

Decision 90 05 045

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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of)
Pacific Bell for approval, to the)
extent required or permitted by law,)
of its plan to provide enhanced)
services.)

Application 88-08-031
(Filed August 15, 1988)

O P I N I O N

In this opinion, we grant Pacific Bell (Pacific) provisional authority to continue to provide public packet switching (PPS) services subject to several conditions. One of those conditions requires Pacific's shareholders, rather than its ratepayers, to assume the risk for profitability of PPS services.

Background

In the present application, Pacific seeks continued provisional authority to provide an existing service. Pacific filed its present PPS tariff in October 1988. The Commission, in Resolution T-13026, approved the advice letter in part, pending the outcome of hearings considering the viability of the service, the appropriateness of the prices, and expansion of the service into the Sacramento and San Diego areas.

Five days of hearings were held in June 1989 on the subject of Pacific's PPS application. The matter was submitted upon receipt of briefs on August 1, 1989. Briefs on the PPS application were filed by Pacific, the Division of Ratepayer Advocates (DRA), and Tymnet-McDonnell Douglas Network Systems Co. and Telenet Communications Corporation (Tymnet/Telenet).

Description of PPS Services

PPS is a switched digital data transmission service which offers improved efficiencies to users. Certain customers benefit from PPS because facilities are "timeshared." Because data transmissions are often intermittent, the packetization of

transmissions made possible by packet technology permits the combined use of the network. Each message does not require the full use of a trunk or line as is required by use of traditional voice network facilities.

Pacific's PPS services are offered with either public dial, private dial, dedicated analog or dedicated digital access to the network, depending on the customer-use requirements.

The Viability of Pacific's PPS Services

The viability of Pacific's PPS services may be considered from the standpoint of whether it is appropriately priced and whether cost and revenue projections are realistic. Generally, Tymnet/Telenet argue that Pacific's prices are too low. DRA and Tymnet/Telenet take issue with Pacific's demand projections and with Pacific's estimates of costs.

DRA questions the viability of PPS because it believes Pacific's demand forecasts are unrealistic. Pacific's customer survey, according to DRA, is based on outdated pricing information and does not demonstrate whether customers surveyed have ever made use of the product. DRA points to the discrepancy between forecasted demand and actual demand during an earlier period to support its view that Pacific's forecasting methods are flawed.

DRA also doubts Pacific's contention that its customer base will rise with the availability of protocol conversion and expansion to the Sacramento and San Diego areas. These service improvements notwithstanding, DRA points out that Pacific's service provides fewer protocols than its competitors, limiting customer interest. DRA also notes that Pacific may be at a competitive disadvantage because Tymnet/Telenet will have PPS access in nearly twice the locations as Pacific would even with Pacific's proposed expansion.

Although DRA, on brief, suggests the product may not be viable, the testimony of its witness supports approval of the application on the basis that Pacific may realize "greater than

forecasted revenues due to the attractiveness of the service offering, and proper pricing."

On the subject of cost, DRA believes Pacific's estimates are flawed because it has unrealistically assumed that existing hardware will be adequate through the year 2000.

Tymnet/Telenet oppose Pacific's pricing proposals, arguing that PPS prices are below cost. Tymnet/Telenet suggest that even assuming Pacific's projected demand rates, PPS will not be profitable until "well into the first decade of the twenty-first century." Like DRA, Tymnet/Telenet are critical of Pacific's surveys, joining DRA's concerns and adding that the surveys failed to include customers in the Sacramento and San Diego areas.

Tymnet/Telenet also assert that Pacific's cost studies grossly underestimate the costs associated with a new product because those cost studies do not include reasonable estimates of marketing and sales costs. The cost studies, according to Tymnet/Telenet also fail to include any depreciation expense, overhead expense, interoffice facilities costs, or legal expenses. Pacific's monthly tracking reports offer more realistic cost estimates but, according to Tymnet/Telenet, also fail to include the tariffed charges for interoffice transmission facilities.

Pacific asserts that its proposed PPS pricing is reasonable, reflecting its ability to concentrate end users, information providers, and enhanced service providers or value-added networks on a single system. Economies of scope are further realized compared to other providers because, according to Pacific, it may collocate facilities, and use its existing sales, administration, and personnel employees. Finally, Pacific contends its offering is more limited than those of providers like Telenet.

Pacific explains that it has set its prices for PPS in response to the market for such services and in consideration of its demand forecasts and service cost analyses. As a check on their reasonableness, Pacific demonstrated that its prices were in

the midrange of prices charged by other Bell operating companies. Pacific urges the Commission to permit the proposed pricing structure in order to assure healