billion.

The pro-competition camp states that the best way to ensure universal service is to provide any needed subsidy out of general tax revenues or, failing that, by a gross receipts tax on the industry. These mechanisms avoid the arbitrariness of cross-subsidization through the rate design and place primary responsibility for any subsidy with an independent third party. A tax administered by a public body to a targeted group of beneficiaries minimizes the misallocations and inefficiencies of a massive, untargeted cross-subsidization. Most importantly, such a tax is fully consistent with all of the benefits of competitive entry. So long as the tax burden is shared proportionately, it wholly eliminates universal service preservation problems as a reason to consider banning intraLATA entry.

MCI points out that there are both federal and state tax programs specifically addressing post-divestiture local exchange costs and preservation of universal service:

a. The Federal Universal Service Fund will moderate the price of local exchange rates in high cost areas. In connection with Docket 80-286, the F.C.C. and the Federal-State Joint Board have adopted a telephone separations program which includes a "high cost factor"

(HCF). The HCF will be charged against interstate toll carriers to produce funds to subsidize directly local telephone companies having high-cost subscriber plant. The subsidy will flow to those companies having subscriber line costs above 115% of the national average subscriber line cost.

b. The Gwen Moore Bill (Assembly Bill 1348) will generate substantial funding for subsidizing basic local service for low income subscribers. This new law sets up a Universal Telephone Service Fund generated by a tax on intrastate telecommunications providers of up to 4% of gross toll revenues. The Commission is empowered to appropriate the fund "for the purposes of instituting universal telephone service for eligible low and moderate-income persons who might otherwise be unable to afford basic minimum telephone service."[4]

The proponents of competition argue that, even if the Commission concludes that the two tax programs do not adequately address the problem of affordable telephone service, there would be a variety of other resources available to the Commission short of excluding competition. Divestiture will bring substantial cost savings and new sources of revenue from which Pacific will soon begin to benefit. MCI contends that in painting a gloomy picture of its post-divestiture needs, Pacific has left these out entirely.

The applicants claim that the OCCs' presence in intraLATA markets would create additional revenues for Pacific by stimulating additional demand for the communications services provided by all carriers, and thereby generating increased access charge revenue. MCI claims there will be the following substantial cost savings:

1. Pacific's payments to AT&T for its "General Service and License Contract" and for certain "non-license projects" and interest on advances alone for 1983 is estimated to have been over $200 million.

[4] The Commission implemented Assembly Bill 1348 by Decision 84-04-053.

2. By an agreement dated April 7, 1983, AT&T agreed to assume five of Pacific's outstanding debt issues, totalling $850 million; agreed to convert $600 million of its outstanding advances to equity capital; and agreed to provide $86 million to retire additional debt. These agreements reduced Pacific's embedded cost of funded debt to below 9.5% and will reduce its debt ratio to below 47.7%.

3. By the terms of the MFJ, AT&T has granted Pacific royalty-free licenses to use telecommunications equipment and operational methods as to "all existing patents owned or controlled by AT&T and all other patents issued to AT&T on or before five years after the date of divestiture," as well as rights to sublicense those patents to manufacturers.

4. Finally, AT&T has guaranteed that Pacific will recover all costs of providing equal access: if any of the actual costs of providing equal access and reconfiguring the network have not been recovered through access charges imposed on interexchange carriers by 1994, AT&T must reimburse those expenses.

MCI claims that furthermore, there is every indication that Pacific will be generating significant revenues from services it did not previously provide. Interstate and intrastate interLATA access charges and billing revenues are described as obviously "big ticket" items. With intraLATA entry, intraLATA access charge revenue will be generated. MCI states that Pacific will be generating large revenues from leasing back to AT&T facilities it obtained from AT&T. MCI states that Pacific's estimate of the amount it will receive from AT&T for such leased facilities is $110 million. MCI claims that beyond these items, Pacific simply fails to address its prospects in internally highly-touted areas like marketing and servicing of CPE, intraLATA cellular radio, local exchange access services, and other informational service ventures.

Another party that supports the authorization of intraLATA competition is CABLE. CABLE explains that its interests result from the scope of this proceeding, which appears to address competitive issues relating to all telecommunications transmission services. CABLE states that its members are involved in the broadband distribution of new communications services, some that can be characterized as straight transmission, while with others the signal transmitted is enhanced by computers operated by the cable television system. CABLE's concern is that its members would be precluded from providing these services such as digital termination systems, point-to-point microwave, satellite services, optical lasers, etc., which utilize neither a central switch nor individual lines and do not exhibit natural monopoly characteristics.

CABLE argues that existence of many different providers utilizing different technologies is an additional reason why the business of providing advanced telecommunications services is a competitive one. CABLE observes that in the OII we stated:

> "Competitive pressure might exist if different carriers vied for the same market with alternative technologies (e.g., satellites vs. terrestrial cable)."

CABLE claims that such circumstances make competition in advanced services appropriate. CABLE states that the local distribution systems used by the telephone companies were designed to provide ubiquitous switched voice service, but are deficient in their ability to provide an efficient local link for a variety of new demands, such as high-speed data and video conferencing.

CABLE claims that the public switched network is capable of transmitting data at speeds up to only 4,800 bits per second (bps). Through the use of analog private lines, the data rate can be increased to 9,600 bps. CABLE argues the apparent complexity of offering data over facilities designed for basic switched voice services has led to considerable customer dissatisfaction with the quality of service furnished.

According to CABLE, as a result of these shortcoming in the public switched telephone network and the inability of the telephone companies to respond quickly to commercial users' requests for special facilities with higher data rates, the needs of commercial users in California must be met some other way.

CABLE argues that it is not only the needs of commercial users which cannot be met by the telephone companies, but the needs of residential users as well. For example, one service for which there seems to be a great deal of interest is the delivery of information to the home. One application of this service is the so-called electronic newspaper. The ideal transmission rate for the delivery of such services to home terminals is 19,200 bps, because that is the speed at which "the whole page is projected almost instantaneously to you," allowing you to "flip through pages very much like when you flip through pages of a newspaper."

CABLE argues that a state policy of competitive entry into the provision of advanced telecommunications services will have no adverse effects on the availability of universal service, nor will such a policy threaten the viability of the telephone companies. CABLE states that both the Federal Communications Commission and Congress have adopted a communications policy approach which realizes that competition in the provision of advanced telecommunications services promotes the efficient development of such services and argues that this Commission should adopt that same policy approach here.

B. The Adverse Consequences of Competition

The parties opposing the introduction of competition into the intraLATA toll market are the local exchange companies, our staff, TURN and the Cities. These parties generally are concerned with the adverse potential consequences which competition would bring to this state's telecommunications network. It is their basic

contention that these consequences outweigh the benefits of competition and would jeopardize the regulatory policies which this Commission has formulated to date, among them, the nurturing of universal telephone service.

It is claimed that intraLATA toll revenues support local exchange costs, and that competition would eliminate such support, driving up the cost of basic telephone service and curtailing universal service. It is contended that the existence of such a toll contribution to exchange costs has been generally accepted and recognized by this Commission. In this proceeding, proof was offered as to the fact that such a contribution exists and the extent of the support.

The Gueldner analysis, introduced by Pacific, consists of a determination of the direct cost of furnishing every service that Pacific offers, matched against the revenues derived from those services. Gueldner's study, which required more than six months to complete and is based on data developed over several years, involved examination of every category of cost incurred by Pacific and the assignment of those costs on an item-by-item basis to the services that caused them to be incurred. Pacific claims that the Gueldner analysis is "probably the closest thing that Pacific has to a profit and loss statement arranged on a service by service basis."

The general conclusions from that study are summarized by Pacific as follows:

> "Local exchange service--exchange access and local usage--is furnished at rates that fall short of covering cost by over $2.2 billion, and service connection charges are $370 million below the cost of establishing service. IntraLATA toll, on the other hand, is highly profitable--at least until exchange costs are assigned against it--and thus provides essential support for the local services that are 'underwater'."

As a corollary to his companywide study of the costs and revenues associated with each of Pacific's services, Gueldner analyzed the cost of providing local access at a number of selected Pacific wire centers throughout California. Pacific states that the object was not to provide a cross-section that would be representative of the state as a whole, but to identify the wire centers where costs would be close to the high and low ends of the spectrum. Pacific thus contends that Gueldner determined whether local service rates cover the cost of service in the low-cost areas, and by how much local service rates would have to be increased to cover cost in the high-cost areas.

According to Pacific, the results of Gueldner's wire center analysis will not be startling to the Commission, although they will be a shock to the public if local service rates must someday be increased to recover the cost of providing that service. Pacific claims that even in the lowest cost areas the cost of providing local access and usage is substantially above the current monthly rate. For example, residence customers in Los Angeles currently pay $7 per month; the cost to Pacific of providing that access and local usage is $24.

Pacific states that the disparity between the cost and price of access and local usage escalates rapidly as one moves from the dense metropolitan areas to smaller communities. Its study shows that in King City the cost of furnishing access and local usage is $70; the residential basic rate is currently $6.70. And in Baker--which is the extreme or close to it, but typical of outlying areas--the cost of providing access and local usage is $112.

Pacific's study also shows that service connection--the cost involved in connecting service for a new customer--displays the same gap between cost and price. The cost of establishing new single-line residence access is $94. The current charge is $23.

Thus Pacific claims that its analysis shows that local access, local usage and service connection fall short of covering costs by over $2.5 billion in 1984, and that intraLATA toll contributes to the recovery of that shortfall by over $700 million. Pacific contends that even though the applicants were liberal in their potshots at Pacific's analysis, no hard evidence was introduced to undermine the basic truth that toll rates do support local service rates.

Staff witness Popenoe concluded that toll picks up over $900 million annually in local service costs, using a different methodology than Pacific's. Popenoe treated the cost support to local exchange service from intraLATA toll as an appropriate economic assignment of costs, and in fact concluded that local service pays its own way and earns a return even higher than that earned on toll service.

Pacific argues that in the final analysis it matters little whether the Commission concludes that Gueldner is correct, and that local access, usage, and service connection do not pay their way, or that staff is right that exchange does pay its way after exchange costs are assigned to toll. Pacific claims that in either case the preservation of toll revenue is imperative--the staff and Pacific are agreed on that. Every dollar of toll revenue that disappears from the support of local service is a dollar that must be recovered somewhere else; the only "somewhere else" is local service itself.

According to staff, even without intraLATA competition, basic monthly service rates are increasing substantially. Most of the increases come from factors over which this Commission has little or no control. These factors include faster depreciation resulting from an increased rate of technological advance, local operating companies' loss of interLATA toll revenues by virtue of the MFJ, and inflation. Staff states that now another rate pressure has appeared on the horizon - namely intraLATA toll competition. Staff contends that, unlike the case with other rate pressures, the Commission has some power to control this one.

Staff states that it vehemently rejects the notion that we must first permit competitive entry--with all its potential for harm to ratepayers--in order to learn whether a subsidy exists. Staff contends that the notion of experimenting with ratepayers and the prices which they must bear is astounding. Staff argues that there are certainly adequate sources upon which the Commission can rely in determining the existence of a contribution from toll to basic monthly service.

Staff raises two additional policy considerations which are consequences of high rates. The first, based on broad social rationale, is that every home should have the ability to access emergency services such as police and fire departments. It is through universally affordable telephone service that access to local police and fire protection has traditionally been supplied.

Staff states that the other rationale for encouraging universal service is a more subtle one. This involves the universal service externality. The universal service externality is centered on the concept that the telephone network is more than just the sum of its parts. Each new telephone subscriber brings benefits to the entire network, and each time a subscriber discontinues service, the entire network suffers. Every time a new subscriber attaches to the network, the new telephone provides access to millions of other telephones in businesses and residences. Staff claims that this enhances the value of both the local network and the toll network.

According to staff, the existence of the universal service externality is one of the important reasons why toll currently contributes to the cost of the local exchange. Toll usage is impossible without local subscribers. In the interactive, synergistic network that we have today, it is fair that toll pay some of the local service costs.

As to the argument that competition has not proven detrimental in Texas, Pacific contends that there has not been a "decade of experience" with intrastate toll competition in Texas. Pacific states that MCI entered Texas in 1974, before Texas began regulating the Texas telecommunications industry on a statewide basis, but it was not until the last few years that MCI began to make its presence felt.

According to Pacific, the Texas intraLATA picture is totally different than that in California. Texas local calling areas are enormous and intraLATA toll is relatively insignificant. The support that Pacific's intraLATA toll provides to local service exceeds Texas' total intraLATA toll revenues. Pacific states that in California, on the other hand, local calling areas have deliberately been reduced to preserve low basic exchange rates, and intraLATA toll has become even more important to the preservation of basic service.

Further, Pacific states that Southwestern Bell's Texas operation has recently experienced a dramatic fall-off in intrastate toll message growth. Pacific admits that how much of that decline is attributable to intrastate toll entry is impossible to know, but claims that one thing is certain: Southwestern Bell toll messages are not continuing to grow at a rapid rate.

Pacific states that staff witness Popenoe summarized the value to this Commission of the experience with intrastate toll competition in Texas correctly as follows:

> "Q. In your opinion, should the experience with intrastate toll entry in Texas, whatever that experience may have been, be given weight by the Commission in deciding issues about intraLATA entry in California?
>
> "A. No.
>
> "THE WITNESS: In my opinion, it [Texas] is not at all comparable, because those OCCs were at a much smaller level nationwide at that time, and they were concentrating on nationwide business.

> "Now they have got a substantial foot in the interstate nationwide market, and they are in a much different position than MCI was in '77.
>
> "I don't think it is at all comparable to what would happen here."

Thus, according to Pacific, there is no clear picture of the impact that intrastate toll competition has had in Texas or may have in the future. More important, even if this Commission had a readable blueprint of the past, present and future of Texas toll competition, its significance in California would be nil.

It is also stated that one of the goals of this Commission has been the establishment of toll rates that not only are above cost, but that are uniform throughout the State. A 50-mile telephone call costs the customer no more from San Francisco to San Jose than from Healdsburg to Ukiah. Statewide toll rate uniformity would be still another victim of intraLATA entry.

In this light, it is contended that if applicants pursue in the intraLATA market their accustomed course of offering service over selected high-density routes at much lower rates than otherwise available, local exchange companies will have to match those rates or perish as toll competitors. Slashing rates over the routes on which applicants choose to compete will spell an instant end to uniform statewide toll rates. As staff witness Wyse stated:

> "Commission rate design flexibility could be diminished relatively quickly if the Commission wishes to permit the operating companies to be able to compete fairly and effectively...[t]his implies that the Commission probably will be obliged to raise basic monthly rates in order to lower toll rates to economic cost, and to deaverage the toll rate schedule."

It is concluded from the above arguments that if the Commission wanted to salvage whatever could be saved from the wreckage that would be caused by a multi-carrier intraLATA toll

market, toll rates over the noncompetitive routes must either be maintained at the preexisting level, or increased in order to save some of the former toll revenue support. The result would be that those subscribers fortunate enough to place their 50-mile calls from San Francisco to San Jose will enjoy much lower rates than those who find it necessary to make their calls from Healdsburg to Ukiah. Statewide toll uniformity--and the California citizens who have the misfortune to reside in areas that are unattractive to the applicants-- will thus be among the first casualties of the intraLATA toll wars.

We are also warned that another consequence that will necessarily attend intraLATA toll entry is the duplication of facilities that have been deployed by the telephone companies in fulfillment of their public utility obligations. California telephone utilities are obligated to furnish service to all those within their service territories who apply, and are obligated to maintain service at levels that are mandated by the Commission. The cost of meeting the public need is high--Pacific's capital budget in 1984 alone will exceed $2 billion. The cost of failing that obligation is also high; a penalty was recently imposed on General Telephone of California on the ground that its facilities were inadequate to furnish service at the level required by the Commission.

It is asserted that if intraLATA entry is allowed and the applicants are permitted to undercut intraLATA toll rates just as they have undercut AT&T's interstate rates, intraLATA toll traffic will be diverted from the telephone companies to the new companies and the facilities that formerly carried that traffic will be idled. Similarly, if the entrants are allowed to circumvent the exchange networks of the local telephone companies by furnishing both exchange and toll service to large business customers, the outcome will be still more idle facilities. According to this assertion, among the countless unknowns that will face the Commission if intraLATA entry is authorized is the rate at which utility plant will be stranded, with its ultimate impact on the utilities.

It is argued that utility plant that has been prudently acquired, thereafter devoted to public service, and then made idle by a change in regulatory policy, cannot be foisted off on the shareholders. The utility's obligation to serve carries with it the right to an opportunity to earn a fair return on prudent investment devoted to public service. The obliteration of that opportunity is a deprivation of constitutional dimension.

Stating the constitutional principle, however, is only one element of the problem. The revenues that will allow local companies to recover investment that may be stranded by competition can be obtained only from the company's customers. The very intraLATA entry that produced idle facilities will make it difficult--perhaps impossible--to raise the revenue necessary to permit recovery of the capital invested in that plant. Under the theory of those parties opposed to competition, local service rates and service connection charges will already have been increased substantially; intraLATA toll rates will have to be reduced, not increased, if the local companies are to be able to stave off further erosion of essential toll revenues.

Parties opposed to competition also argue that it is no answer that applicants' current share of the market is small. If they are permitted to furnish intraLATA toll service over Pacific's most profitable routes, at rates that are a fraction of Pacific's, it is claimed the most important segment of Pacific's intraLATA toll business will quickly erode. Pacific states that the fact that it can count on clinging to low-density rural toll routes affords no solace.

Pacific argues that if MCI's and Sprint's 1983 revenue estimates are extrapolated into 1984, using the growth that these applicants themselves have shown, the result would be startling even to those who do not regard MCI and Sprint as a potent intrastate

force. Pacific calculates that based on their own 1981-1983 rates of growth, the 1984 California intrastate revenues of MCI and Sprint should approach $175,000,000; their intraLATA revenues should approach $65,000,000. Pacific states that none of this takes into account that (1) the latter half of 1983 and 1984 should mark a time of economic recovery, (2) MCI and Sprint claim that they now discourage the use of their service for intrastate calling, and (3) MCI and Sprint have stated as a reason for immediate authority to legitimize their intrastate service offerings that they intend to launch promotions of intrastate service.

Pacific argues that the modest revenue estimates of MCI and Sprint, which seem benign on first glance, reveal on closer examination that these carriers will soon present a grave threat to the preservation of the California toll and exchange rate structure. Pacific argues that this is particularly so in the intraLATA market where their own estimates show MCI and Sprint to be enjoying the greatest rate of growth. Pacific states that its estimates of revenue diversion were rough but, as it has turned out, close enough to the mark even if, as seems unlikely, the Sprint and MCI estimates are themselves reliable.

It is argued that Resellers--carriers that have no facilities of their own but subscribe to and resell Pacific's services--present the same kind of threat to the Commission's ratemaking flexibility as do MCI, Sprint, WU, and the other facility-based carriers. Staff and Pacific were uniform in urging that resale be forbidden and were uniform in the reasoning that led to their conclusion.

Wide Area Telephone Service (WATS) was designed to enable customers with a large volume of toll traffic to obtain a favorable rate that reflects the timing and volume of their incoming or outgoing calling. The WATS offering was deliberately designed to

discourage its use by low-volume toll users, and the estimates of revenue stream that have been used by the Commission in determining Pacific's rates and revenue requirement have assumed that only those toll users with large traffic volumes would qualify for WATS.

It is contended that the WATS Resellers have evaded the objectives of that offering by aggregating small toll users into volumes adequate to support WATS lines. The consequence is that the toll revenue streams on which the Commission and the local exchange companies have relied in determining revenue requirements and rates are disappearing.

WATS resale is allegedly destructive of the message toll rate structure and the purposes for which that structure was designed. If resale is permitted, the asserted toll revenue loss can only be offset by higher message toll rates--which will encourage still more resale or reduce usage--or by increasing WATS rates--which will provide further incentive to bypass on the part of the customers for whom the WATS service was intended. Pacific concludes that the resale of WATS service as an alternative to intraLATA message toll service should be forbidden.

According to Pacific, the cable television issue has not assumed major proportions in this case because, unlike the message toll applicants who are already providing intrastate toll service and who present an immediate and important threat to the preservation of affordable local exchange service, two-way cable service is embryonic. The concern, however, is that as two-way capability develops, and as experience is gained in offerings such as those already initiated by Cox Cable in Omaha and San Diego, the danger that Pacific's network will be bypassed in its entirety--which is already very real--will begin to threaten the viability of the telephone system itself.

Pacific claims that two-way cable carries with it the prospect of a duplicate telephone network not dissimilar from the duplicate networks that provided much of the original impetus for regulation of the telecommunications industry. Pacific argues that if cable bypass becomes important it will have its immediate impact in the loss to Pacific of urban customers and those who generate large volumes of voice and data traffic. Pacific warns that its indirect impact should be of at least as much concern. Pacific states that as the most attractive and profitable parts of Pacific's business are drawn away through bypass of the telephone network, the burden of sustaining the network will fall on those who remain. According to Pacific, those who remain will be those who can least afford to carry that burden.

Pacific advocates that a ban on intraLATA competition be enforced by requiring the applicants to block intraLATA calls. It claims that the technology exists to screen intraLATA calls effectively, and offered specific proposals for blocking devised by its witness Ireland.

Cities state that they disagree with Pacific and the staff on the blocking issue. They suggest that the Commission should wait and see what happens in 1984-85 in order to see if blocking is necessary or desirable. They observe that the equivalent of blocking might be accomplished by rate structures, advertising and agreements. When an OCC or reseller is granted a certificate of public convenience and necessity, the Commission could require that its rates for most intraLATA distances be the same or higher than Pacific's rates for the same distances. In addition, the OCC or reseller could be required to advertise that its intraLATA rates are the same or higher than those of Pacific.

The Cities state that another possible solution to the blocking problem, if the Commission bans intraLATA competition, is to require the IECs to account for and turn over to the Commission any

revenues collected for services that had not been authorized by the Commission. These revenues could be used to support universal service. Cities state that in the event the Commission decides blocking is necessary it should not require blocking until provision of equal access.

Those opposed to competition also warn that if competitive entry is allowed, there is no turning back. Investments will be made, subsidies will be lost, and ratemaking for the good of all will be extremely difficult. The policy decisions emanating from this OII will affect not only today's ratepayers, but will have great significance for future generations of ratepayers.

It is submitted that a pro-competition decision at this time carries with it far greater risks to the public interest than any perceivable benefits to be derived. Uncertainty in the industry at this time is high with the breakup of the Bell System, the implementation of access charges, the restriction of Pacific and General to services related to intraLATA markets, the impact of interLATA competition, the growing loss of revenues due to customers utilizing bypass of the network, and the potential threat to the viability of universal service. More time and a great deal more information is required to analyze and properly plan for the best methods of serving telecommunications markets in the years ahead.

The Small Independents particularly warn that there will be substantial disruption to the telecommunications system and to the economics of its participants as a result of divestiture and commencement of the access charge system. These revolutionary events will affect interstate and interLATA toll traffic, which has been decreed to be the bailiwick of the "long lines" carrier. They warn that no one is possessed of a crystal ball of sufficient clarity to predict with certainty the outcome of this grand experiment. The Smaller Independents believe that a close examination of the overall

effects of competition on the telephone network following divestiture and access charges may well produce the conclusion that the distinction between "long lines" and local toll traffic should be drawn at the LATA boundaries. On the other hand, experience following divestiture and access charges could demonstrate otherwise. Certainly, it will be much easier to open up the LATA to toll competition at a future date than it will be to cut off competition if it is allowed now and proves to constitute a disaster.

In response to the question raised by the Commission in this proceeding of whether continuation of the system of exclusive franchise service in any part of the telecommunications system is justified, the Small Independents presented the testimony of Harry H. Baker, Jr., president of Sierra Telephone Company and Mariposa Telephone Company. Mr. Baker's testimony demonstrated some critical economic factors presented by the issue of potential competition within the local exchange area of a small rural independent company.

Mr. Baker's conclusion was that <u>any</u> uncertainty as to the continued exclusive and monopoly nature of the right of the Small Independent telephone company to be the sole provider of telephone service within its service territory would produce such economic uncertainty as to threaten the viability of the local exchange company and its ability to maintain adequate telephone service in its local service area.

Baker noted that the provision of telephone service in any area is a capital-intensive business, but that this was particularly true in the service areas of rural telephone companies. The extent of plant investment has been determined by the respective needs and populations of the rural communities served by the Small Independents. This plant investment has also been determined by the requirement that the respective telephone systems interconnect with the balance of the statewide and nationwide telephone system and that

they conform to technical standards which are consistent with the state of the art of those other components of the nationwide telecommunications system. There is in addition, of course, another overriding factor which has entered into every decision to construct, extend, or modernize the Small Independents' telephone plant, and that is the economic analysis that the investment can and will yield a rate of return commensurate with the extent of investment and the degree of economic risk.

According to the Small Independents, the entry of a competitor in the provision of telephone service in the franchised service territory of a rural telephone company would increase substantially the economic risk without reducing the franchised company's capital requirements. If the new competitor succeeded in attracting customers from the existing company, it would have a negligible effect upon the total plant investment of the existing company, but it would have a direct and proportional effect upon the plant investment per main station within the service territory, which would increase the degree of investment risk. The revenue requirement of the existing company associated with maintaining the plant investment would, in total, continue to be the same, while the number of customers among whom that revenue requirment would be spread would be reduced. The cost of a mile of telephone plant that serves thirty subscribers is, essentially, the same if you remove ten or fifteen of those subscribers from the line.

In his testimony, Baker referred to a recent analysis by the Rural Electrification Administration as to the "stand alone" revenue requirement of small independent telephone companies nationwide. The California companies included within this survey would have a "stand alone" local telephone rate ranging from $38 to $80 per month per subscriber, after receipt of all funds to which they are entitled from the "high-cost fund" provided for by the Federal Communications Commission, and after full phase-in of the

FCC's access charge plan (assuming "mirror image" access charge rates for the intrastate jurisdiction). Baker claims this is the economic reality of separation of the telephone system into its component parts.

The Small Independents state that they are in a particularly precarious position as these issues go forward, because they derive a larger proportionate share of their revenue from toll revenue sources than does the larger carrier, and the developments of divestiture, access charges and competition all directly affect the extent and the distribution of these toll revenues which constitute the lifeblood of the Small Independents.

As matters presently stand, the Small Independents have reached an agreement with Pacific to provide for continuation of a variation of the present system of toll cost and revenue pooling, which should allow the Small Independents to maintain local service rates comparable to the local service rates of Pacific in its rural exchanges. They state that the decisions reached by the Commission on the subject of competition, however, will necessarily impact the availability of toll revenue sources to fund these pooling agreements.

Staff suggests that, should the Commission decide to prohibit intraLATA competition, the Commission needs to specifically set forth what telecommunication services it intends to ban from competition. The Commission must make careful distinctions between the effects competition will have on different categories of telecommunications services, and thus, the effects on different groups of consumers.

Staff has described and placed current intraLATA services in three categories:

1. IntraLATA switched services for which staff recommends a prohibition on competitive entry.
2. All private line services, which staff recommends be opened to intraLATA competition.

3. Services not dealt with in this proceedings--primarily Radiotelephone Services which fall partly under FCC jurisdiction.

Staff states that it made a distinction between services necessary for local operating companies to preserve universal service and those which would not threaten universal service. Since it was not possible to make a distinction between voice and data transmittal, the distinction was made between switched and nonswitched service.

Staff recommends that competition be allowed in the provision of all intraLATA private line services. Staff set forth the following reasons:

1. The revenues derived from private line form a miniscule portion (less than 2%) of Pacific's total local service revenues. Pacific's toll private line revenues would only amount to an estimated 2.3% of post divestiture revenues, or less if access charges are figured in.
2. Private line competition does not threaten the universal network.
3. The value to be accrued from connection to the universal network raises the probability that private line users may desire connection and may be charged an access charge.
4. A clear distinction can be made between switched and nonswitched services, allowing different regulatory treatment.
5. Staff wishes to encourage the potential for technological advancement in private line, especially in high-speed data transmission, an area of current interest.
6. It is practically impossible to enforce a restriction due to the rusty switch principle. This is the situation where a local private line terminates on some switch which could be used to connect the local line to an interstate line. Also carriers have managed to get FCC preemption over such lines even though the line may never handle any

interstate traffic. The FCC estimates that at least one-third of the private lines now remaining under state jurisdiction will be preempted as of January 1, 1984. There will be very little for the Commission to regulate.

7. Competition may solve the problem of considerable customer dissatisfaction with the quality of service currently being furnished by private lines.

8. Competition in the private line market will allow Pacific to get out of those private line sections that are not compensatory.

Staff's recommendation to allow competition in the intraLATA private line market is primarily intended to encourage competitive data transmission facilities. As previously mentioned, it is not possible to allow data transmission and disallow voice transmission in this context. It would be impossible to determine what type of transmission was occurring at any moment. Staff states that it does not appear to be necessary to be able to distinguish data and voice if private line competition is allowed.

Pacific notes that the staff not only would permit entry with respect to private lines that are independent of the message telephone network, but also would allow entry into the market for private line services that interconnect with that network. Pacific claims that the result would be private line bypass of the switched network.

Pacific states that one example makes the point against the staff proposal. If entry were allowed into the interconnected private line market, Pacific suggests that businesses with substantial toll traffic between San Francisco and San Jose would promptly shift from the message telephone network to San Francisco-San Jose private line services that interconnect with the telephone network at each end. According to Pacific, the result would be no

different than if applicants were allowed to offer cut-rate intraLATA toll service between San Francisco and San Jose. Pacific argues that its intraLATA toll revenues, which are essential if the Commission is to retain the flexibility to keep local service rates at affordable levels, would be drawn off into the hands of alternative carriers--in this instance suppliers of private line service--who have no interest in contributing to the support of local service.

Finally, TURN states that its policy position is two-fold:

1. A "protective wall" should be placed around basic, voice-grade local exchange customers. These customers should in no way pay more than their share of the costs of the integrated telephone system, and should be the primary beneficiaries of any extra revenues (e.g. from directory services).
2. When not inconsistent with No. 1 above, competition should be encouraged.

For the present purposes, TURN translates this abstract position into the following policy recommendations:

1. The Commission should not allow intraLATA competition for basic voice grade services at this time. A continued "local" monopoly will allow rates for "local" services to continue to maximize the universality of telephone service, by preserving low access costs.
2. The Commission should consider applications by would-be competitors for intraLATA private line voice, data, and signalling services. These services appear to be the most susceptible to competitive pressures, and their customers best able to take advantage of the benefits of competition.

VI. Discussion

As is evident from the extent and tone of the parties' contentions, this was a vigorously contested proceeding. The parties obviously took seriously the issues specified in the OII and responded impressively. When combined with the extensive material developed in the access charge proceeding, A.83-06-65, et al., the result is a well-developed record. There are, however, several crucial questions yet to be answered, and only time will provide those answers.

An impression that emerges clearly is of an industry in transition--structurally and technologically. At the outset we intended that in this proceeding we would define the post-transition regulatory climate that would prevail for years to come. However, we now realize that many of the eventual impacts of divestiture are still unknown. We must approach this crucial transition period carefully, so that actions taken now in the face of substantial uncertainty will provide a solid foundation as the effects of divestiture unfold.

There is no question that competition is the cornerstone of our economic system. As the federal court observed in its decision approving the MFJ:

> "...The need to safeguard free competition is a direct result of the fundamental premise of our economic system that 'unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality, and the greatest material progress, while at the same time providing an environment conducive to the preservation of our

democratic political and social institutions. Northern Pacific Railway Co. v. United States, 356 U.S. 1, 4..." United States v. AT&T, 552 F. Supp. 131, 150-151 (D.D.C., 1982).

In the decision approving the MFJ, the Court also observed:

> "There is a dispute, reflected at the trial as well as other forums, over the question whether local telephone services have actually been subsidized by intercity service as AT&T has consistently claimed. ... The government contended that, to the contrary, local telephone revenues have subsidized AT&T's intercity rates ... and since the trial was aborted by settlement, no final decision was reached in the issue." (United States v. AT&T, supra at 169 n. 160).

It was further stated by the Court in approving the MFJ that:

> "The divestiture of the Operating Companies will not necessarily have an adverse effect upon the cost of local telephone service. The decree would leave state and federal regulators with a mechanism -- access charges -- by which to require a subsidy from intercity service to local service. By means of these access charges, the regulators would be free to maintain local rates at current levels or they could so set the charges as to increase or decrease local exchange." (U.S. v. AT&T, supra at 164).

Consequently the Court reacted "with considerable surprise and some dismay" when the FCC opted "to saddle the local subscribers with the access costs of interexchange carriers."

While we concur in the Court's assessment of the importance of competition, we believe that competition in the telecommunications arena must be implemented very carefully. Staff suggests that the continued availability of telephone service at affordable rates should be of overriding concern to regulators. We also share the Court's views regarding the burdening of local exchange costs as a result of the restructuring decision itself.

A. The Uncertain Future and the Universal Service Principle

This proceeding was originally intended to resolve the question of the extent to which competition should be permitted in the intraLATA toll market. Our resolution of this question was to have been dependent upon evidence as to the extent and direction of the effects competitive entry might have on universal telephone service. However, all that can be said with any degree of certitude is that the telecommunications industry is going through an unprecedented transition marked by technological and corporate upheaval. We have determined that this transition period demands caution. If we err, we should err on the side of universal service. Caution, as a transition strategy, serves and bears that bias.

In this order, we will therefore adopt a prohibition on competitive entry into the intraLATA toll market. In our opinion, competition in this market requires findings of fact which we cannot make upon the record before us. Rather, the record is replete with uncertainties which prevent us from concluding that competitive entry will not jeopardize our goal of universal telephone service. We discuss those uncertainties presently.

1. The Upward Pressures on Basic Exchange Rates

Inflation and other predictable phenomena have always placed upward pressures on local exchange rates for basic telephone service. Recently, several new factors have appeared which increase the difficulty of holding local exchange rates to an affordable level.

The divestiture of the Bell System will have significant effects on rates and revenues. The net effect is not predictable at this time. We today issue our first Pacific general rate case decision which incorporates the specific effects of divestiture on revenue requirements. Experience is necessary before we can determine whether we have correctly or fully anticipated those effects.

We have previously authorized competitive entry into the intrastate interLATA toll market and the FCC has done so at the interstate level. As we have heard throughout this proceeding, competitors in those markets incidentally carry intraLATA traffic, diminishing toll revenues to the local exchange company. We cannot estimate with any accuracy the magnitude of this revenue diversion.

The level and form of interstate access charges are still being debated. Based on the current separations procedure and cost allocation methodologies, about a quarter of the nontraffic-sensitive (NTS) subscriber plant costs in California are currently recovered through interstate toll revenues. While we continue to seek state flexibility in designing rates and access charges to recover this revenue requirement, we do not know yet to what extent recovery through end-user charges of NTS costs now allocated to interstate traffic may be mandated by the FCC. If added to the basic exchange rate, interstate access charges would increase the threat to universal telephone service in California.

We established intrastate interLATA access charges in D.83-12-024 which recover the portion of NTS subscriber plant costs allocated to the intrastate interLATA market through common carrier line charges. Our concerns about maintaining affordable exchange rates contributed to this decision. However, our lingering concerns about bypass and controversy over the proper allocation of NTS costs on the basis of cost causation may result in the modification of that decision. Further, while we reserve judgment, there are strong arguments in favor of making interstate and intrastate interLATA access charges consistent, if not equal, for simplicity's sake and to avoid rate arbitrage. Along with other issues, the desirability of parity between intrastate and interstate access charges, and proposals for future reallocation of costs, including NTS costs, between intrastate access services and intraLATA services have been set for further hearings in the access charges proceeding. The disposition of these issues may well affect the basic exchange rate.

Other factors contributing to inexorable increases in local rates include FCC actions to require faster depreciation of capital equipment, the direct expensing of the costs of connections, installations, and moves, and an amortization of the accumulated, capitalized past charges of this kind; federal tax law changes; and, particularly for some rural companies, increased interest costs.

The parties have vigorously debated whether local exchange rates will remain affordable assuming competitive entry at the intraLATA toll level. The above factors do not paint an optimistic picture of this Commission's ability to maintain those rates at a level which will avoid the jeopardizing of universal service. Allowance of intraLATA toll competition could add yet another potentially adverse factor, the reduction or loss of intraLATA toll contributions to NTS costs. An already bleak situation could then turn desperate.

2. Marginal Cost Pricing and Its Economic Efficiencies

As we have heard from many experts in both this and the access charges proceeding, theory holds that prices tend to be driven to marginal costs in a competitive market, and the pricing of goods and services at their marginal costs results in the most efficient use of those goods and services and of the nation's resources. Particularly for electric utilities, we have long sought to apply these principles, and have devoted considerable efforts to calculating and implementing prices based on marginal costs, both for electricity sales and for utility purchases from nonutility power producers. However, there are at least two significant barriers to implementing a marginal cost-based pricing system for telecommunications services at this time. First, little effort has been spent even formulating the principles that ought to apply, let alone calculating the marginal costs of various components of telephone service. Second, the universal service externality represents a greater public interest than the economic efficiencies which are allegedly inherent in marginal cost pricing.

While the accuracy of the various embedded cost studies was hotly debated in this proceeding, no testimony was devoted to the development of marginal costs. At this time, we simply do not have the tools or studies available to us to allow marginal cost pricing with any degree of accuracy. The behavior of the OCCs in the intrastate interLATA toll market will provide valuable evidence in this regard. We would expect that the OCCs will devote their resources to the most profitable routes and configure

their systems to accommodate the most lucrative toll traffic patterns. The local exchange companies have always been required to extend service to unprofitable routes and to accommodate all anticipated traffic patterns. Thus, they have not pursued the resource allocations which marginal cost pricing would dictate but have incurred substantial NTS costs made artificially economic by our system of rate regulation of public utility monopolies. It is simply unrealistic to expect the local exchange public utilities to effectively compete with their modern brethren having been born and bred under vastly differing environments.

Furthermore, the substantial economic and social benefits to society of a fully integrated and universal telecommunications system should restrain us from adopting a pricing system based completely on competitive theory. Our regulatory posture in this regard is directly related to what economists refer to as the elasticities of demand when competitive options are made available. Given the pace of technological advancement in this industry, the introduction of competition tends to give large users of telecommunication services, whose demand is highly elastic (or price-sensitive), greater market power to fend off the common costs (fixed costs such as NTS costs) of an integrated telecommunications system than smaller users (such as POTS users), whose demand tends to less elastic, except perhaps at poverty levels of income. This is what bypass concerns are all about -- the ability of large users to view their cost options apart from societal benefits and costs and to opt out of all or part of the network, leaving more of the network's fixed costs to be borne by others who are without the ability or who have less opportunity to opt out. Many of the latter include small and moderate businesses. In this context, preventing common costs from falling too heavily on small users has become a major issue in our efforts to maintain the essential character of our telephone system. Where the shifting of common costs under competitive pricing concepts has threatened to push some small users out of the system, the Legislature has responded with the passage of the Moore Lifeline Tax bill, as referenced below. Short of pushing users out of the system, however, a substantial shifting of common costs in itself can raise serious equity issues, especially when the allocation of common costs,

such as NTS, has been a major factor in the development of universal service. From a public policy point of view, therefore, universal service is more than just an economic externality. It is a critical element of our integrated telephone system as part of the "infrastructure" glue that holds our society together. We cannot allow competitive pricing theory to push regulatory policy to the brink of destroying or even undermining the community function of a telephone service acknowledged to be the best in the world.

To date the implementation of interLATA competition has focused these issues on the amount of common exchange costs, principally NTS, to be allocated to interexchange carriers through access charges. While the level of sustainable access charges will loom large in Phase II of the pending access proceeding, it is clear that our efforts to find an equitable method of allocating common costs in the face of interexchange competition is already causing major problems in designing rates and meeting the revenue requirements of Pacific and other exchange carriers. Long-run concerns about aggravating the economic bypass options of larger users and the possible involvement of carriers in such bypass options are constraining influences in our efforts to moderate the impact of divestiture on rates for exchange services in our decision in Pacific's A.82-11-07 to be issued concurrently with this order. These issues, in turn, are compounded by the serious limitations of current cost studies that provide the underpinning for moving toward greater reliance on competitive pricing concepts. Under these circumstances, it would appear that the extension of competition to intraLATA traffic would be undesirable at the present time even if there were sound economic reasons for doing so.

3. Embedded Costs and Their Relevance to IntraLATA Competition

Both Pacific and staff performed embedded cost studies which conclude that intraLATA toll revenues now provide substantial support of local exchange costs, though they take differing viewpoints regarding whether this support constitutes a "subsidy" of local rates. On the other hand, Sprint, MCI, and WU presented witnesses who asserted either that no toll-to-local subsidy exists or at least that existing data is insufficient to determine whether a contribution from toll to local service exists.

We do not believe that embedded cost studies can be dispositive of the issues for which they have been presented to us, namely whether the various services are priced properly and whether revenue from toll services is used to subsidize exchange rates. However, the studies do shed light on these issues, and we wish to comment on them briefly in hopes of preventing a repeat of the lengthy record developed here in some future Commission proceeding.

The basic difference among the Pacific (Gueldner), staff (Popenoe), and WU (Wilson) embedded cost studies lies in their treatment of NTS costs. Pacific assignes all NTS costs to the local exchange; staff allocates a portion of NTS costs to the provision of toll services in accordance with current separations and settlements procedures; and WU allocates them based on the FCC-Joint Board recommended Gross Allocator method.

We reject the notion that any of these three methods of assigning NTS costs represents an accurate determination of cost causation. Pacific's assignment of all NTS costs to the local exchange is based on its argument that the NTS investment must be in place for local use to occur. A similar, and equally valid (or invalid) argument could be made for assigning almost all NTS costs to toll services since the NTS investment is equally necessary for toll calls, which almost everyone makes at one time or another. The distinction between toll and local usage is a regulatory convenience. The only accurate theory of cost causation is that telephone service causes NTS investment. The statement that toll revenues "subsidize" local exchange rates is nonsensical. We hope that the issue of cost causation in this context can now be laid to rest.

This is not to say that cost allocation cannot be a useful regulatory tool. We have allocated NTS costs among local exchange, interstate toll, and (now interLATA and intraLATA) intrastate toll

services for many years for purposes of cost recovery. However, the allocation factors have been chosen by the federal and state regulatory agencies largely to achieve the desired distribution of costs, and certainly not based on any theory of cost causation.

The parties offer many valid criticisms of portions of Pacific's cost study. Pacific reports directory revenues of $483 million, and operating expenses and depreciation of $189 million, but a combined return and tax component of only $8 million. We have never before encountered the notion that $300 million in net income "causes" less than $8 million in income taxes. Conversely, Pacific reports that the operating expenses and depreciation allocated to the access line (the local loop and associated plant) exceed revenues, but that the access line "causes" hundreds of millions of dollars of income taxes.

Pacific reports that directory assistance services generate revenues of $9 million while causing direct costs of $239 million. However, Pacific did not allocate to directory assistance any revenues generated from toll calls placed over its network after the number is obtained from directory assistance, even though its witness admitted that "perhaps" such calls occur.

Similarly, Pacific includes in the "access line" category the costs of all Yellow Page business listings, but no revenues from Yellow Page advertising, and includes the capital costs of all pay phones but no toll revenues generated through use of pay phones.

Pacific admits that some of the criticisms aimed at its cost study may be valid, but contends that all the identified shortcomings taken together are far too minor to undermine its basic conclusions.

While the details of the parties' cost studies can be debated ad infinitum, we conclude (without finding that a subsidy is involved) that the evidence in this proceeding overwhelmingly supports Pacific's and staff's common

conclusion that intraLATA toll services now provide a substantial support of the NTS subscriber plant costs of the local exchange. We believe that the underlying questions of how much of the revenue requirement for the NTS subscriber plant costs (the fixed costs of the local exchange) should be collected from intraLATA toll users and how much from users of basic exchange services are even more important for purposes of intraLATA competition than our interLATA decision.

Many parties have argued that economic forces dictate against an indefinite continuation of the current level of NTS costs included in toll rates. Further, the size and source of any support of NTS costs needed to ensure universal service also engendered much controversy. In allocating the excess of the embedded costs of the local exchange over the marginal costs of providing telecommunications services, we find ourselves in search of a solution that balances the benefits of universal service against the desirability of pricing toll and other exchange services closer to their marginal costs in order to increase economic efficiency of their usage. We must consider intra-LATA competition in this light. At the present time, not only are our cost studies inadequate, but the issues concerning the allocation of NTS are still to be resolved in pending proceedings.

4. Rate Design v. Governmental Support

As the parties to this case acknowledge, it has been this Commission's policy to develop rate design schemes reasonably calculated to foster universal service. We have been largely successful. However, issues have been raised as to whether our rate design policy has been misdirected or could be effectively replaced by alternative supports.

Several parties argued that any support of NTS subscriber plant costs besides that obtained from local exchange rates should be narrowly focused to provide the minimum support necessary to maintain universal service, and that the resulting additional revenue requirement should be allocated on the basis of respective

elasticities. Under this approach, only those residential customers most likely to be forced to abandon telephone service in favor of even more pressing necessities of life would receive local telephone service at a rate below the total costs, including all NTS costs, of providing service. The revenue requirement needed for this support would then come primarily from the local exchange rates of businesses and other residential customers since exchange service exhibits a much lower elasticity than does toll service. Business and nontargeted residential customers would also receive hefty rate increases to recognize the NTS costs of their own services.

In D.83-12-024, the access charges decision, these issues were discussed at length. We concluded that,

> "We cannot fault the abstract principle of assigning costs to the cost-causer, nor the proposition that efficient pricing will be based on marginal cost and demand elasticity considerations. Where we part company with Pacific and Dr. Kahn is in applying these principles to the assignment of NTS costs to particular telecommunications services." (p.33)

Two efforts are underway which would target low income or otherwise needy families, and exchange companies in high cost areas. In California, Assembly Bill 1348 (AB 1348) and our D.84-04-053 implementing it seek to provide affordable basic telephone service to those residential customers least able to absorb rate increases. The FCC's proposed "high cost fund" would lessen somewhat the pressure on local rates due to use of its proposed Gross Allocator Method, for those exchange companies with NTS subscriber plant costs significantly above the national average.

Both of these efforts are in their infancy. The FCC is still receiving comments on its high cost fund proposal. We do not know precisely in what form it will be implemented. According to

staff, AB 1348 is a step in the right direction toward maintaining universal service in the face of rising local rates but does not address the problem completely.

Staff notes that AB 1348 could contribute, at current rates, approximately $68 million if the full 4% tax rate were applied to interLATA revenues solely and another $85 million if it were applied to intraLATA toll revenues. As an example, $95 million a year would be needed to provide a $60 annual subsidy to each family whose income is less than $10,000. This $5 per month subsidy would defray a large portion of most current basic exchange rates, but would not go very far if substantially greater portions of NTS costs were recovered through dramatic increases in the local rates, as advocated by several parties.

A targeted subsidy, if coupled with very large increases in basic exchange rates, could result in a situation where only the rich and the very poor could afford telephone service.

Under these circumstances, we can hardly be confident that viable alternatives exist to replace the rate design policies we have vigorously pursued for several decades or that such alternatives will ensure universal telephone service. Once again, we find substantial uncertainties and will affirm our faith in the wisdom of California rate design principles.

5. The Benefits and Consequences of Competition

The proponents of intraLATA competition base their case largely on the theoretical benefits of competition: a firm exhibits increased efficiency in a competitive marketplace, competition encourages increased choices of service and price/quality options and

also more technological innovations, and the need for and complexity of regulation are reduced. They argue further that intraLATA competition would enhance, not hinder, universal service because the efficiency gains and technological innovations would result in lower service costs, and because intraLATA access charges would be generated.

As we have stated earlier, we wholeheartedly agree that competition can engender many of the benefits alleged by its proponents. However, we do not believe that the proponents have adequately addressed the preservation of universal service.

We do not know what the marketing patterns of OCCs and resellers would be in the intraLATA market. There is a substantial likelihood that some loss of toll contribution to NTS costs and some rate deaveraging would occur due to competition. Applicants claim that these effects may not occur at all and, to the extent that they do, they will occur gradually.

Staff argues that a gradual deterioration of our rate structure is not necessarily any more palatable than quick disruption; that the benefits of gradual change are very small if the result is still a tripling of rates three, four, or five years from now; and further that the applicants may well penetrate the intraLATA market, if they are allowed to compete freely, much more rapidly than they would have us believe.

Upon examination, all the claims and counterclaims regarding the extent and rate of entry by the applicants into the intraLATA market appear to be merely informed (and often self-serving) speculation. Since many of the market conditions that would accompany the allowance of intraLATA competition, e.g., access charges, are not now known, we conclude that the extensive data presented by the various parties to support their positions in this respect are of little value.

6. Conclusions

In reviewing the contentions of the various parties, we reach the inevitable conclusion that no one can accurately predict the configuration of the future telecommunications market. Local exchange rates may be driven up by the forces beyond our control without adding the threat of losing intraLATA toll revenue support. On the other side, we do not yet know the extent to which targeted subsidies such as the new lifeline rate in California or the nationwide "high cost fund" will succeed in reducing the cost burden of telephone service to those persons or areas of the country most vulnerable to rising rates. To be frank, even if we were so inclined, we doubt that political considerations would allow the large basic rate increases propounded by Dr. Kahn and other economists. The FCC has certainly encountered substantial political resistance in Congress to the limited end user charges it is attempting to implement.

The forces of competition have been unleashed in the interstate and intrastate interLATA markets. In those arenas, perhaps the largest ever experiment of free-market competition is already well underway. As competition develops further in those markets, much will be learned as to the wisdom and effects of telecommunications competition.

In the face of such uncertainty, we must refrain for now from surrendering the reservoir of support for NTS costs that is being realized from within LATAs. As we have noted, economic theory holds that revenue requirements in excess of marginal costs should be recovered from the least elastic services (absent a general tax, which appears highly unlikely at this point). This means that basic exchange rates will be viewed more and more as the revenue source of last resort. We must also keep in mind, as our staff points out, that a decision to allow intraLATA competition is not a short-term decision. Once such a decision is made and interexchange companies establish a presence, however small, in the intraLATA market, our decision would be irreversible for all practical purposes.

While on a theoretical level we agree that intraLATA competition may have considerable merit, the risks and market uncertainties are too large to allow us to authorize it at this time. Unless and until we are convinced that a feasible alternative has been developed which will protect universal service in the manner of the toll-to-exchange contribution engendered by the intraLATA monopoly we leave in place, we must prohibit intraLATA competition. We fully embrace staff witness Wyse's recommendation:

> "The time is not ripe for intraLATA competition. While intraLATA competition could benefit consumers through technological advancement, diversity of choice and more efficient management of resources, these long term benefits are outweighed by the risk of so thoroughly disrupting the historic rate structure that universal service becomes jeopardized in the near term. The Commission should wait until it has more experience in a post-divestiture world before making an affirmative decision to permit competitive entry."

We take small comfort from the arguments of the OCCs that they are unlikely to achieve more than a negligible share of the market or that, if they do, it will be a larger market with "plenty for everyone." The record certainly leaves the penetration rate and market growth issues open to speculation. Nor do we find the Texas experience to be at all compelling. As staff points out, the structure of rate design in Texas is hardly comparable to our own. More importantly, competition was introduced under a pre-divestiture scenario quite different from the facts now at hand. The OCCs there "competed" with the Bell System ; AT&T did not compete with the local exchange carrier as it could in our case. Customer awareness as to the availability of choices is at an all-time high due to divestiture. We simply cannot rely on the evidence garnered from a vastly different place and time to draw conclusions as to the future California market.

In recognition of the economic considerations we have discussed, we have already begun steps to improve the efficiency of the pricing structure for telecommunications services. We have authorized competition in the interLATA market. We will examine various proposals to determine the portion of NTS costs to be recovered through intrastate access charges in phase two of our access charges proceeding, as well as proposals for tapered or declining block toll rates as a further means of capping the imposition of NTS costs on large users of toll services. And in our decision in Pacific's general rate case which we issue today, we order Pacific and staff to begin examining the marginal costs of various Pacific services. We expect to rely on their evaluations for guidance as we reexamine our current rate design procedures in future general rate proceedings.

As we stand at the dawn of a new age in telecommunications, we realize that our first few steps are necessarily cautious. However, we believe that caution will more assuredly safeguard the public interest which it is our solemn duty to protect. We will willingly reexamine our current prohibition against intraLATA competition as experience with interLATA markets and in the post-divestiture era turns dawn to daylight.

B. Implementation Issues

Having determined that intraLATA competition should not be authorized at this time, there are several residual issues yet to be decided. These issues generally concern the implementation of our adopted policy. They are as follows:

- Whether special exemptions from the restraints on competitive entry should be applied to private line facilities or WATS resellers;

- Whether blocking of intraLATA calls be carriers other than the local exchange companies should be required;
- Whether a prohibition of carrier bypass should be imposed;
- Whether Western Union should be exempted from our order proscribing the offerings of competitive intraLATA services.

We address these issues in this part.

1. Private Line Facilities and WATS Resellers

As an exception to its overall opposition to intraLATA competition, staff recommends that private line services be open to competition. It is staff's opinion that there is a clear distinction between switched and nonswitched (private line) services in terms of their importance to universal service. Due to considerations unique to private line technologies, coupled with the fact that private lines constitute a miniscule portion of Pacific's revenues, we find that there is some merit in staff's recommendation.

Private line services consist of direct access line connections which avoid the need for switching over the public network. Private line service is primarily used to provide direct telephone connections and high speed data transmission over dedicated non-switched access lines. Other uses which seem to be growing are services such as digital termination service, along with burglar and fire alarm services.

We believe that there is some merit in opening up the private lines market to some limited form of competition. We therefore invite applications from persons who are interested in providing high-speed data transmission services over private line networks. In our view, Pacific's (or any other local exchange company's) facilities may not be well suited to the provision of these specialized services and competitors should be allowed to provide them on an intraLATA basis. We intend to encourage the development of these technologies by this order. While we do not completely open the private lines market to full competition, we may in the future reexamine our policy on this issue. For now, however, we will not since we have concerns that the fullest competition will only encourage carrier bypass which, as we discuss elsewhere in this opinion, poses a threat to the switched network.

Pacific has argued that private lines competition should be entirely prohibited. It views any encroachment on its markets as jeopardizing the local exchange. However, the specialized and technologically advanced services present a compelling distinction among the various private line services which could be made available, and we would be remiss if we did not provide an opportunity to the developers and providers of these services to apply for authority to offer such services in California without regard to LATA boundaries. Pacific should review the applications which might be filed and present its case if necessary to address the issues raised by them. In the general rate case decision which we issue today, we invite Pacific to file responsive tariffs and rates for private line services which it might want to defend from private lines competition. We reiterate that invitation here.

Pacific has, however, raised an important issue regarding private lines regulation. The difficulty in regulating private lines service rests with the problem of distinguishing among the many configurations and uses involved with these services. We are concerned about the lack of clear distinctions between private line and switched services. Some private line equipment lends itself to use for services which duplicate or are identical to those of the switched

network. For example, private lines that terminate on a PBX provide a customer with switched access to a greater area of distribution. The "leaky PBX" might enable customers to bypass the local exchange. Any increased opportunity or incentives for bypass of the local exchange is a matter of concern to the Commission. We find this concern sufficient reason in itself to limit competitive entry in private lines to the extend we do so today.

We reach an entirely contrary disposition on the question posed by WATS resellers. There is no logical reason to distinguish between intraLATA toll services which might be provided over an OCC's facilities as compared to over Pacific's facilities via its WATS services. Since we do not allow intraLATA toll competition through OCC facilities, we will not do so through WATS resale either.

The arguments of the resellers are simply not persuasive. The resellers essentially argue that this Commission should enhance the marketability of the service they provide. The resellers point out that it would be easier for them to market an all inclusive service, i.e., one encompassing interstate, interLATA and intraLATA calling, as opposed to a service offering only interstate and interLATA calling. The marketability of their resale service is not a compelling public interest in our opinion. There is simply no intrinsic value to fostering a competition for identical traffic when the competition would essentially be between Pacific's retail (message toll) and "wholesale" (WATS) services. None of the efficiencies or benefits resulting from market competition would accrue from such inbred competition.

The resellers posit that large WATS users are already reselling intraLATA WATS through privately-owned PBXs and that we should strip ourselves of our self-imposed naivete and allow them to legally share in that now illicit market. We will not permit competition because some WATS customer is illegally offering WATS.

on a resale basis. While we allow joint users to share an intraLATA WATS service, we have never authorized the resale of that service for profit. Our staff and Pacific are hereby advised to intensify the enforcement of Commission-approved WATS tariffs and to terminate the provision of intraLATA WATS service to uncertificated intraLATA WATS resellers in order to halt these illegal operations.

Finally, assuming we were to authorize intraLATA WATS resale, OCCs could easily purchase WATS capacity for resale and thereby hold out the intraLATA services we would not certificate with respect to their own facilities. It is intuitively obvious that both doors in a two-door barn should be closed if our aim is to keep the horse inside. We will therefore prohibit the resale of intraLATA WATS services except to complete an interLATA or interstate call.

2. Blocking

"Blocking" generally refers to the interception and automatic termination of certain specified transmissions, here unauthorized intraLATA traffic. Several parties, most notably Pacifi and staff, have advocated that a ban on intraLATA competition be enforced by requiring interLATA carriers to employ blocking schemes to prevent intraLATA usage of their networks.

The implementation of blocking, before the implementation of equal access, by every parties' contention, would require a considerable commitment of capital, resources and time. Under certain proposals, switching capacity and memory would have to be added by the OCCs in order to facilitate blocking. New software would have to be developed for the proposals proposed by Pacific. Although these facts are conceded by all, the OCCs and Pacific differ on the extent of the burdens blocking would entail.

The OCCs claim that Pacific's blocking proposals would take years and millions of dollars to implement and would be ineffective in any event. According to the OCCs, implementation is not so readily achieved because under their current ENFIA A interconnection arrangements the OCCs do not know the point of origination for any call placed over their systems. In order to provide, store and utilize that data, the OCCs must redesign or reconfigure their existing systems. The OCCs note that they would be required to overcome all these difficulties even though equal access would shortly present a different system configuration which would require new blocking arrangements.

The OCCs also argue that blocking can easily be evaded through the use of adjunct facilities. MCI maintains that successful evasion requires no cleverness, just "a PBX sitting in a closet" through which a subscriber's calls would be routed to obtain the most favorable toll rate. It is also argued that, whatever schemes are devised, there would be the extreme likelihood that interstate and interLATA calls would also be blocked.

Pacific responds that the OCCs should not be trusted. Pacific argues that the OCCs have done nothing to discourage unauthorized calls and the OCCs have the technological competence to prevent such calls. Although Pacific concedes that the OCCs are correct in their assessment of the technical difficulties the implementation of blocking poses, Pacific argues that the difficulties are surmountable or peripheral.

Staff also concedes the difficulties of implementing blocking prior to equal access but adopts an approach differing from Pacific. Staff concludes a blocking requirement should be adopted, if at all, upon the implementation of equal access. We agree that this approach is prudent since Pacific will be in a position to prevent unauthorized calls under presubscription after equal access.

As noted above, all parties agree that months and millions of dollars would be required to implement Pacific's blocking proposals immediately even assuming the ready availability of appropriate technological means, an assumption in which we have little confidence prior to equal access. The OCCs have configured and constructed their present systems in good faith, free from any FCC or other requirement to accommodate blocking. The Bell affiliates certainly did not bring any successful actions of which we are aware either before the FCC or any state regulatory agency timely seeking such a requirement despite their full knowledge that intrastate traffic could be carried over the networks of the OCCs. See, e.g., MCI Telecommunications, supra. It is, quite simply, too late in the game to require blocking prior to equal access.

We note that the record before us establishes that the technological progress that has blurred the interstate-intrastate dividing line may soon offer us the ability to separate interstate from intrastate and interLATA from intraLATA traffic. Upon the implementation of equal access commencing in the fall of 1984, Pacific will have the capability of distinguishing intraLATA calls from interLATA or interstate calls. AT&T has not opposed the implementation of blocking even before equal access because Pacific can presently block intraLATA calls placed over AT&T's facilities. As equal access is implemented and the OCCs are in the same relationship to Pacific as is the current case with respect to AT&T, we will order Pacific to block any intraLATA call placed over an OCC's facilities.

We note that Pacific will be phasing in equal access throughout its territory over a two year period. Pacific should also phase in the implementation of blocking. As equal access is fully implemented within a single LATA, Pacific shall block unauthorized intraLATA traffic carried over or through the facilities, whether owned or leased, of any interexchange carrier. Upon the full implementation of equal access within a LATA, Pacific shall file an advice letter with the Commission stating that fact and that it will commence blocking of unauthorized intraLATA calls ten (10) days following the filing of the advice letter. Pacific shall serve a copy of said advice letter upon all interexchange carriers operating within that LATA. Should any such carrier not accept the interconnection arrangement constituting equal access and/or maintain any

interconnections other than those offered under equal access, that carrier should file a notice of such facts with the Commission within five (5) days of receiving Pacific's advice letter. Such notice will stay the implementation of blocking for that carrier within that LATA for ninety (90) days, in which time the carrier shall implement all necessary means by which it or Pacific as may be appropriate shall commence the blocking of unauthorized intraLATA traffic.

We will also continue our policy of prohibiting the applicants from holding out the availability of intraLATA service. Such a prohibition hardly intrudes upon the FCC's authority to permit the applicants to provide interstate service over common facilities. We will add one further requirement at Pacific's request. The applicants, in answering customer inquiries as to whether their facilities may physically be used to complete intraLATA calls, shall advise current and potential customers that such calls (1) may not be lawfully placed over their networks and (2) should be placed over the facilities of the local exchange carriers without any further advice being given.

3. Prohibition of Carrier Bypass

The questions of the extent to which NTS costs should be recovered through usage sensitive charges and the extent to which they can continue to be recovered in this manner without resulting i significant bypass are central ones on several fronts. The FCC has wrestled with this on the interstate level, and we have examined it carefully in establishing intrastate interLATA access charges. In Decision 83-12-024, we stated that:

> "...the ubiquitous nature of the telephone network offers benefits to all subscribers. Those benefits tend to increase as the subscriber makes greater use of the network. Thus, although the costs of subscriber plant may not be usage sensitive, the benefits derived by customers from the sum total of Pacific's subscriber plant do increase with increased usage.
>
> "There is no denying that any particular subscriber loop is of more benefit to the subscriber served by that loop than to any other customers. So it is appropriate that the particular subscriber bears the greatest share of the costs of the facilities provided for his service. Still, the logic of telephone utility accounting practices and the shared benefits of a ubiquitous telecommunications network strongly imply, even dictate, that the costs of the network should be shared as well...

"We accept Dr. Kahn's theoretical principle that it is economically inefficient to recover fixed costs through charges based on usage.

" The need to recover fixed costs is not, however, peculiar to the telephone industry, or even to regulated industries. The fact was cited in this proceeding that Sears Roebuck does not bear the costs of its customers' driveways although it may use them to deliver merchandise. More significantly, Sears Roebuck does bear the fixed costs of its retail stores and it must recover those costs through its sales of goods. In terms of Dr. Kahn's economic ideal, Pacific's pricing of its services is more efficient than that of Sears, because Pacific recovers at least a portion of its fixed costs through fixed monthly charges.

"Probably Sears, or any other competitive provider of goods and services, would like nothing better than to be able to recover its fixed overhead costs through fixed taxes levied periodically on the public at large. In the real world few businesses other than franchised public utilities or providers of uniquely valuable services are able to implement this economic ideal, through fixed monthly service charges, retainer fees, and the like...

"Clearly, in an 'open market situation' users of toll services would be willing to pay for the use of local subscriber plant. We believe that such market considerations are relevant to the assignment of the NTS costs associated with that subscriber plant.

"The risk of bypass is one market consideration relevant to NTS cost assignment. It is to be weighed against other market considerations, such as the loss of subscribers which would result from massive shifts in NTS cost assignment to the end-user. It is also to be weighed against considerations of fairness and social policy. The manner in which Pacific has selectively, and moderately, applied market factors to pricing traffic-sensitive rate elements should also be applied to the assignment of NTS costs, in preference over a rigid application of abstract economic theory.

"Based on the record developed in this proceeding, we do not view the emergence of competition and the threat of bypass as such drastic changes of circumstances as Pacific would have us believe. The evidence shows that Pacific has long fostered competition with its own switched network services through its WATS and private line service offerings. Dr. Kraemer's survey of the extent of bypass among Pacific's larger customers offers grounds for concern but does not justify concluding that Pacific faces any serious threat to its viability in the foreseeable future.

"On the other hand, we recognize that the range and attractiveness of competitive alternatives to the use of Pacific's exchange network are increasing and that it would be unwise to expose Pacific unnecessarily to risks of uneconomic bypass. This situation justifies close attention to Pacific's costs in the setting of access charges, particularly in the longer term.

"Bypass is a long-term problem. Commitments to bypass investments by IECs or large customers will be based on their expectations as to the future trend of Pacific's rates. To this extent we agree with Pacific on the importance of signalling clearly the seriousness with which we take the bypass problem and the seriousness of our intent to limit uneconomic bypass."

"Our intent is not to eliminate all NTS costs from the revenue requirement for access charges. We share the concern of our staff, the Cities, and TURN that IECs and the users of their services need not and should not be given free use of Pacific's local subscriber plant. The benefit to users which arises from the ubiquitous character of the local network fully justifies continued imposition of a significant share of NTS costs upon those who take advantage of their access to that network." (D.83-12-024, pp 35-38.)

We find similarly in the intraLATA arena that bypass does not appear to be a short-term problem for Pacific and that toll rates (or, if we allowed intraLATA competition, access charges) can continue to be used to recover NTS costs at this time.

Some additional observations are appropriate in elaboration of the relationship between the threat of bypass and intraLATA competition.

Bypass is either economic or uneconomic. Economic bypass occurs when the economic cost of the bypass is less than the economic cost of providing the equivalent service over the switched network. Uneconomic bypass occurs when the converse condition prevails.

Uneconomic bypass of the local exchange could be economically attractive for large toll users if toll rates (including access charges if applicable) are set substantially above the marginal costs of providing toll service. This could occur due to any or a combination of the following effects: the averaging of toll rates over geographic areas encompassing high-cost areas; inclusion in toll rates of excessive NTS costs of the local exchange; or the development of new, relatively low-cost toll technologies. Exchange rate averaging in combination with relatively low-cost exchange technologies could also contribute to uneconomic bypass.

Bypass may be by either customer or carrier. Customer bypass occurs when a customer constructs its own facilities for the purpose of serving its own internal telecommunications needs. Carrier bypass occurs when a carrier constructs facilities that permit its customers to bypass the local exchange for originating or terminating calls. No customer is likely to bypass the local exchange for all its requirements. Pacific is concerned that large customers will bypass its facilities for their toll calling purposes, and proposed that carrier bypass be prohibited.

Carrier bypass of the exchange raises serious regulatory issues. Under competitive pricing, as noted earlier, large users of telephone services may opt to bypass the exchange for all or part of their needs for strictly economic reasons, regardless of whether or not a decision to do so is harmful to the network. There is little that regulatory policy can do about bypass by customers

themselves. Whether we should sanction carrier bypass of the exchange, however, is clearly another matter. Currently, in setting tolls and in dealing with access charges, we have been making a conscious effort to avoid policy choices that would encourage bypass by either customers or carriers. In fact, when possible, we have been giving signals to actively discourage bypass. Our rate case order of today contains such signals. But while we may have limited options in dealing with customer bypass it is questionable whether, as a matter of regulatory policy, we should permit regulated carriers to facilitate such bypass. There are strong reasons related to maintaining a universal telephone service that would support the prohibition of carrier bypass. Rather than making a decision at this time, however, we will ask for comment on such a prohibition by the parties within 30 days of the issuance of this order. This proceeding will remain open for the explicit purpose of considering these comments, and the disposition of this issue including the possibility of further hearings will be severed from the interim decision we issue today.

Finally, we note that denying intraLATA competition at this juncture and asking for comment on the prohibition of carrier bypass are intended to protect our universal service goals and to further provide Pacific an opportunity to adjust to the post-divestiture world. Pacific should view this opportunity not as a respite but as a time to develop creative strategies which will ensure the continuation of the high level of service quality and universal service to which California has become accustomed.

4. Western Union

The question posed by WU is a simple one: to what extent do WU's Civil War era operations require the Commission to permit WU to provide intraLATA toll services? WU contends that since its operations predate the enactment of the State Public Utilities Act it need only file tariffs in order to lawfully enter any communications-related market. Upon such a filing, WU contends that the sole issue which the Commission may consider is whether the rates presented in the filing are just and reasonable. We hold that WU's contentions are wholly without legal merit.

WU's position merely points out, as we have in this opinion, that the law and regulatory principles are in many respects anachronistic. The statutes under which WU claims a franchise all distinguish between telephone and telegraph service,[5] yet WU's facilities, once exclusively dedicated to telegraph service, at some point in time were capable of carrying telephonic messages. As a result of this progress, the statutory separation of telegraphic and telephonic communications is hardly a compelling one. Indeed, we use the term "telecommunications" in this opinion to describe the business of the parties rather than the more arcane "telephone" or "telegraph".

WU is nonetheless quite incorrect in its assertions. The cases WU cites indicate quite clearly that the privileges of a utility franchise, whether granted by Commission order or by implication (i.e. grandfathered), are subject to the full regulatory authorities of this Commission. See Pacific Tel. & Tel. Co. v. City of Los Angeles, 44 Cal.2d 272, 276 (1955); and, Postal Telegraph-Cable Co. v. Railroad Commission, 200 Cal. 463, 469-470 (1927). In fact, the latter case is fully consistent with the jurisdictional discussion in Part IV of this opinion. In that case, the court found that the Commission could not prohibit intrastate operations where such operations were incidental to operations conducted under a

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[5] See, e.g., Pub. Util. C.§§233 to 236, 7901.

lawful, federally-authorized interstate franchise. Id., at 472; accord, California, supra, 567 F.2d at 86. However, the court carefully noted that the Commission retained full "regulatory", as opposed to "prohibitory", powers over grandfathered public utilities. Id., at 470. We therefore conclude that it is within our broad discretion to prevent WU from holding out intraLATA services. WU's arguments to the contrary would require us to abdicate our responsibilities with respect to the orderly administration and regulation of the local exchange and intraLATA toll markets. We refuse to do so. WU will be subject to the same proscriptions applicable to the other OCCs.

VII. The Pacific Complaint

Pacific filed Case 83-05-05 seeking a cease and desist order against the intrastate operations of MCI, Sprint and WU. By various amendments, Pacific added a number of defendants and, as a result of these amendments, the defendants to its complaint are by and large the parties whose applications have been consolidated with OII 83-06-01. Pacific also seeks an accounting from the defendants of all revenues accruing from the operations Pacific alleges to be unlawful.[6] For the reasons set forth below, Pacific's complaint is denied in all respects.

By the various decisions rendered in these matters, we have authorized numerous parties to provide intrastate interLATA telecommunications services. See, e.g., Decision 84-01-037. Having ratified the provision of such services by the defendants, we find Pacific's complaint for a cease and desist order, to the extent it is directed at interLATA operations is moot.

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[6] Several parties have argued that this Commission is not empowered to award damages to Pacific in any event. Pacific does not request damages but an "accounting" of allegedly illicit gains. The jurisdictional issue does not arise under the complaint and we need not reach it.

In this decision, we address the issue of intrastate intraLATA services and determine that switched toll services should remain the exclusive domain of Pacific. Pacific's request for a cease and desist order as it may apply against the intraLATA operations of the defendants therefore remains ripe. However, there are two key proofs which Pacific, as a complainant, was obligated to provide but did not. Pacific failed to prove either that the intraLATA traffic carried over the defendants' facilities was not incidental to otherwise lawful services or that a cease and desist order which might go beyond a prohibition on the holding out of intraLATA service could be crafted without unduly burdening or proscribing otherwise lawful service offerings.

We specifically found in D.84-01-037 that the carriage of intraLATA traffic over the defendants' facilities was incidental to the use of those same facilities for otherwise lawful, i.e. certificated and supervised activities. (Id., Finding of Fact 11.) The question of whether the intraLATA traffic at issue constitutes an incidental use turns on the defendants' intentions. We find that the defendants have never manifested an intention to provide uncertificated services.

In this case, facilities were designed and constructed pursuant to federally-tariffed and -certificated operations. Defendants' tariffs specifically state that no intrastate service is offered. Contrary to Pacific's claims, the defendants were under no obligation to configure, design or construct their facilities in such a manner as to permit the precise and efficacious blocking of unauthorized traffic. We note that, as an example, AT&T protested MCI's application for interstate authority alleging that MCI could provide intrastate service pursuant to the latter's tariff filing but never raised the issue of blocking; its protest was dismissed upon MCI's inclusion of a tariff provision excluding intrastate services.

MCI Telecommunications, supra, 70 FCC 2d at 667. Thus we find no prior legal duty was ever imposed upon the defendants to configure their respective networks so as to permit blocking. To impose such a duty at this late date would impose potentially severe and onerous burdens upon the defendants, burdens created in large part by Pacific's and AT&T's collective and individual failure to more timely raise the issue. And, as noted above in our discussion of blocking, the difficulty of blocking is a product of the inferior interconnections presently provided by Pacific to defendants. This situation will be changed with the advent of equal access and we impose a blocking requirement as a result.

Pacific also alleges that the defendants have held themselves out as intrastate carriers. However, we find that the defendants have taken reasonable steps to advise their subscribers as to the lawful limits of the services they offer.[7] While we might agree with Pacific that they could have done more, we cannot find on the record before us that the defendants exhibited an affirmative intent to hold out the availability of uncertificated services nor can we find that the defendants have acted unscrupulously or contumaciously.

The promotional materials that Pacific cites to the contrary are apparently from national advertising programs, not tailored to any particular jurisdiction. The advertising does list cities that may be reached by a subscriber but when such materials are distributed on a national basis, the information is more reasonably interpreted as promoting interstate calling, since a subscriber in one state is advised of the various places that may be reached over the network. Defendants allege that they have never used an intrastate city pair as the basis for a comparison of their rates with the Bell system rates. Thus, we agree that they have never actively promoted their service as an intrastate service.

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[7] Our additional requirements placed upon the intrastate interLATA carriers to refer intraLATA callers to the local exchange company provides additional steps to the ones voluntarily undertaken to date.

Pacific's reported conversations with defendants' sales personnel are ultimately no more persuasive. Although it is true that defendants did not discourage the intrastate use of their network, they were under no obligation to do so. The evidence only shows that defendants' salespersons were not equal to the task of fending off persistent subscribers. In this light, the defendants are in much the same position as was the petitioner in the recent case of Sony Corporation v. Universal City Studios, Inc., ____U.S. _____, 78 L.Ed. 574 (1984). That case involved the question of whether the sale of home videotape recorders constituted contributory infringement of television program copyrights. In its holding, which is equally applicable here, the Court stated:

> "Accordingly, the sale of copying equipment, like the sale of other articles of commerce, does not constitute contributory infringement if the product is widely used for legitimate, unobjectionable purposes. Indeed, it need merely be capable of substantial noninfringing uses." Id., at 592.

Applying that principle to the specific case, the Court stated:

> "The question is thus whether the Betamax is capable of commercially significant noninfringing uses. In order to resolve that question we need not explore all the different potential uses of the machine and decide whether or not they would constitute infringement. Rather, we need only consider whether on the basis of facts as found by the district court a significant number of them would be non-infringing (sic)." Id., at592.

The Court found that at least one potential use plainly satisfied this standard.

In the case at hand, there are numerous "noninfringing" uses; we suspect that they constitute the dominating users. The record in fact establishes that, for a great deal of the intraLATA toll market, Pacific's service and rates are superior to those of the

defendants. Pacific would itself do much to discourage the diversion of intraLATA traffic by disseminating these facts. Moreover, it is in the business interests of the defendants to do the same in order to prevent the dissatisfaction of their subscribers should the latter use the defendants' facilities for intraLATA calls only to later discover Pacific's rate advantage. We are willing to rely upon the parties in this case to exercise good faith, business judgment and fair business practices in complying with our order. We therefore decline to issue a cease and desist order to effect compliance.

In light of the above discussion, we see no point in issuing an order for an accounting as requested by Pacific. Its proofs are not compelling and an accounting serves no independent purpose in the context of Pacific's complaint. It will be denied.

VII. Regulation of Interexchange Carriers

The major question in this area is whether this Commission will adopt the FCC dominant/non-dominant carrier distinction to regulate the intrastate interLATA operations of AT&T and its competitors. Under this system AT&T is subject to rate base/rate of return regulation, while its competitors are free to set their rates as they choose. The idea is that the "dominant" carrier has the market power either to extract monopoly profits or to price predatorily, while the non-dominant carier has the power to do neither.

AT&T argues that this Commission should recognize that effective competition requires fair and equitable treatment for all participants. AT&T states that efforts to handicap one carrier in order to provide a competitive advantage to another carrier not only victimize the first carrier's customers, but preclude delivery to the public of the true benefits of competition. Thus, AT&T argues that the "dominant/non-dominant" blanket scheme of rate and tariff regulation proposed by its competitors is inappropriate in the new competitive communications environment. According to AT&T, if the Commission finds there are any competitive "problems," they should be dealt with directly. The Commission should not destroy real competition by continuing full rate-base, rate-of-return restrictions on AT&T Communications, while excusing its competitors from these requirements.

AT&T states that it should be noted that after January 1, 1984, AT&T will be the only interLATA carrier dedicated to serving all Californians. It will be the only carrier available to many low income, rural and occasional users, and it will be attempting to maintain statewide toll rate averaging. AT&T claims that if the Commission were to adopt the proposal of the competitors, it would be turning its back on all these Californians and undermining the viability of statewide toll rate averaging.

AT&T urges the Commission to introduce pricing flexibility and decreased regulation, and to pursue over a transition period the deregulation of the telecommunications industry. AT&T argues that pricing flexibility is necessary if the competitive marketplace is to operate efficiently; therefore, the Commission should immediately authorize the use of tariffs with upper and lower price bounds. According to AT&T, such tariffs would permit the public to receive the benefits of competition while protecting against the possibility of pricing abuses.

AT&T states that the uncontroverted evidence is that the OCCs are viable entities whose rate of growth "almost boggles the imagination;" they "grow by leaps and bounds, and do it very aggressively." AT&T claims that statistics introduced in this proceeding demonstrate that its competitors are not in need of regulatory favoritism. MCI has annual sales of about $2 billion and a customer base of about 1.3 million subscribers in California. MCI already has 17 switching machines and terminates directly into 9 of the 10 LATAs. Thus, AT&T states that the fact is that MCI is clearly a significant competitor, with a large and expanding network and ready access to the capital markets.

According to AT&T, the other OCCs are also strong, viable competitors. AT&T points out that GTE recently paid $727.4 million for the Sprint operations, nearly twice the book value, in obvious anticipation of rapid growth by those companies, and Satellite Business Systems, which has applied for intrastate certification, is owned by three powerful companies--IBM, Aetna, and Comsat General. At least 26 interstate resellers are headquartered in California, and major value-added network carriers and domestic satellite companies are providing service to customers in the state. Thus, AT&T's interexchange competitors are big businesses in their own right.

AT&T states that a commonly stated basis for handicapping it through regulation as a dominant carrier is that AT&T has a larger market share than other carriers and thus may be able to engage in some form of monopolistic abuse. AT&T argues that this deceivingly simple rationale ignores the facts and, if relied on to formulate regulatory policy, will hinder competition, not encourage it.

According to AT&T, competitive activity can and does exist even when one firm is large, quoting its witness Dr. Alessio who testified:

> "The fact is that the firms do not have to be of equal size. The firms do not have to have equal shares in the market, and in fact there can be intensely competitive activity between small firms and large firms, when in fact the small firms individually and collectively have only a small piece of the market. That has been a characteristic of the main frame computer market in recent years. It has happened in copy machines, cash registers, and electronic point-of-sale equipment, fairly clear".

Further, AT&T claims that Sprint's own witness, Dr. Cornell, belied the OCCs' argument when she acknowledged that market share analyses ("concentration ratios") are "very poor measures of competition".

AT&T claims that the telecommunications industry is characterized by contestability and rivalrous activity. Entry can and has occurred with highly mobile capital, particularly through resale and sharing by either pure resellers or facilities-based carriers seeking to expand their networks through acquisition of existing lines. AT&T states that Dr. Alessio has defined a number of considerations within the category of rivalrous activity--such as the growth of competing companies, both in market penetration and in financial strength; ease of entry; price competition; and vigorous advertising compaigns. According to AT&T, these practical measures

of market behavior reveal that competition is clearly pervasive in California's telecommunications transmission markets today; indeed, this whole proceeding demonstrates cogently the presence of rivalrous competition.

AT&T states that rather than size, it is market power over entry, the pace of technological innovation, and the development of quality standards and potential substitute products and services which must be protected against. AT&T claims that it clearly has no control over these elements. The facts of the present marketplace are ample evidence of this. Further, AT&T states that it does not control the prices charged for interexchange services; rather, in a regulated structure, the Commission is the price leader. In a competitive and deregulated market, AT&T states that the carrier who can design service to fit customer needs--the carrier who is the most efficient in real engineering and service provisioning--is going to be the price leader. Size will be but one--and clearly not the most important--of many factors impacting competition in the new telecommunications marketplace.

AT&T observes that in addition to a market share rationale, a few witnesses have based recommendations for "dominant" regulation on the allegedly superior interconnection with local exchange companies enjoyed by AT&T Communications. According to AT&T, the subject of such engineering comparisons and the propriety of a "premium access" carrier charge have been exhaustively discussed in the Commission's hearings in A.83-06-05, and that docket is the appropriate forum for addressing this issue in full. AT&T argues that any differences in access arrangements have absolutely no relevance to the form of regulation necessary in the new environment. AT&T claims that whatever those differences are--and AT&T claims they are minimal--they are not a valid excuse for any pervasive regulatory procedures or requirements which handicap AT&T vis-a-vis its competitors.

AT&T states that, in order to achieve the full benefits of competition, it has urged the Commission to establish a transition plan to maximize the self-regulatory ability of the interexchange services marketplace and to minimize the formalities of traditional regulation. According to AT&T, during this transition, AT&T, as other carriers, should be regulated in an innovative fashion, with pricing flexibility and rate structure changes encouraged. AT&T suggests that there should be a certain duration for such a program, such as 2-3 years.

According to AT&T, one critical feature of such a transition period would be the immediate introduction of flexible tariffs, with upper and lower price bounds. The upper limit would be one judged by the Commission not to be monopoly abusive, while the lower bound would be one found not to involve any anticompetitive cross-subsidization. AT&T states nearly 40 states have allowed flexible pricing tariffs during the past 10 years. AT&T argues that such a mechanism is an appropriate solution to the need of competitive carriers to respond quickly to market demands without sacrificing the public interest concerns protected by this Commission.

According to AT&T, a second element of change in traditional regulation should be greater reliance on market trials and experiments. AT&T quotes its witness Wilcoxon, who testified: "Experimentation performed without prolonged regulatory consideration will limit the financial risks associated with introducing new features or pricing packages and will permit early introduction of services that consumers find beneficial and attractive." AT&T urges the Commission to forbear from regulation of new services, including those developed through market trials. AT&T claims that the clear benefit to the public would be more prompt introduction of new and innovative services.

AT&T states that ultimately the Commission should eliminate regulation of the interexchange services market altogether. According to AT&T, in this way, consumers will be free to receive the optimal benefits from an open and fair competitive marketplace through the selection of that package of service options most responsive to their needs. AT&T observes that Sprint's witness, Dr. Cornell, has written that "[r]ate of return regulation, however well carried out, does not service society well. It neither protects customers against abuses of monopoly or oligopoly power nor prevents predatory pricing in nonmonopoly situations." AT&T states that it would not cast regulation in so negative a light, but it does believe that, in a competitive environment, regulation with its costs and market encumbrances is not necessary. AT&T states that regulation should be removed from the competitive marketplace as promptly as possible.

Sprint argues that AT&T clearly is the dominant carrier in interLATA and interstate telecommunications markets. Sprint claims that the extent of AT&T's continuing domination is illustrated by its ability to retain approximately 95% of these markets, despite the eight years of competitive effort by OCCs and resellers. Sprint claims that AT&T's overwhelming market power is reinforced by its superior access to the consuming public and its ability, because of its immense size, to manipulate cost and economic data to justify unreasonably high or low prices. Sprint warns that absent some form of regulatory control by the Commission, AT&T's dominant market position would enable it to prevent competition from developing in interLATA markets to the detriment of the consuming public.

According to Sprint, the unlawful and anticompetitive exercise and unrestrained overwhelming market share or monopoly power could appear in numerous ways. For example, AT&T, as a dominant carrier, could afford to engage in a long and protracted predatory pricing campaign in order to drive its competitors out of business.

Sprint states that the Commission should ensure that AT&T would not be able to exploit its dominant market position by adopting a type of regulation which adequately protects the public and makes the benefits of competition generally available. According to Sprint, the FCC has met these twin goals by adopting the dominant/non-dominant form of regulation. Sprint explains that this type of regulation, as originally adopted in 1980, applied traditional rate regulation to AT&T, the dominant carrier. It applied less burdensome regulation to non-dominant carriers, which were allowed to file new tariffs on 14 days' notice and were not required to file detailed cost and economic data. Sprint states that recently the FCC further reduced its regulation of non-dominant carriers. Sprint states that on October 19, 1983, the FCC decided to forbear from applying even these less burdensome filing requirements to specialized common carriers, basing its decision on these carriers' lack of market power and its three years of experience with regulating them as non-dominant carriers.

Sprint contends that the FCC's decision to apply different levels of regulation to AT&T and to non-dominant carriers was based on its finding that these carriers were effectively regulated already by the marketplace. Sprint states that the FCC determined that the OCCs' lack of market power would require them to price their services close to cost, thus ensuring that the prices charged to the consuming public would be just and reasonable.

According to Sprint the merits of this type of regulation, which takes account of the realities of the marketplace, have been demonstrated over the past three years, during which time increasingly healthy competition has been developing in interstate markets. Sprint observes that the FCC recently stated, in its further deregulation of non-dominant carriers:

> "The purposes of the Communications Act are best satisfied by reduced entry, exit, and pricing barriers and burdens for non-dominant carriers, [because] such barriers and burdens impair competition by delaying or deterring carriers in their service and rate offerings and causing them to bear additional costs. Consequently, users pay higher rates and there is limited availability of services satisfying users needs."

Sprint further notes that the FCC also stated that "full regulatory scrutiny under Title II of firms lacking market power can impose costs on these firms and consumers without offsetting benefits."

Sprint observes that AT&T urges the Commission not to adopt dominant carrier regulation, claiming that such regulation is unnecessary because AT&T does not have the power to dominate or control interLATA markets. According to Sprint, AT&T's conclusion that it is not a dominant market force in the intrastate telecommunications market is based upon contestability theory.

Sprint argues that AT&T's reliance on contestability theory is misplaced because this theory assumes preconditions which clearly are not present in telecommunications markets. Sprint states that according to those who developed the theory, William J. Baumol and John C. Panzer, "A contestable market is one into which entry is absolutely free, and exit is absolutely costless."

Sprint argues that telecommunications markets are not completely open to entry in the way required by Baumol's definition, nor will they be even if other carriers are allowed to provide interexchange service. Sprint contends that, contrary to the conditions cited by Baumol for freedom of entry, entrants into interLATA markets will face cost disadvantages and their customers will perceive lower product quality compared to AT&T or Pacific, due to unequal access. These conditions will last at least as long as there is unequal access.

Further, Sprint argues that there is not freedom of exit without capital losses in telecommunications markets. A firm that wishes to serve these markets must design networks of microwave towers and switching facilities for particular expected traffic flows, and must install these facilities on particular rights of way, after those rights of way are acquired. The firm must also make other investments in equipment and labor. Sprint states that a telecommunications firm forced to exit from serving a market would not be able to recover this investment fully, because the facilities and rights of way designed to serve a particular market generally cannot be moved to serve a different market. Sprint contends that these barriers to entry and exit make "hit and run" competition impossible, and show that these markets are not contestable.

Sprint urges the Commission to regulate resale carriers in the same manner that it regulates OCCs. According to Sprint, the FCC already has decided to apply the same level of regulation to both resellers and OCCs. This decision was based upon its finding that both of these types of carriers lack the market power to set prices contrary to the goals of the Communications Act of 1934.

Sprint states that there are additional policy considerations which mandate similar treatment of these two types of carriers. According to Sprint, resellers generally provide the same services as the OCCs, and at similar prices. Therefore, there is no way for the public to distinguish between OCCs and resellers and the public has a legitimate expectation that these carriers would be subject to the minimum regulation necessary to assure dependable and honest service. Sprint states that, as with OCCs, resellers fall within the statutory definition of telephone corporations subject to PUC regulation, by virtue of their operation of the switch which allows resellers to route calls over leased lines or their own facilities. Sprint claims that even the traditional distinctions between OCCs and resellers have become blurred, as many "resellers" now are constructing their own facilities, and the "OCCs" which have been primarily facilities-based also resell some services.

CABLE states that once a policy of open entry is adopted, the question remains as to whether any regulation at all should be applied to the entrants. According to CABLE, in the area of advanced services, since those services will generally not be provided on a common carrier basis, and since those services exhibit no monopoly characteristics, there should be no utility-type entry, exit, rate or other regulation imposed on those providers, unless such a provider also operates as a regulated public utility. CABLE argues that because an entity providing both monopoly and competitive services has the opportunity to cross-subsidize its competitive endeavors with revenues from its monopoly ratepayers, regulatory oversight is needed to protect both the competitors and the ratepayers.

CABLE claims that for those providing competitive basic telephone service, traditional rate regulation is not appropriate except for those dominant providers whose market power is sufficient to foreclose emerging competitors.

Staff notes that AT&T has raised its objection to "dominant carrier" interLATA regulation. Staff observes that the OCCs have recommended that AT&T be subject to pricing restraints and the duty to serve all routes, even unprofitable ones. Under this recommendation, the OCCs would have considerable flexibility to set interLATA rates of their choosing, and to serve the routes of their choice. Staff states that when competition becomes sufficient, dominant carrier regulation should end and all carriers should compete on an equal basis.

Staff originally made this recommendation in its August 22, 1983, brief relating to interLATA competition. Staff states that it continues to recommend dominant carrier regulation for AT&T. Staff observes that AT&T now commands 95% of all interstate toll business in this country.

Staff states that the company is one of the largest firms in the world. According to staff, under these circumstances, AT&T

could either drive its competitors out of business by under-pricing, or it could over-price and milk exorbitant profits for considerable time before being forced to lower its prices. Staff states that neither condition would be in the public interest.

Staff states that the Commission needn't now set specific dominant carrier rules for AT&T. According to staff, that can largely be left to future AT&T rate cases. Staff suggests that the decision here should merely adopt the general principle of dominant carrier regulation.

The Cities believe that the Commission should adopt a dominant/non-dominant standard, at least initially. They state that there is no doubt that AT&T will have a disproportionately high market share relative to its competitors. They suggest that as equal access becomes available this policy should be reviewed and changed as market conditions change. They add that in setting any standard that favors the non-dominant carrier, the Commission must consider that AT&T should be required to provide service to any California customer who requests it, whereas no OCC will have this responsibility immediately.

AT&T replies that Sprint pays lip service to the benefits which competition in the provision of interexchange services would provide to the public, but it reveals its real goal--market allocation, not competition. AT&T argues that Sprint's program is to prevent AT&T from being able to respond to marketplace forces in a timely or effective way. According to AT&T, Sprint would undermine the competitive initiatives of AT&T by the application of so-called dominant regulation, while itself avoiding comparable regulatory processes or oversight. AT&T contends that this OCC proposal should be recognized for what it is--a blatant attempt to avoid real competition and obtain market allocation.

AT&T claims that current market share is a product of past economic conditions, which are forever gone for the telecommunications industry, and in no way measures the future economic conditions upon which future sales will be made.

AT&T contends that Sprint's speculation that AT&T could somehow engage in predatory pricing to drive its competitors out of business or earn monopoly profits is simply wrong. AT&T argues that there is no support in fact or sound logic for such a proposition. AT&T cites the court in the August 11, 1982 opinion generally approving the AT&T divestiture, which stated:

> "The divestiture...will remove...barriers that previously deterred firms from entering or competing effectively in the interexchange market... The Operating Companies will own the local exchange facilities. With the removal of these barriers to competition, AT&T should be unable to engage in monopoly pricing in any market... For these reasons, it appears that after divestiture, AT&T will largely lack the monopoly power that the opponents of the decree suggest." 552 F. Supp. 131, 171-172 (D.D.C. 1982).

AT&T contends that Sprint attempts to avoid the fact of a rivalrous and competitive marketplace by asserting that AT&T witness Dr. Alessio improperly relied on "contestability theory" to support his empirical observation that the marketplace is highly competitive. According to AT&T, Dr. Alessio's testimony is generally supported by, but does not rest on, contestability theory. AT&T states that it agrees that contestability theory is an abstract notion intended "as a new widely applicable benchmark that both encompasses and transcends the concept of perfectly competitive markets", and that its proponents did not "believe that most markets are perfectly contestable." The authors of contestability theory only intended the theory "to be more or less applicable" to real world situations.

AT&T contends that Sprint misses the point in faulting Dr. Alessio because entry or exit from telecommunications markets may not be "absolutely costless". According to AT&T, the incontrovertible fact is that costs of entry and exit are low, relative to the potential profits to be earned, and that outside firms can and do enter the market to take advantage of market opportunities.

AT&T states that Sprint makes much of the FCC's repeatedly revised decisions in Docket No. 79-252, by which the FCC has established various rules for tariff filings and supporting data. According to AT&T, the fundamental premise behind the FCC's decision in 1980 to impose a "dominant" label on AT&T is obsolete, since that premise, as stated by the FCC, was:

> "The Bell System controls access to over 80% of the nation's telephones. Since many of AT&T's competitors must have access to this network if they are to succeed, AT&T possesses control of bottleneck facilities. Therefore, we believe that AT&T must be treated as dominant."

AT&T observes that divestiture terminates the Bell System enterprise and removes AT&T from any semblance of control of bottleneck facilities. AT&T states that it is no wonder that on October 19 of last year the FCC established a proceeding to consider adopting for AT&T the streamlined treatment previously established for "non-dominant" carriers.

According to AT&T, this FCC proceeding expressly seeks consideration of "whether the domestic, interstate telecommunications marketplace warrants, or soon may warrant, a new long-range direction for reduced regulation of AT&T's basic interstate services under the [Communications] Act." AT&T states that the FCC has recognized that major developments have increased competition, including "regulatory approval of entry by new competitors: the MFJ; greater reliance on market forces to promote the public interest regarding the rates and facilities of many carriers; and the requirement of equal interconnection arrangements and access charges."

According to AT&T, there is a clear movement by the FCC towards the regulation-free marketplace envisioned by FCC Chairman Fowler and several fellow Commissioners in public remarks earlier this year. AT&T states that contrary to Sprint's exposition, the FCC is moving to obtain the benefits of real competition by removing the outdated and unnecessary handicaps previously applied to AT&T. AT&T concludes that this Commission has no reason in fact or sound policy to accept Sprint's proposal for market allocation.

We are confident that interLATA competition will eventually develop to the point that we can substantially reduce the extent of economic regulation that is imposed on AT&T. However, we are persuaded that conditions do not support any reduction at this time. Thus, we maintain rate base/rate of return regulation of AT&T.

While it is true that divestiture has severed the knot tying together the long distance carrier and the local operating companies, it is not in and of itself a sufficient remedy for the anticompetitive conduct that preceded and precipitated it. Rather, the central feature of the MFJ is the provision for equal access. Given the differences in the nature and quality of access provided by the BOCs to AT&T and its competitors prior to equal access, we find it highly unlikely that meaningful interLATA competition can occur prior to the widespread availability of equal access.

While it is true that MCI and Sprint are growing and that more resellers enter the market daily, their presence does not obscure AT&T's dominance. After equal access allows competitors to provide equivalent service, we will entertain AT&T's application for more flexible regulation.

On the other hand, there is no party that has proposed rate base/rate of return regulation of all applicants. Such regulation is perceived as unnecessary in light of their inability to extract monopoly profits or to maintain predatory prices. Obviously, rate

base/rate of return regulation would impose a substantial burden on such entities; it would also impose an impossible burden on this Commission and its staff. Therefore, we adopt the dominant/non-dominant carrier distinction as the basis for regulating the emerging competitive market.

By non-dominant carrier regulation we intend that applicants have the freedom to set and change their rates as their self-interests indicate, subject only to such conditions as are necessary to protect their customers from exploitation.

The tariff filing rules now in effect are certainly adequate to protect the customers, but are not nearly flexible enough to accommodate competitive interests. MCI and Sprint each proposed modified tariff filing rules in their applications. The adequacy of their respective proposals was not examined in this proceeding. We are not prepared to adopt detailed rules at this time.

This is the sort of problem that is well suited for a rulemaking proceeding, leading to a modified general order. We will provide, in a subsequent order, for a prompt resolution of this problem. We direct staff to prepare an order instituting rulemaking for this purpose.

As public utilities, applicants are subject to this Commission's jurisdiction generally. With that status attaches a number of obligations on their part and ours, such as regulation of securities transactions and encumbrances or transfers of property. By A.84-03-92 the California Association of Long Distance Telephone Companies requests that the Commission exempt such utilities from various provisions of the Public Utilities Code on the ground that such requirements are antithethical to the concept of limited regulation of non-dominant carriers. Evidentiary hearings are appropriate for the purpose of evaluating their position, and we suggest that interested parties who are not members of that association should appear in that proceeding and be heard.

One of the issues specified in the OII is whether resellers should be treated differently from facilities-based carriers. No party proposed that any distinction be made, and we find that any distinction would be inappropriate, in part because the public is not aware of any difference and will expect public utility type service from either kind of entity. There is also a difficulty in distinguishing between these types of carriers, because even the larger facilities-based carriers rely on reselling for some of their traffic, and even the smaller resellers are likely to install their own transmission capability if the market response is sufficient. Some of the applicants have indicated an intention to expand their business by way of franchises or limited partnerships that would result in one entity providing service in several locations with different affiliations in each. Given that individual customers will most often deal only with the entity providing service at each location, we find that each such venture is an individual carrier and must have its own certificate and tariff on file.

Several parties have observed that applicants are under no obligation to serve statewide and may "skim the cream" by serving only the most lucrative markets. It has been suggested that we impose an obligation to serve as a condition to receiving a certificate. This reasoning overlooks the implications of the natural monopoly evidence.

Several of the witnesses indicated that some toll routes may be naturally monopolistic because traffic volumes are not sufficient to support more than one carrier. In those instances it would be unsound regulation to require competition that would not be sustainable.

Rather than attempting to identify such routes and preserve their monopoly status, it is more efficient to allow the marketplace to make the distinction. There is no point in criticizing competitors for not entering markets in which the existing carrier has a natural monopoly.

Another issue that stimulated substantial discussion is the problem of deaveraged rates. The notion is that "cream skimming" will force down rates in competitive markets and force up rates on noncompetitive routes. We find there is no foreseeable danger that deaveraging will occur spontaneously in the near future, in light of the access charges that we adopted; however, in order to further diminish the probability, we will require that each applicant file rates that are uniform on a distance basis.

Findings of Fact

1. Virtually all OCC connections with local operating companies are ENFIA A, "line-side", connections.

2. Line-side connections require that the OCC customer dial a lengthy series of digits in order to reach a desired telephone number.

3. Rotary dial telephones cannot be used with ENFIA A connections without a separate tone-generating device. Also, special features such as answer supervision and automatic number identification are unavailable through OCCs with line-side connections.

4. Due to the inferior configuration of a line-side connection, OCCs with such connections suffer a loss of transmission quality.

5. Pacific provides AT&T with a "trunk-side" connection which does not suffer from the inconveniences and technical difficulties associated with line-side connections.

6. The divestiture order issued by the Federal District Court (MFJ) requires the provision of "equal access" to all carriers commencing in 1984, to be completed no later than September of 1986. Under equal access, the OCCs will be provided interconnections equal in type, quality and price to that provided to AT&T and its affiliates.

7. The telecommunications industry is an industry in dramatic transition, both structurally and technologically.

8. In order to protect universal telephone service in California, it is appropriate to adopt a prohibition on competitive entry into the intraLATA toll market.

9. The intraLATA toll market should be left in the monopoly control of the local exchange companies.

10. There are various upward pressures on basic exchange rates which individually and collectively threaten universal telephone service in California.

11. The loss of intraLATA toll contributions to the local exchange companies and their nontraffic-sensitive (NTS) costs could jeopardize universal telephone service in California by driving up the cost of basic exchange service.

12. IntraLATA toll services now provide a substantial support of the NTS subscriber plant costs of the local exchange companies.

13. The substantial economic and social benefits to society created by a universal telephone service, which absent a governmental willingness to independently provide the funding needed to maintain universal service, justify the rejection of a pricing system based completely on marginal cost.

14. The universal service benefit represents a greater public interest than the economic efficiencies which are allegedly inherent in marginal cost pricing.

15. It has been this Commission's policy to develop rate design schemes reasonably calculated to foster universal telephone service.

16. Neither the FCC's High-Cost Fund proposal nor 1983 Assembly Bill 1348 are unqualifiedly viable alternatives to replace the rate design policies which insure universal telephone service.

17. There is a substantial likelihood that some loss of toll contribution to NTS costs and rate deaveraging would occur due to intraLATA toll competition.

18. Private line services consist of direct access line connections which avoid the need for being switched over the public network.

19. Private line services are primarily used to provide direct telephone connections and high-speed data transmission over dedicated non-switched access lines.

20. Private lines constitute a small portion of the revenues of the local exchange companies.

21. It is desirable to permit some limited private line competition.

22. IntraLATA competition by WATS resellers would provide none of the efficiencies or benefits resulting from competition.

23. Blocking generally refers to the interception and automatic termination of certain specified transmissions, here unauthorized intraLATA traffic.

24. The implementation of blocking prior to equal access would require a considerable commitment of capital, resources, and time. Upon the implementation of equal access, these commitments are no longer required.

25. The OCCs have configured and constructed their systems in good faith, free from any Federal Communications Commission (FCC) or other requirement to accommodate blocking.

26. Upon the offering of interconnections under the mandated equal access, all interexchange carriers would be provided the immediate means to block intraLATA traffic without affecting their other services.

27. Western Union holds a utility franchise by implication of law under the principles of "grandfathering."

28. The carriage of intraLATA traffic over the facilities of the defendants in Case (C.) 83-05-05 is incidental to the use of those same facilities for otherwise lawfully provided services.

29. The defendants in C.83-05-05 have never manifested an intention to provide uncertificated intraLATA services.

30. No prior legal duty was ever imposed upon the defendants in C.83-05-05 to configure their respective networks so as to permit blocking of unauthorized intrastate traffic.

31. The defendants in C.83-05-05 have taken reasonable steps to advise their subscribers as to the lawful limits of the services they offer.

32. Given the differences in the nature and quality of access provided by the Bell Operating Companies to AT&T and its competitors prior to equal access, it is highly unlikely that meaningful interLATA competition can occur prior to the widespread availability of equal access.

33. Except for AT&T, no other interexchange carrier in California has an ability to extract monopoly profits or to make maintain predatory prices.

Conclusions of Law

1. The Commission has broad regulatory authority over the providers of intrastate telecommunications services.

2. Intrastate telecommunications traffic carried over facilities as an incidence to lawfully provided interstate services are encompassed within interstate operating authorities and may not be prohibited by this Commission.

3. The Federal Communications Commission (FCC) may not certificate intrastate services.

4. The Commission may neither burden nor discriminate against federally authorized telecommunications, however, FCC certification does not preempt this Commission's consideration of applications for the provision of the intrastate services of persons holding such federal authority.

5. This Commission has jurisdiction to consider the issues presented by the OII, the applications and complaints now before us.

6. Private line competition in intraLATA telecommunications should be permitted in limited form.

7. The resale of intraLATA WATS service should be prohibited, except to complete an interLATA or interstate call.

8. Blocking should not be required prior to equal access.

9. Persons not authorized to provide intraLATA telecommunications services should be prohibited from holding out the availability of such services and should be required to advise their subscribers that intraLATA communications should be placed over the facilities of the local exchange company.

10. The privileges of a utility franchise, whether granted expressly by this Commission or by implication of law, are subject to the full regulatory authorities of this Commission.

11. Western Union may be prohibited from holding out intraLATA telecommunications services.

12. Pacific's complaint against the intrastate carriers should be denied.

13. AT&T should be regulated under the dominant/nondominant carrier system of regulation. AT&T should be regulated under the rate base/rate of return regulations applied to other California public utilities.

14. Resellers should be regulated in the same manner as facilities-based interexchange carriers.

15. Uniform rates should be required.

INTERIM ORDER

IT IS ORDERED that:

1. All applications to the extent not previously granted are denied. Persons not authorized to provide intraLATA telecommunications shall refrain from holding out the availability of such services and shall advise their subscribers that intraLATA communications should be placed over the facilities of the local exchange company.

2. Pacific Bell (Pacific) shall block unauthorized intraLATA traffic carried over or through the facilities of any interexchange carrier upon full implementation of equal access within a LATA.

3. In accordance with Ordering Paragraph 2, Pacific shall file an advice letter with the Commission stating that it will commence blocking unauthorized intraLATA calls ten (10) days following the filing of the advice letter. Pacific shall serve a copy of said advice letter upon all interexchange carriers operating within that LATA.

4. Any interexchange carrier not accepting the interconnection arrangement constituting equal access and/or maintaining any interconnections other than those offered under equal access shall file a notice of such facts (with the same distribution as an advice letter) within five (5) days of receiving Pacific's advice letter.

5. Providers of private line services offering high speed data transmission services may file applications if they wish to offer such services intraLATA subject to the limitations set forth in the decision. Pacific and any other local exchange company which provides competing service, where its rates exceed or cover the costs of providing that service, in the LATA relevant to any such application may appear as a protestant and/or file responsive rate tariffs in order to preserve its market share.

6. Within 30 days from the date of this order, parties to this proceeding shall file with our Docket Office the original and 12 copies of Comments on the Issue whether a prohibition of interexchange carrier bypass of the switched network should be imposed and, if so, in what manner.

7. AT&T shall be regulated as the dominant interexchange carrier in California. All other interexchange carriers shall be regulated in a manner which permits them to compete in the California interLATA market.

8. Applicants are authorized to have on file with this Commission tariff schedules for the provision of intrastate interLATA telecommunications services, subject to the condition that rates shall be uniform on a distance basis. If any applicant has an effective FCC approved tariff, it may file a notice adopting such FCC

tariffs with a copy of the FCC tariff included in the filing. Those applicants that have no effective FCC tariffs, or that wish to file tariffs applicable only to California, are authorized to do so, including rates, rules, regulations, and other provisions necessary to offer service to the public. Such filings shall be made in accordance with General Order 96-A, excluding Sections IV, V, and VI and shall be effective not less than one day after filing.

9. Case 83-05-05 filed by Pacific against various defendants is denied.

10. The tariffs suspended in I&S Case 83-11-05, to the extent not previously authorized, are permanently suspended and the case is closed.

11. Each of the applications, to the extent not previosuly granted, is denied.

This order is effective today in order to provide for the continued effect of our previous orders prohibiting the holding out of intraLATA toll services by persons other than the local exchange companies.

Dated June 13, 1984, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
DONALD VIAL
WILLIAM T. BAGLEY
Commissioners

Commissioner Priscilla C. Grew, being necessarily absent, did not participate.

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Joseph E. Bodovitz

Joseph E. Bodovitz, Executive Director

APPENDIX A
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List of Appearances

Applicants: Brad E. Mutschelknaus, J. Manning Lee, (Virginia), Attorneys at Law, and Messrs. Sullivan & Cromwell, by Robert Bell, Attorney at Law, for Satellite Business Systems; Michael Gary Perdue, Attorney at Law, for CALL USA, Inc.

Respondents: Richard A. Bromley, and Hathaway Watson. III, Attorneys at Law, and John E. Dennis, for AT&T Communications; James S. Hamasaki, Richard W. Odgers, and James B. Young, Attorneys at Law, for The Pacific Telephone and Telegraph Company; Messrs. Brobeck, Phleger & Harrison, by Gordon E. Davis and William H. Booth, Attorneys at Law, for Western Union Telegraph Company; Lawrence P. Keller, Attorney at Law, for The Western Union Telegraph Company; Petty, Andrews, Tufts & Jackson, by Dennis Swanson, Attorney at Law, for Telemarketing Communications; Preston Moore and Gary Rinck, Attornyes at Law, for MCI Telecommunications; Messrs. Graham & James, by Thomas MacBride, Jr., and James Scueri, Attorneys at Law, for Telephone and CALTEL; and Ann C. Pongracz, Attorney at Law, and Messrs. McCutchen, Doyle, Brown & Enersen, by James B. Lewis, Richard D. Zimmerman, and Terry J. Houlihan, Attorneys at Law, for GTE Sprint Communication Corporation.

Interested Parties: Richard Arrington, for Contra Costa County and the League of California Cities; Jon F. Elliott, Attorney at Law, and Sylvia M. Siegel, for Toward Utility Rate Normalization (TURN); Messrs. Orrick, Herrington & Sutcliffe, by Robert J. Gloistein and David R. Pigott, Attorneys at Law, for Continental Telephone Company; H. Ralph Snyder, Jr., Attorney at Law, for General Telephone Company of California; William L. Knecht, Attorney at Law, for Execuline of California, Inc.; Lloyd I. Krause, Telecommunications Industry Consultant, for himself; John S. Loewen, for Savenet; Harriet Moss, for the City of Mountain View; Messrs. Pelavin, Norberg, Harlick & Beck, by Alvin H. Pelavin and William R. Haerle, Attorneys at Law, for Calaveras Telephone Company, California-Oregon Telephone Company, Capay Valley Telephone System, Inc., Dorris Telephone Company, Ducor Telephone Company, Evans Telephone Company, Foresthill Telephone Company, Happy Valley Telephone Company, Hornitos Telephone Company, Kerman Telephone Company, Livingson Telephone Company, Inc., Pinnacles Telephone Company, Sierra Telephone Company, Inc., The Ponderosa Telephone Co., The Siskiyou Telephone Company, and The Volcano Telephone Company; August Sairanen, for State of

California - Office of Telecommunications; John W. Witt, City Attorney, by William S. Shaffran, Deputy City Attorney, for the City of San Diego; George Agnost, City Attorney, by Leonard L. Snaider, Deputy City Attorney, for the City and County of San Francisco; William M. Winter and Michael A. Morris, Attorneys at Law, for California Cable Television Association; Thomas L. Feeney, for TeleMarketing Communications of Monterey; William J. Irving, for County of Los Angeles; Ira Reiner, City Attorney, by Ed Perez, Deputy City Attorney, for City of Los Angeles; Messrs. Farrow, Schildhause, Wilson, & Rains, by E. Nicholas Selby, Attorney at Law (D.C.), for itself; Victor J. Toth, Attorney at Law (Virginia), for American Telephone Exchange, Comprehensive Communication Systems, Inc., Transcall America, Inc.; Francis L. Young, Attorney at Law (Texas), for CP National Corporation; and Octavio A. Lee, for California State Board of Equalization, Valuation Division.

Commission Staff: Robert Cagen and Javier Plasencia, Attorneys Law, and Emily Marks and Duncan Wyse.

(END OF APPENDIX A)

democratic political and social institutions. Northern Pacific Railway Co. v United States, 356 US 1, 4..." United States v AT&T, 552 F. Supp. 131, 150-151 (D.D.C., 1982).

While we concur in the Court's assessment of the importance of competition, we believe that competition in the telecommunications arena must be implemented very carefully. Staff suggests that the continued availability of telephone service at affordable rates should be of overriding concern to regulators. We agree that, for purposes of this decision, the critical determination is whether the allowance of intraLATA competition might jeopardize the universality of telephone service which California now enjoys.

A. The Uncertain Future and the Universal Service Principle

This proceeding was originally intended to resolve the question of the extent to which competition should be permitted in the intraLATA toll market. Our resolution of this question was to have been dependent upon evidence as to the extent and direction of the effects competitive entry might have on universal telephone service. However, all that can be said with any degree of certitude is that the telecommunications industry is going through an unprecedented transition marked by technological and corporate upheaval. We have determined that this transition period demands caution. If we err, we should err on the side of universal service. Caution, as a transition strategy, serves and bears that bias.

In this order, we will therefore adopt a prohibition on competitive entry into the intraLATA toll market. In our opinion, competition in this market requires findings of fact which we cannot make upon the record before us. Rather, the record is replete with uncertainties which prevent us from concluding that competitive entry will not jeopardize our goal of universal telephone service. We discuss those uncertainties presently.

We established intrastate interLATA access charges in D.83-12-024 which recover the portion of NTS subscriber plant costs allocated to the intrastate interLATA market through common carrier line charges. Our concerns about maintaining affordable exchange rates contributed to this decision. However, particularly if various parties' dire warnings regarding the threat of bypass prove true, we recognize that this decision may require modification. Further, while we reserve judgment, there are strong arguments in favor of making interstate and intrastate interLATA access charges consistent, if not equal, for simplicity's sake and to avoid rate arbitrage. Along with other issues, the desirability of parity between intrastate and interstate access charges, and proposals for future reallocation of costs, including NTS costs, between intrastate access services and intraLATA services have been set for further hearings in the access charges proceeding. The disposition of these issues may well affect the basic exchange rate.

Other factors contributing to inexorable increases in local rates include FCC actions to require faster depreciation of capital equipment, the direct expensing of the costs of connections, installations, and moves, and an amortization of the accumulated, capitalized past charges of this kind; federal tax law changes; and, particularly for some rural companies, increased interest costs.

The parties have vigorously debated whether local exchange rates will remain affordable assuming competitive entry at the intraLATA toll level. The above factors do not paint an optimistic picture of this Commission's ability to maintain those rates at a level which will avoid the jeopardizing of universal service. Allowance of intraLATA toll competition could add yet another potentially adverse factor, the reduction or loss of intraLATA toll contributions to NTS costs. An already bleak situation could then turn desperate.

2. Marginal Cost Pricing and Its Economic Efficiencies

As we have heard from many experts in both this and the access charges proceeding, prices tend to be driven to marginal costs in a competitive market, and the pricing of goods and services at their marginal costs results in the most efficient use of those goods and services and of the nation's resources. Particularly for electric utilities, we have long recognized these principles, and have devoted considerable efforts to calculating and implementing prices based on marginal costs, both for electricity sales and for utility purchases from nonutility power producers. However, there are at least two significant barriers to implementing a marginal cost-based pricing system for telecommunications services at this time. First, little effort has been spent even formulating the principles that ought to apply, let alone calculating the marginal costs of various components of telephone service. Second, the universal service externality represents a greater public interest than the economic efficiencies which are allegedly inherent in marginal cost pricing.

While the accuracy of the various embedded cost studies was hotly debated in this proceeding, no testimony was devoted to the development of marginal costs. At this time, we simply do not have the tools or studies available to us to allow marginal cost pricing with any degree of accuracy.

We suspect that marginal cost studies will demonstrate that the marginal costs of toll service are substantially lower than the costs allocated to toll under embedded cost studies. The behavior of the OCCs in the intrastate interLATA toll market will provide valuable evidence in this regard. We would expect that the OCCs will devote their resources to the most profitable routes and configure

their systems to accommodate the most lucrative toll traffic patterns. The local exchange companies have always been required to extend service to unprofitable routes and to accommodate all anticipated traffic patterns. Thus, they have not pursued the resource allocations which marginal cost pricing would dictate but have incurred substantial NTS costs made artificially economic by our system of rate regulation of public utility monopolies. It is simply unrealistic to expect the local exchange public utilities to effectively compete with their modern brethren having been born and bred under vastly differing environments.

Furthermore, the substantial societal benefits of universal telephone service create an externality which, absent a governmental willingness to independently provide the funding needed to maintain universal service, justify the rejection of a pricing system based completely on marginal cost. Some individual customers are unwilling or unable to pay as much for phone service as it is worth to society or as it costs to provide. There was unanimous agreement among the parties regarding this universal service externality. Until we see evidence that marginal cost pricing would not jeopardize the universal service goal, our bias will be to pursue that goal without extreme deference to the economic efficiencies of marginal cost pricing. We expect to reexamine the issue in Pacific's next general rate case, as discussed in our decision in A.82-11-07 issued today.

3. Embedded Costs and Their Relevance to IntraLATA Competition

Both Pacific and staff performed embedded cost studies which conclude that intraLATA toll revenues now provide substantial support of local exchange costs, though they take differing viewpoints regarding whether this support constitutes a "subsidy" of local rates. On the other hand, Sprint, MCI, and WU presented witnesses who asserted either that no toll-to-local subsidy exists or at least that existing data is insufficient to determine whether a contribution from toll to local service exists.

services for many years for purposes of cost recovery. However, the allocation factors have been chosen by the federal and state regulatory agencies largely to achieve the desired distribution of costs, and certainly not based on any theory of cost causation.

The parties offer many valid criticisms of portions of Pacific's cost study. Pacific reports directory revenues of $483 million, and operating expenses and depreciation of $189 million, but a combined return and tax component of only $8 million. We have never before encountered the notion that $300 million in net income "causes" less than $8 million in income taxes. Conversely, Pacific reports that the operating expenses and depreciation allocated to the access line (the local loop and associated plant) exceed revenues, but that the access line "causes" hundreds of millions of dollars of income taxes.

Pacific reports that directory assistance services generate revenues of $9 million while causing direct costs of $239 million. However, Pacific did not allocate to directory assistance any revenues generated from toll calls placed over its network after the number is obtained from directory assistance, even though its witness admitted that "perhaps" such calls occur.

Similarly, Pacific includes in the "access line" category the costs of all Yellow Page business listings, but no revenues from Yellow Page advertising, and includes the capital costs of all pay phones but no toll revenues generated through use of pay phones.

Pacific admits that some of the criticisms aimed at its cost study may be valid, but contends that all the identified shortcomings taken together are far too minor to undermine its basic conclusions.

While the details of the parties' cost studies can be debated ad infinitum, we conclude that the evidence in this proceeding overwhelmingly supports Pacific's and staff's common

conclusion that intraLATA toll services now provide a substantial support of the NTS subscriber plant costs of the local exchange. We believe that the underlying questions of how much of the revenue requirement for the NTS subscriber plant costs (the fixed costs of the local exchange) should be collected from intraLATA toll users and how much from users of basic exchange services are much more important for the purposes of our decision regarding intraLATA competition.

Many parties, including both proponents and opponents of intraLATA competition, have argued that economic forces dictate against an indefinite continuation of the current high level of NTS costs included in toll rates. Further, the size and source of any support of NTS costs needed to ensure universal service also engendered much controversy. We find ourselves searching for a solution which balances the benefits of universal service against the desirability of pricing toll service closer to its marginal cost to increase the economic efficiency of toll usage. We must consider intraLATA competition in this light. With no solution in sight, we cannot support such competition.

4. Rate Design v. Governmental Support

As the parties to this case acknowledge, it has been this Commission's policy to develop rate design schemes reasonably calculated to foster universal service. We have been largely successful. However, issues have been raised as to whether our rate design policy has been misdirected or could be effectively replaced by alternative supports.

Several parties argued that any support of NTS subscriber plant costs besides that obtained from local exchange rates should be narrowly focused to provide the minimum support necessary to maintain universal service, and that the resulting additional revenue requirement should be allocated on the basis of respective

6. Conclusions

In reviewing the contentions of the various parties, we reach the inevitable conclusion that no one can accurately predict the configuration of the future telecommunications market. Local exchange rates may be driven up by the forces beyond our control without adding the threat of losing intraLATA toll revenue support. On the other side, we do not yet know the extent to which targeted subsidies such as the new lifeline rate in California or the nationwide "high cost fund" will succeed in reducing the cost burden of telephone service to those persons or areas of the country most vulnerable to rising rates. To be frank, we don't know whether political considerations would allow the large basic rate increases propounded by Dr. Kahn and other economists. The FCC has certainly encountered substantial political resistance in Congress to the limited end user charges it is attempting to implement.

The forces of competition have been unleashed in the interstate and intrastate interLATA markets. In those arenas, perhaps the largest ever experiment of free-market competition is already well underway. As competition develops further in those markets, much will be learned as to the wisdom and effects of telecommunications competition.

In the face of such uncertainty, we must refrain for now from surrendering the last bastion of additional support of NTS costs. As we have noted, economic theory holds that revenue requirements in excess of marginal costs should be recovered from the least elastic services (absent a general tax, which appears highly unlikely at this point). This means that basic exchange rates will be viewed more and more as the revenue source of last resort. We must also keep in mind, as our staff points out, that a decision to allow intraLATA competition is not a short-term decision. Once such a decision is made and interexchange companies establish a presence, however small, in the intraLATA market, our decision would be irreversible for all practical purposes.

While on a theoretical level we agree that intraLATA competition has many merits, the risks and market uncertainties are too large to allow us to authorize it at this time. Unless and until we are convinced that a feasible alternative has been developed which will protect universal service in the manner of the toll-to-exchange contribution engendered by the intraLATA monopoly we leave in place, we must prohibit intraLATA competition. We fully embrace staff witness Wyse's recommendation:

> "The time is not ripe for intraLATA competition. While intraLATA competition could benefit consumers through technological advancement, diversity of choice and more efficient management of resources, these long term benefits are outweighed by the risk of so thoroughly disrupting the historic rate structure that universal service becomes jeopardized in the near term. The Commission should wait until it has more experience in a post-divestiture world before making an affirmative decision to permit competitive entry."

We take small comfort from the arguments of the OCCs that they are unlikely to achieve more than a negligible share of the market or that, if they do, it will be a larger market with "plenty for everyone." The record certainly leaves the penetration rate and market growth issues open to speculation. Nor do we find the Texas experience to be at all compelling. As staff points out, the structure of rate design in Texas is hardly comparable to our own. More importantly, competition was introduced under a pre-divestiture scenario quite different from the facts now at hand. The OCCs there "competed" with the Bell System ; AT&T did not compete with the local exchange carrier as it could in our case. Customer awareness as to the availability of choices is at an all-time high due to divestiture. We simply cannot rely on the evidence garnered from a vastly different place and time to draw conclusions as to the future California market.

In recognition of the economic considerations we have discussed, we have already begun steps to improve the efficiency of the pricing structure for telecommunications services. We have authorized competition in the interLATA market and now in private line intraLATA services. We will examine various proposals to reduce the portion of NTS costs to be recovered through intrastate access charges in phase two of our access charges proceeding, as well as proposals for tapered or declining block toll rates as a further means of capping the imposition of NTS costs on large users of toll services. And in our decision in Pacific's general rate case which we issue today, we order Pacific and staff to begin examining the marginal costs of various Pacific services. We expect to rely on their evaluations for guidance as we reexamine our current rate design procedures in future general rate proceedings.

As we stand at the dawn of a new age in telecommunications, we realize that our first few steps may appear faltering and weak to those who would stride boldly forward. However, we believe that caution will more assuredly safeguard the public interest which it is our solemn duty to protect. We will willingly reexamine our current prohibition against intraLATA competition as experience in the interLATA markets and in the post-divestiture era turns dawn to daylight.

B. Implementation Issues

Having determined that intraLATA competition should not be authorized at this time, there are several residual issues yet to be decided. These issues generally concern the implementation of our adopted policy. They are as follows:

- Whether special exemptions from the restraints on competitive entry should be applied to private line facilities or WATS resellers;

on a resale basis. While we allow joint users to share an intraLATA WATS service, we have never authorized the resale of that service for profit. Our staff and Pacific are hereby advised to intensify the enforcement of Commission-approved WATS tariffs and to terminate the provision of intraLATA WATS service to uncertificated intraLATA WATS resellers in order to halt these illegal operations.

Finally, assuming we were to authorize intraLATA WATS resale, OCCs could easily purchase WATS capacity for resale and thereby hold out the intraLATA services we would not certificate with respect to their own facilities. It is intuitively obvious that both doors in a two-door barn should be closed if our aim is to keep the horse inside. We will therefore prohibit the resale of intraLATA WATS services.

2. Blocking

"Blocking" generally refers to the interception and automatic termination of certain specified transmissions, here unauthorized intraLATA traffic. Several parties, most notably Pacific and staff, have advocated that a ban on intraLATA competition be enforced by requiring interLATA carriers to employ blocking schemes to prevent intraLATA usage of their networks. In reviewing the record, however, blocking does not appear to be as efficacious an enforcement method as Pacific and staff contend.

The implementation of blocking, by every parties' contention, would require a considerable commitment of capital, resources and time. Under certain proposals, switching capacity and memory would have to be added by the OCCs in order to facilitate blocking. New software would have to be developed for the proposals proposed by Pacific. Although these facts are conceded by all, the OCCs and Pacific differ on the extent of the burdens blocking would entail.

The OCCs claim that Pacific's blocking proposals would take years and millions of dollars to implement and would be ineffective in any event. According to the OCCs, implementation is not so readily achieved because under their current ENFIA A interconnection arrangements the OCCs do not know the point of origination for any call placed over their systems. In order to provide, store and utilize that data, the OCCs must redesign or reconfigure their existing systems. The OCCs note that they would be required to overcome all these difficulties even though equal access would shortly present a different system configuration which would require new blocking arrangements.

The OCCs also argue that blocking can easily be evaded through the use of adjunct facilities. MCI points out that successful evasion requires no cleverness, just "a PBX sitting in a closet" through which a subscriber's calls would be routed to obtain the most favorable toll rate. It is also argued that, whatever schemes are devised, there would be the extreme likelihood that interstate and interLATA calls would also be blocked.

To all this, Pacific merely responds that the OCCs should not be trusted. Pacific argues that the OCCs have done nothing to discourage unauthorized calls and that the OCCs should be using this opportunity to exhibit their technological prowess. Although Pacific concedes that the OCCs are correct in their assessment of the technical difficulties the implementation of blocking poses, Pacific offers that nothing in life is foolproof and that the difficulties are surmountable or peripheral.

Staff also concedes the difficulties of implementing blocking but adopts an approach differing from Pacific. Staff concludes a blocking requirement should be adopted, if at all, upon the implementation of equal access. We agree that this approach is prudent and will defer adoption of a blocking requirement until a later time.

As noted above, all parties agree that months and millions of dollars would be required to implement Pacific's blocking proposals even assuming the ready availability of appropriate technological means, an assumption in which we have little confidence. The OCCs have configured and constructed their systems in good faith, free from any FCC or other requirement to accommodate blocking. The Bell affiliates certainly did not bring any successful actions of which we are aware either before the FCC or any state regulatory agency timely seeking such a requirement despite their full knowledge that intrastate traffic could be carried over the networks of the OCCs. See, e.g., MCI Telecommunications, supra. It is, quite simply, too late in the game to require blocking prior to equal access.

Given the record before us, we cannot conclude that a blocking requirement would neither interfere with nor otherwise place undue, onerous burdens upon the OCCs' lawful interstate (and now intrastate interLATA) services. We reject Pacific's invitation to disregard this issue. To do so may well exemplify and result in the type of state regulation that the courts have found to be repugnant to the orderly administration and development of a national telecommunications network. North Carolina I, supra, at 793; New York Tel. Co., supra, at 1065.

The evidence before us leads us to the inexorable conclusion that AT&T and Pacific are largely responsible for our current predicament. The inferior ENFIA A interconnections offered to the OCCs preclude the immediate means to block intraLATA traffic without affecting their other services. AT&T gratuitously offers that it will accept an order to block intraLATA calls placed over its system. This is a hollow offer. Pacific can readily do so given the configuration of the present system. If all parties stood in

AT&T's shoes, a more compelling case for blocking arrangements would be made. But this is not the case before us and it is not the case due to the failure or refusal of the Bell affiliates to provide similar interconnections to all comers. These circumstances add equitable grounds to the technical problems discussed above; the sum is that no blocking requirement shall be imposed.

We note that the record before us establishes that the technological progress that has blurred the interstate-intrastate dividing line may soon offer us the ability to separate interstate from intrastate and interLATA from intraLATA traffic. Upon the full implementation of equal access in the fall of 1986, Pacific will assertedly have the capability of distinguishing wholly intraLATA traffic from interLATA or interstate calls. At an appropriate time and in a proper procedural context, we intend to revisit the blocking issue. We leave this matter to the future.

As for the moment, we will continue our policy of prohibiting the applicants from holding out the availability of intraLATA service. Such a prohibition hardly intrudes upon the FCC's authority to permit the applicants to provide interstate service over common facilities. We will add one further requirement at Pacific's request. The applicants, in answering customer inquiries as to whether their facilities may physically be used to complete intraLATA calls, shall advise current and potential customers that such calls (1) may not be lawfully placed over their networks and (2) should be placed over the facilities of the local exchange carriers without any further advice being provided. In the event that this measure proves unsuccessful in preventing the diversion of local exchange intraLATA toll revenues or the applicants do not observe our order, we will consider available enforcement alternatives.

3. Prohibition of Carrier Bypass

In the closing paragraphs of its reply brief, Pacific proposed that a prohibition against interexchange carrier bypass would be an appropriate manner in which to enforce a ban on intraLATA competition. Pacific is apparently concerned that certain carriers will leave the switched network to avoid the ban and the access charges imposed upon them. Although this idea may have merit, it was not considered in the evidence or arguments of the parties to this proceeding. We therefore will not adopt Pacific's proposal but will set further hearings to determine whether such a prohibition is indeed appropriate and, if so, in what manner.

The questions of the extent to which NTS costs should be recovered through usage sensitive charges and the extent to which they can continue to be recovered in this manner without resulting in significant bypass are central ones on several fronts. The FCC has wrestled with this on the interstate level, and we have examined it carefully in establishing intrastate interLATA access charges. In Decision 83-12-024, we stated that:

> "...the ubiquitous nature of the telephone network offers benefits to all subscribers. Those benefits tend to increase as the subscriber makes greater use of the network. Thus, although the costs of subscriber plant may not be usage sensitive, the benefits derived by customers from the sum total of Pacific's subscriber plant do increase with increased usage.
>
> "There is no denying that any particular subscriber loop is of more benefit to the subscriber served by that loop than to any other customers. So it is appropriate that the particular subscriber bears the greatest share of the costs of the facilities provided for his service. Still, the logic of telephone utility accounting practices and the shared benefits of a ubiquitous telecommunications network strongly imply, even dictate, that the costs of the network should be shared as well...

> "Based on the record developed in this proceeding, we do not view the emergence of competition and the threat of bypass as such drastic changes of circumstances as Pacific would have us believe. The evidence shows that Pacific has long fostered competition with its own switched network services through its WATS and private line service offerings. Dr. Kraemer's survey of the extent of bypass among Pacific's larger customers offers grounds for concern but does not justify concluding that Pacific faces any serious threat to its viability in the foreseeable future.
>
> "On the other hand, we recognize that the range and attractiveness of competitive alternatives to the use of Pacific's exchange network are increasing and that it would be unwise to expose Pacific unnecessarily to risks of uneconomic bypass. This situation justifies close attention to Pacific's costs in the setting of access charges, particularly in the longer term.
>
> "Bypass is a long-term problem. Commitments to bypass investments by IECs or large customers will be based on their expectations as to the future trend of Pacific's rates. To this extent we agree with Pacific on the importance of signalling clearly the seriousness with which we take the bypass problem and the seriousness of our intent to limit uneconomic bypass."
>
> "Our intent is not to eliminate all NTS costs from the revenue requirement for access charges. We share the concern of our staff, the Cities, and TURN that IECs and the users of their services need not and should not be given free use of Pacific's local subscriber plant. The benefit to users which arises from the ubiquitous character of the local network fully justifies continued imposition of a significant share of NTS costs upon those who take advantage of their access to that network." (D.83-12-024, pp. 35-38.)

We find similarly in the intraLATA arena that bypass does not appear to be a short-term problem for Pacific and that toll rates (or, if we allowed intraLATA competition, access charges) can continue to be used to recover NTS costs at this time without fear of bypass. We will examine these issues in the coming hearings.

MCI Telecommunications, supra, 70 FCC2d at 667. Thus, we find no prior legal duty was ever imposed upon the defendants to configure their respective networks so as to permit blocking. To impose such a duty at this late date would impose potentially severe and onerous burdens upon the defendants, burdens created in large part by Pacific's and AT&T's collective and individual failure to more timely raise the issue. And, as noted above in our discussion of blocking, the difficulty of blocking is a product of the inferior interconnections presently provided by Pacific to defendants.

Pacific also alleges that the defendants have held themselves out as intrastate carriers. However, we find that the defendants have taken reasonable steps to advise their subscribers as to the lawful limits of the services they offer.[7] While we might agree with Pacific that they could have done more, we cannot find on the record before us that the defendants exhibited an affirmative intent to hold out the availability of uncertificated services nor can we find that the defendants have acted unscrupulously or contumaciously.

The promotional materials that Pacific cites to the contrary are apparently from national advertising programs, not tailored to any particular jurisdiction. The advertising does list cities that may be reached by a subscriber but when such materials are distributed on a national basis, the information is more reasonably interpreted as promoting interstate calling, since a subscriber in one state is advised of the various places that may be reached over the network. Defendants allege that they have never used an intrastate city pair as the basis for a comparison of their rates with the Bell system rates. Thus, we agree that they have never actively promoted their service as an intrastate service.

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[7] Our additional requirements placed upon the intrastate interLATA carriers to refer intraLATA callers to the local exchange company provides additional steps to the ones voluntarily undertaken to date.

One of the issues specified in the OII is whether resellers should be treated differently from facilities-based carriers. No party proposed that any distinction be made, and we find that any distinction would be inappropriate, in part because the public is not aware of any difference and will expect public utility type service from either kind of entity. There is also a difficulty in distinguishing between these types of carriers, because even the larger facilities-based carriers rely on reselling for some of their traffic, and even the smaller resellers are likely to install their own transmission capability if the market response is sufficient. Some of the applicants have indicated an intention to expand their business by way of franchises or limited partnerships that would result in one entity providing service in several locations with different affiliations in each. Given that individual customers will most often deal only with the entity providing service at each location, we find that each such venture is an individual carrier and must have its own certificate and tariff on file.

Several parties have observed that applicants are under no obligation to serve statewide and may "skim the cream" by serving only the most lucrative markets. It has been suggested that we impose an obligation to serve as a condition of receiving a certificate. This reasoning overlooks the implications of the natural monopoly evidence.

Several of the witnesses indicated that some toll routes may be naturally monopolistic because traffic volumes are not sufficient to support more than one carrier. In those instances it would be unsound regulation to require competition that would not be sustainable.

9. The intraLATA toll market should be left in the monopoly control of the local exchange companies.

10. There are various upward pressures on basic exchange rates which individually and collectively threaten universal telephone service in California.

11. The loss of intraLATA toll contributions to the local exchange companies and their nontraffic-sensitive (NTS) costs could jeopardize universal telephone service in California by driving up the cost of basic exchange service.

12. IntraLATA toll services now provide a substantial support of the NTS subscriber plant costs of the local exchange companies.

13. The substantial societal benefits of universal telephone service create an externality which, absent a governmental willingness to independently provide the funding needed to maintain universal service, justify the rejection of a pricing system based completely on marginal cost.

14. The universal service externality represents a greater public interest than the economic efficiencies which are allegedly inherent in marginal cost pricing.

15. It has been this Commission's policy to develop rate design schemes reasonably calculated to foster universal telephone service.

16. Neither the FCC's High-Cost Fund proposal nor 1983 Assembly Bill 1348 are unqualifiedly viable alternatives to replace the rate design policies which insure universal telephone service.

17. There is a substantial likelihood that some loss of toll contribution to NTS costs and rate deaveraging would occur due to intraLATA toll competition.

18. Private line services consist of direct access line connections which avoid the need for being switched over the public network.

19. Private line services are primarily used to provide direct telephone connections and high speed data transmission over dedicated non-switched access lines.

20. Private lines constitute a small portion of the revenues of the local exchange companies.

21. It is desirable to permit private line competition.

22. IntraLATA competition by WATS resellers would provide none of the efficiencies or benefits resulting from competition.

23. Blocking generally refers to the interception and automatic termination of certain specified transmissions, here unauthorized intraLATA traffic.

24. The implementation of blocking would require a considerable commitment of capital, resources and time.

25. The OCCs have configured and constructed their systems in good faith, free from any Federal Communications Commission (FCC) or other requirement to accommodate blocking.

26. Upon the offering of interconnections under the mandated equal access, all interexchange carriers would be provided the immediate means to block intraLATA traffic without affecting their other services.

27. Western Union holds a utility franchise by implication of law under the principles of "grandfathering".

28. The carriage of intraLATA traffic over the facilities of the defendants in Case (C.) 83-05-05 is incidental to the use of those same facilities for otherwise lawfully provided services.

29. The defendants in C.83-05-05 have never manifested an intention to provide uncertificated intraLATA services.

30. No prior legal duty was ever imposed upon the defendants in C.83-05-05 to configure their respective networks so as to permit blocking of unauthorized intrastate traffic.

31. The defendants in C.83-05-05 have taken reasonable steps to advise their subscribers as to the lawful limits of the services they offer.

32. Given the differences in the nature and quality of access provided by the Bell Operating Companies to AT&T and its competitors prior to equal access, it is highly unlikely that meaningful interLATA competition can occur prior to the widespread availability of equal access.

33. Except for AT&T, no other interexchange carrier in California has an ability to extract monopoly profits or to make maintain predatory prices.

Conclusions of Law

1. The Commission has broad regulatory authority over the providers of intrastate telecommunications services.

2. Intrastate telecommunications traffic carried over facilities as an incidence to lawfully provided interstate services are encompassed within interstate operating authorities and may not be prohibited by this Commission.

3. The Federal Communications Commission (FCC) may not certificate intrastate services.

4. The Commission may neither burden nor discriminate against federally authorized telecommunications, however, FCC certification does not preempt this Commission's consideration of applications for the provision of the intrastate services of persons holding such federal authority.

5. This Commission has jurisdiction to consider the issues presented by the OII, the applications and complaints now before us.

6. Private line competition in intraLATA telecommunications should be permitted.

7. The resale of intraLATA WATS service should be prohibited.

8. Blocking should not presently be required.

9. Persons not authorized to provide intraLATA telecommunications services should be prohibited from holding out the availability of such services and should be required to advise their subscribers that intraLATA communications should be placed over the facilities of the local exchange company.

10. The privileges of a utility franchise, whether granted expressly by this Commission or by implication of law, are subject to the full regulatory authorities of this Commission.

11. Western Union may be prohibited from holding out intraLATA telecommunications services.

12. Pacific Bell's complaint against the intrastate carriers should be denied.

13. AT&T should be regulated under the dominant/nondominant carrier system of regulation. AT&T should be regulated under the rate base/rate of return regulations applied to other California public utilities.

14. Resellers should be regulated in the same manner as facilities-based interexchange carriers.

O R D E R

IT IS ORDERED that:

1. All requests to provide intraLATA toll service are denied to the extent of said requests. Persons not authorized to provide intraLATA telecommunication shall refrain from holding out the availability of such services and shall advise their subscribers that intraLATA communications should be placed over the facilities of the local exchange company.

2. Providers of private line services, including cable operators, may file applications for the offering of intraLATA private line services. Pacific Bell and any other local exchange company which provides competing service, where its rates exceed or cover the costs of providing that service, in the LATA relevant to any such application may appear as a protestant and/or file responsive rate tariffs in order to preserve its market share.

3. Further hearings at a time and place to be later determined

responsive rate tariffs in order to preserve its market share.

3. Further hearings at a time and place to be later determined shall be held for the purpose of determining whether a prohibition of interexchange carrier bypass of the switched network should be imposed and, if so, in what manner.

4. Case 83-05-05 filed by Pacific Bell against various defendants is denied.

5. AT&T shall be regulated as the dominant interexchange carrier in California. All other interexchange carriers shall be regulated in a manner which permits them to compete in the California interLATA market.

This order shall be effective today in order to provide for the continued effect of our previous orders prohibiting the holding out of intraLATA toll services by persons other than the local exchange companies.

Dated _____, at San Francisco, California.

democratic political and social institutions. Northern Pacific Railway Co. v. United States, 356 U.S. 1, 4..." United States v. AT&T, 552 F. Supp. 131, 150-151 (D.D.C., 1982).

In the decision approving the MFJ, the Court also observed:

> "There is a dispute, reflected at the trial as well as other forums, over the question whether local telephone services have actually been subsidized by intercity service as AT&T has consistently claimed. ... The government contended that, to the contrary, local telephone revenues have subsidized AT&T's intercity rates ... and since the trial was aborted by settlement, no final decision was reached in the issue." (United States v. AT&T, supra at 169 n. 160).

It was further stated by the Court in approving the MFJ that:

> "The divestiture of the Operating Companies will not necessarily have an adverse effect upon the cost of local telephone service. The decree would leave state and federal regulators with a mechanism -- access charges -- by which to require a subsidy from intercity service to local service. By means of these access charges, the regulators would be free to maintain local rates at current levels or they could so set the charges as to increase or decrease local exchange." (U.S. v. AT&T, supra at 164).

Consequently the Court reacted "with considerable surprise and some dismay" when the FCC opted "to saddle the local subscribers with the access costs of interexchange carriers."

While we concur in the Court's assessment of the importance of competition, we believe that competition in the telecommunications arena must be implemented very carefully. Staff suggests that the continued availability of telephone service at affordable rates should be of overriding concern to regulators. While we concur in the Court's assessment of the importance of competition, we also share its views regarding the burdening of local exchange costs as a result of the restructuring decision itself. We believe that competition in the telecommunications arena must be implemented very carefully.

We established intrastate interLATA access charges in D.83-12-024 which recover the portion of NTS subscriber plant costs allocated to the intrastate interLATA market through common carrier line charges. Our concerns about maintaining affordable exchange rates contributed to this decision. However, lingering concerns about bypass and controversy over proper allocation of NTS costs on the basis of causation may result in the modification of that decision. Further, while we reserve judgment, there are strong arguments in favor of making interstate and intrastate interLATA access charges consistent, if not equal, for simplicity's sake and to avoid rate arbitrage. Along with other issues, the desirability of parity between intrastate and interstate access charges, and proposals for future reallocation of costs, including NTS costs, between intrastate access services and intraLATA services have been set for further hearings in the access charges proceeding. The disposition of these issues may well affect the basic exchange rate.

Other factors contributing to inexorable increases in local rates include FCC actions to require faster depreciation of capital equipment, the direct expensing of the costs of connections, installations, and moves, and an amortization of the accumulated, capitalized past charges of this kind; federal tax law changes; and, particularly for some rural companies, increased interest costs.

The parties have vigorously debated whether local exchange rates will remain affordable assuming competitive entry at the intraLATA toll level. The above factors do not paint an optimistic picture of this Commission's ability to maintain those rates at a level which will avoid the jeopardizing of universal service. Allowance of intraLATA toll competition could add yet another potentially adverse factor, the reduction or loss of intraLATA toll contributions to NTS costs. An already bleak situation could then turn desperate.

2. Marginal Cost Pricing and Its Economic Efficiencies

As we have heard from many experts in both this and the access charges proceeding, theory holds that prices tend to be driven to marginal costs in a competitive market, and the pricing of goods and services at their marginal costs results in the most efficient use of those goods and services and of the nation's resources. Particularly for electric utilities, we have long sought to apply these principles, and have devoted considerable efforts to calculating and implementing prices based on marginal costs, both for electricity sales and for utility purchases from nonutility power producers. However, there are at least two significant barriers to implementing a marginal cost-based pricing system for telecommunications services at this time. First, little effort has been spent even formulating the principles that ought to apply, let alone calculating the marginal costs of various components of telephone service. Second, the universal service externality represents a greater public interest than the economic efficiencies which are allegedly inherent in marginal cost pricing.

While the accuracy of the various embedded cost studies was hotly debated in this proceeding, no testimony was devoted to the development of marginal costs. At this time, we simply do not have the tools or studies available to us to allow marginal cost pricing with any degree of accuracy.

We suspect that marginal cost studies will demonstrate that the marginal costs of toll service are substantially lower than the costs allocated to toll under embedded cost studies. The behavior of the OCCs in the intrastate interLATA toll market will provide valuable evidence in this regard. We would expect that the OCCs will devote their resources to the most profitable routes and configure

their systems to accommodate the most lucrative toll traffic patterns. The local exchange companies have always been required to extend service to unprofitable routes and to accommodate all anticipated traffic patterns. Thus, they have not pursued the resource allocations which marginal cost pricing would dictate but have incurred substantial NTS costs made artificially economic by our system of rate regulation of public utility monopolies. It is simply unrealistic to expect the local exchange public utilities to effectively compete with their modern brethren having been born and bred under vastly differing environments.

Furthermore, the substantial economic and social benefits to society of a fully integrated and universal telecommunications system should restrain us from adopting a pricing system based completely on competitive theory. Our regulatory posture in this regard is directly related to what economists refer to as the elasticities of demand when competitive options are made available. Given the pace of technological advancement in this industry, the introduction of competition tends to give large users of telecommunication services, whose demand is highly elastic (or price sensitive), greater market power to dend off the common costs (fixed costs such as NTS costs) of an integrated telecommunications system than smaller users (such as POTS users), whose demand tends to less elastic,(except perhaps at poverty levels of income). This is what bypass concerns are all about -- the ability of large users to view their cost options apart from societal benefits and costs and to opt out of all or part of the network, leaving more of the common costs to be borne by others who have less opportunity to opt out. Many of the latter include small and moderate businesses. In this context, preventing common costs from falling too heavily on small users has become a major issue in our efforts to maintain the essential character of our telephone system. Where the shifting of common costs under competitive pricing concepts has threatened to push some small users out of the system, the Legislature has responded with the passage of the Moore Lifeline Tax bill, as referenced below. Short of puching users out of the system, however, a substantial shifting of common costs in itself can raise serious equity issues, especially when the allocation of common costs,

such as NTS, has been a major factor in the development of universal service. From a public policy point of view, therefore, universal service is more than just an economic externality. It is a critical element of our integrated telephone system as part of the "infra-structure" glue that holds our society together. We cannot allow competitive pricing theory to push regulatory policy to the brink of destroying or even undermining the community function of a telephone service acknowledged to be the best in the world.

To date the implementation of inter-LATA competition has focused these issues on the amount of common exchange costs, principally NTS, to be allocated to inter-exchange carriers through access charges. While the level of sustainable access charges will loom large in Phase II of the pending access proceeding, it is clear that our efforts to find an equitable method of allocating common costs in the face of inter-exchange competition is already causing major problems in designing rates and meeting the revenue requirements of Pacific and other exchange carriers. Long-run concerns about aggravating the economic bypass options of larger users and the possible involvement of carriers in such bypass options are constraining influences in our efforts to moderate the impact of divestiture on rates for exchange services in Decision _____, in Pacific's A.82-11-07 to be issued concurrently with this order. These issues, in turn, are compounded by the serious limitations of current cost studies that provide the underpinning for moving toward greater reliance on competitive pricing concepts. Under these circumstances, it would appear that the extension of competition to intra-LATA traffic would be undesirable at the present time even if there were sound, soley economic reasons for doing so.

3. Embedded Costs and Their Relevance to IntraLATA Competition

Both Pacific and staff performed embedded cost studies which conclude that intraLATA toll revenues now provide substantial support of local exchange costs, though they take differing viewpoints regarding whether this support constitutes a "subsidy" of local rates. On the other hand, Sprint, MCI, and WU presented witnesses who asserted either that no toll-to-local subsidy exists or at least that existing data is insufficient to determine whether a contribution from toll to local service exists.

conclusion that intraLATA toll services now provide a substantial support of the NTS subscriber plant costs of the local exchange. We believe that the underlying questions of how much of the revenue requirement for the NTS subscriber plant costs (the fixed costs of the local exchange) should be collected from intraLATA toll users and how much from users of basic exchange services are even more important for purposes of intraLATA competition than our interLATA decision.

Many parties have argued that economic forces dictate against an indefinite continuation of the current level of NTS costs included in toll rates. Further, the size and source of any support of NTS costs needed to ensure universal service also engendered much controversy. In allocating the excess of exchange embedded costs over marginal costs of providing services, we find ourselves in search of a solution that balances the benefits of universal service against the desirability of pricing toll and other exchange services closer to their marginal costs in order to increase economic efficiency of their usage. We must consider intra-LATA competition in this light. At the present time, not only are our cost studies inadequate, but the issues concerning the allocation of NTS are still to be resolved in pending proceedings.

4. Rate Design v. Governmental Support

As the parties to this case acknowledge, it has been this Commission's policy to develop rate design schemes reasonably calculated to foster universal service. We have been largely successful. However, issues have been raised as to whether our rate design policy has been misdirected or could be effectively replaced by alternative supports.

Several parties argued that any support of NTS subscriber plant costs besides that obtained from local exchange rates should be narrowly focused to provide the minimum support necessary to maintain universal service, and that the resulting additional revenue requirement should be allocated on the basis of respective

staff, AB 1348 is a step in the right direction toward maintaining universal service in the face of rising local rates but does not address the problem completely.

Staff notes that AB 1348 could contribute, at current rates, approximately $68 million if the full 4% tax rate were applied to interLATA revenues solely and another $85 million if it were applied to intraLATA toll revenues. As an example, $95 million a year would be needed to provide a $60 annual subsidy to each family whose income is less than $10,000. This $5 per month subsidy would defray a large portion of most current basic exchange rates, but would not go very far if substantially greater portions of NTS costs were recovered through dramatic increases in the local rates, as advocated by several parties.

~~In implementing AB 1348, we recognize also that there are potential problems in such areas as certification of eligibility. We noted in D.84-04-053 that we have not yet provided for any special communication needs of handicapped and elderly customers. Further, as staff points out,~~ a targeted subsidy, if coupled with very large increases in basic exchange rates, could result in a situation where only the rich and the very poor could afford telephone service.

Under these circumstances, we can hardly be confident that viable alternatives exist to replace the rate design policies we have vigorously pursued for several decades or that such alternatives will ensure universal telephone service. Once again, we find substantial uncertainties and will affirm our faith in the wisdom of California rate design principles.

5. The Benefits and Consequences of Competition

The proponents of intraLATA competition base their case largely on the theoretical benefits of competition: a firm exhibits increased efficiency in a competitive marketplace, competition encourages increased choices of service and price/quality options and

In recognition of the economic considerations we have discussed, we have already begun steps to improve the efficiency of the pricing structure for telecommunications services. We have authorized competition in the interLATA market. We will examine various proposals to determine the portion of NTS costs to be recovered through intrastate access charges in phase two of our access charges proceeding, as well as proposals for tapered or declining block toll rates as a further means of capping the imposition of NTS costs on large users of toll services. And in our decision in Pacific's general rate case which we issue today, we order Pacific and staff to begin examining the marginal costs of various Pacific services. We expect to rely on their evaluations for guidance as we reexamine our current rate design procedures in future general rate proceedings.

As we stand at the dawn of a new age in telecommunications, we realize that our first few steps are necessarily cautious. However, we believe that caution will more assuredly safeguard the public interest which it is our solemn duty to protect. We will willingly reexamine our current prohibition against intraLATA competition as experience with interLATA markets may indicate.

B. Implementation Issues

Having determined that intraLATA competition should not be authorized at this time, there are several residual issues yet to be decided. These issues generally concern the implementation of our adopted policy. They are as follows:

- Whether special examptions from the restraints on competitive entry should be applied to private line facilities or WATS resellers;

- o Whether blocking of intraLATA calls by carriers other than the local exchange companies should be required;
- o Whether a prohibition of carrier bypass should be imposed;
- o Whether Western Union should be exempted from our order proscribing the offerings of competitive intraLATA services.

We address these issues in this part.

1. Private Line Facilities and WATS Resellers

As an exception to its overall opposition to intraLATA competition, staff recommends that private line services be open to competition. It is staff's opinion that there is a clear distinction between switched and nonswitched (private line) services in terms of their importance to universal service. Due to considerations unique to private line technologies, coupled with the fact that private lines constitute a miniscule portion of Pacific's revenues, we find merit in staff's recommendation.

Private line services consist of direct access line connections which avoid the need for switching over the public network. Private line service is primarily used to provide direct telephone connections and high speed data transmission over dedicated non-switched access lines. Other uses which seem to be growing are services such as digital termination service, along with burglar and fire alarm services.

The record suggests that it is desirable to permit private line competition. Many innovative services are delivered over private lines; permitting competition for this service may enhance the further development of these technologies. Also, Pacific's provision of this service has not kept pace with the demand for private lines capable of high speed data transmission. In addition, Pacific's private line services are by and large currently priced below cost and therefore do not contribute revenues to sustaining the

affordability of basic service. Finally, the fact that private lines constitute less than three percent of Pacific's operating revenues suggests that opening this service to competition is unlikely to adversely affect Pacific's operating results or local exchange rates.

As an example, we take special note of the arguments of CABLE that certain of its services are not well-suited to transmission over the switched network and that others are best provided over specialized, computer-enhanced transmission systems. These specialized and technologically advanced services present a compelling distinction and we would be remiss if we did not provide an opportunity to the developers and providers of these services to apply for authority to offer such services in California without regard to LATA boundaries. Cable operators are therefore encouraged to file applications for intraLATA private line services. Pacific's arguments as to the threat cable-type service poses to the intrastate toll market appear to us to be little more than overbroad histrionics. Pacific should review the applications filed by cable-type operators and specifically focus its concerns on the circumstances of each application. In the general rate case decision issued today, we invite Pacific to file responsive rates for private line services which it may want to defend from competition. We reiterate that invitation here. As of this time, however, we are not persuaded by Pacific's arguments as to the magnitude of the threats presented by private line intrusion into the intraLATA toll market.

Pacific has, however, raised an interesting issue and we do not mean to casually dismiss it. The difficulty in regulating private line services rests with the problem of distinguishing among the many uses for which this service may be employed. We are concerned about the lack of clear distinctions between private line and switched services. Some private line equipment lends itself to additional services which may duplicate those of the switched

network. For example, private lines that terminate on a PBX provide a customer with switched access to a greater area of distribution. The "leaky PBX" might enable customers to bypass the local exchange. Any increased opportunity or incentives for bypass of the local exchange is a matter of concern to the Commission. We intend to observe the development of the market and will pay close attention to this issue.

We reach an entirely contrary disposition on the question posed by WATS resellers. There is no logical reason to distinguish between intraLATA toll services which might be provided over an OCC's facilities as compared to over Pacific's facilities via its WATS services. Since we do not allow intraLATA toll competition through OCC facilities, we will not do so through WATS resale either.

The arguments of the resellers are simply not persuasive. The resellers essentially argue that this Commission should enhance the marketability of the service they provide. The resellers point out that it would be easier for them to market an all inclusive service, i.e., one encompassing interstate, interLATA and intraLATA calling, as opposed to a service offering only interstate and interLATA calling. The marketability of their resale service is not a compelling public interest in our opinion. There is simply no intrinsic value to fostering a competition for identical traffic when the competition would essentially be between Pacific's retail (message toll) and "wholesale" (WATS) services. None of the efficiencies or benefits resulting from market competition would accrue from such inbred competition.

The resellers posit that large WATS users are already reselling intraLATA WATS through privately-owned PBXs and that we should strip ourselves of our self-imposed naivete and allow them to legally share in that now illicit market. We will not permit competition because some WATS customer is illegally offering WATS

on a resale basis. While we allow joint users to share an intraLATA WATS service, we have never authorized the resale of that service for profit. Our staff and Pacific are hereby advised to intensify the enforcement of Commission-approved WATS tariffs and to terminate the provision of intraLATA WATS service to uncertificated intraLATA WATS resellers in order to halt these illegal operations.

Finally, assuming we were to authorize intraLATA WATS resale, OCCs could easily purchase WATS capacity for resale and thereby hold out the intraLATA services we would not certificate with respect to their own facilities. It is intuitively obvious that both doors in a two-door barn should be closed if our aim is to keep the horse inside. We will therefore prohibit the resale of intraLATA WATS services.

2. Blocking

"Blocking" generally refers to the interception and automatic termination of certain specified transmissions, here unauthorized intraLATA traffic. Several parties, most notably Pacific and staff, have advocated that a ban on intraLATA competition be enforced by requiring interLATA carriers to employ blocking schemes to prevent intraLATA usage of their networks.

The implementation of blocking, before the implementation of equal access, by every parties' contention, would require a considerable commitment of capital, resources and time. Under certain proposals, switching capacity and memory would have to be added by the OCCs in order to facilitate blocking. New software would have to be developed for the proposals proposed by Pacific. Although these facts are conceded by all, the OCCs and Pacific differ on the extent of the burdens blocking would entail.

We note that the record before us establishes that the technological progress that has blurred the interstate-intrastate dividing line may soon offer us the ability to separate interstate from intrastate and interLATA from intraLATA traffic. Upon the full implementation of equal access in the fall of 1986, Pacific will assertedly have the capability of distinguishing wholly intraLATA traffic from interLATA or interstate calls. This is currently the case in the relationship of AT&T-C to Pacific. AT&T-C has not opposed Pacific's request for blocking even before equal access arrives because Pacific can block AT&T-C from completing intra-LATA calls. As equal access is implemented and the OCCs are in the same relationship to Pacific as AT&T-C is today, we expect Pacific to block intraLATA calls of OCCs. However, when equal access arrives, some of the OCCs may choose to continue the availability of their inferior access for all or some of their customers. In that event, the customers involved would be able to continue to complete intraLATA calls through their OCC. We are advising the OCCs at this time that, when equal access implemented in an entire LATA, ~~arrives,~~ those that choose not to participate in it will be required to block intraLATA calls.

As for the moment, we will continue our policy of prohibiting the applicants from holding out the availability of intraLATA service. Such a prohibition hardly intrudes upon the FCC's authority to permit the applicants to provide interstate service over common facilities. We will add one further requirement at Pacific's request. The applicants, in answering customer inquiries as to whether their facilities may physically be used to complete intraLATA calls, shall advise current and potential customers that such calls (1) may not be lawfully placed over their networks and (2) should be placed over the facilities of the local exchange carriers without any further advice being provided. In the event that this measure proves unsuccessful in preventing the diversion of local exchange intraLATA toll revenues or the applicants do not observe our order, we will consider available enforcement alternatives.

Some additional observations are appropriate in elaboration of the relationship between the threat of bypass and intraLATA competition.

Bypass is either economic or uneconomic. Economic bypass occurs when the economic cost of the bypass is less than the economic cost of providing the equivalent service over the switched network. Uneconomic bypass occurs when the converse condition prevails.

Uneconomic bypass of the local exchange could be economically attractive for large toll users if toll rates (including access charges if applicable) are set substantially above the marginal costs of providing toll service. This could occur due to any or a combination of the following effects: the averaging of toll rates over geographic areas encompassing high-cost areas; inclusion in toll rates of excessive NTS costs of the local exchange; or the development of new, relatively low-cost toll technologies. Exchange rate averaging in combination with relatively low-cost exchange technologies could also contribute to uneconomic bypass.

Bypass may be by either customer or carrier. Customer bypass occurs when a customer constructs its own facilities for the purpose of serving its own internal telecommunications needs. Carrier bypass occurs when a carrier constructs facilities that permit its customers to bypass the local exchange for originating or terminating calls. No customer is likely to bypass the local exchange for all its requirements. Pacific is concerned that large customers will bypass its facilities for their toll calling purposes, and proposed that carrier bypass be prohibited.

Carrier bypass of the exchange raises serious regulatory issues. Under competitive pricing, as noted earlier, large users of telephone services may opt to bypass the exchange for all or part of their needs for strictly economic reasons, regardless of whether or not a decision to do so is harmful to the network. There is little that regulatory policy can do or should do about economic bypass by customers

themselves. Whether regulatory policy should sanction a carrier's involvement in bypassing the exchange, however, is clearly another matter. Currently, in setting tolls and in dealing with access charges, we have been making a conscious effort to avoid policy choices that would encourage bypass by either customers or carriers. In fact, when possible, we have been giving signals to actively discourage bypass. While we may have limited options in dealing with individual customer bypass, as a matter of regulatory policy it is questionable whether we should permit regulated carriers to facilitate such bypass. There are strong reasons related to maintaining a universal telephone service that would support the prohibition of carrier bypass. Rather than making a decision at this time, however, we will ask for comment on such a prohibition by the parties within 30 days of the issuance of this order. This proceeding will remain open for the explicit purpose of considering these comments, and the disposition of this issue including the possibility of further hearings will be severed from the interim decision we issue today.

Finally, we note that denying intraLATA competition at this juncture and asking for comment on the prohibition of carrier bypass are intended to protect our universal service goals and to further provide Pacific an opportunity to adjust to the post divestiture world. Pacific should view this opportunity not as a respite but as a time to develop creative strategies which will ensure the continuation of the high level of service quality and universal service to which California has become accustomed. Pacific is endowed with managers of considerable skill and we are confident that they will meet the test of the times without the protection of measures such as a prohibition on bypass. Imposition of such measures could well provide the wrong signals to Pacific as to what is expected of it and might otherwise impede the development of the telecommunications market. ~~We therefore will not adopt such measures.~~

MCI Telecommunications, supra, 70 FCC2d at 667. Thus, we find no prior legal duty was ever imposed upon the defendants to configure their respective networks so as to permit blocking. To impose such a duty as this late date would impose potentially severe and onerous burdens upon the defendants, burdens created in large part by Pacific's and AT&T's collective and individual failure to more timely raise the issue. And, as noted above in our discussion of blocking, the difficulty of blocking is a product of the inferior interconnections presently provided by Pacific to defendants. This situation will be corrected with the advent of equal access.

Pacific also alleges that the defendants have held themselves out as intrastate carriers. However, we find that the defendants have taken reasonable steps to advise their subscribers as to the lawful limits of the services they offer.[7] While we might agree with Pacific that they could have done more, we cannot find on the record before us that the defendants exhibited an affirmative intent to hold out the availability of uncertificated services nor can we find that the defendants have acted unscrupulously or contumaciously.

The promotional materials that Pacific cites to the contrary are apparently from national advertising programs, not tailored to any particular jurisdiction. The advertising does list cities that may be reached by a subscriber but when such materials are distributed on a national basis, the information is more reasonably interpreted as promoting interstate calling, since a subscriber in one state is advised of the various places that may be reached over the network. Defendants allege that they have never used an intrastate city pair as the basis for a comparison of their rates with the Bell system rates. Thus, we agree that they have never actively promoted their service as an intrastate service.

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[7] Our additional requirements placed upon the intrastate interLATA carriers to refer intraLATA callers to the local exchange company provides additional steps to the ones voluntarily undertaken to date.

19. Private line services are primarily used to provide direct telephone connections and high speed data transmission over dedicated non-switched access lines.

20. Private lines constitute a small portion of the revenues of the local exchange companies.

21. It is desirable to permit some limited private line competition.

22. IntraLATA competition by WATS resellers would provide none of the efficiencies or benefits resulting from competition.

23. Blocking generally refers to the interception and automatic termination of certain specified transmissions, here unauthorized intraLATA traffic.

24. The implementation of blocking prior to equal access would require a considerable commitment of capital, resources and time.

25. The OCCs have configured and constructed their systems in good faith, free from any Federal Communications Commission (FCC) or other requirement to accommodate blocking.

26. Upon the offering of interconnections under the mandated equal access, all interexchange carriers would be provided the immediate means to block intraLATA traffic without affecting their other services.

27. Western Union holds a utility franchise by implication of law under the principles of "grandfathering".

28. The carriage of intraLATA traffic over the facilities of the defendants in Case (C.) 83-05-05 is incidental to the use of those same facilities for otherwise lawfully provided services.

29. The defendants in C.83-05-05 have never manifested an intention to provide uncertificated intraLATA services.

30. No prior legal duty was ever imposed upon the defendants in C.83-05-05 to configure their respective networks so as to permit blocking of unauthorized intrastate traffic.

31. The defendants in C.83-05-05 have taken reasonable steps to advise their subscribers as to the lawful limits of the services they offer.

32. Given the differences in the nature and quality of access provided by the Bell Operating Companies to AT&T and its competitors prior to equal access, it is highly unlikely that meaningful interLATA competition can occur prior to the widespread availability of equal access.

33. Except for AT&T, no other interexchange carrier in California has an ability to extract monopoly profits or to make maintain predatory prices.

Conclusions of Law

1. The Commission has broad regulatory authority over the providers of intrastate telecommunications services.

2. Intrastate telecommunications traffic carried over facilities as an incidence to lawfully provided interstate services are encompassed within interstate operating authorities and may not be prohibited by this Commission.

3. The Federal Communications Commission (FCC) may not certificate intrastate services.

4. The Commission may neither burden nor discriminate against federally authorized telecommunications, however, FCC certification does not preempt this Commission's consideration of applications for the provision of the intrastate services of persons holding such federal authority.

5. This Commission has jurisdiction to consider the issues presented by the OII, the applications and complaints now before us.

6. Private line competition in intraLATA telecommunications should be permitted in limited form.

7. The resale of intraLATA WATS service should be prohibited.

8. Blocking should not be required prior to equal access.

9. Persons not authorized to provide intraLATA telecommunications services should be prohibited from holding out the availability of such services and should be required to advise their subscribers that intraLATA communications should be placed over the facilities of the local exchange company.

10. The privileges of a utility franchise, whether granted expressly by this Commission or by implication of law, are subject to the full regulatory authorities of this Commission.

11. Western Union may be prohibited from holding out intraLATA telecommunications services.

12. Pacific Bell's complaint against the intrastate carriers should be denied.

13. AT&T should be regulated under the dominant/nondominant carrier system of regulation. AT&T should be regulated under the rate base/rate of return regulations applied to other California public utilities.

14. Resellers should be regulated in the same manner as facilities-based interexchange carriers.

15. Uniform rates should be required.

INTERIM ORDER

1. All requests to provide intraLATA toll service are denied to the extent of said requests. Persons not authorized to provide intraLATA telecommunications shall refrain from holding out the availability of such services and shall advise their subscribers that intraLATA communications should be placed over the facilities of the local exchange company. After equal access, OCCs who choose to maintain inferior connection for all or some of their customers, shall be required to block the completion of unauthorized calls.

2. Providers of private line services through cable operators may file applications for the offering of intraLATA private line services. Pacific Bell and any other local exchange company which provides competing service, where its rates exceed or cover the costs

of providing that service, in the LATA relevant to any such application may appear as a protestant and/or file responsive rate tariffs in order to preserve its market share.

3. Within 30 days from the date of this order, parties to this proceeding shall file with our Docket Office the original and 12 copies of Comments on the Issue whether a prohibition of interexchange carrier bypass of the switched network should be imposed and, if so, in what manner.

4. Case 83-05-05 filed by Pacific Bell against various defendants is denied.

5. AT&T shall be regulated as the dominant interexchange carrier in California. All other interexchange carriers shall be regulated in a manner which permits them to compete in the California interLATA market.

6. Applicants are authorized to have on file with this Commission, tariff schedules for the provision of intrastate interLATA telecommunications services, subject to the condition that rates shall be uniform on a distance basis. If any applicant has an effective FCC approved tariff, it may file a notice adopting such FCC tariffs with a copy of the FCC tariff included in the filing. Those applicants that have no effective FCC tariffs, or that wish to file tariffs applicable only to California, are authorized to do so, including rates, rules, regulations, and other provisions necessary to offer service to the public. Such filings shall be made in accordance with General Order 96-A, excluding Sections IV, V, and VI, and shall be effective not less than one day after filing.

This order shall be effective today in order to provide for the continued effect of our previous orders prohibiting the holding out of intraLATA toll services by persons other than the local exchange companies.

Dated JUN 13 1984, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
DONALD VIAL
WILLIAM T. BAGLEY
Commissioners

Commissioner Priscilla C. Crew, being necessarily absent, did not participate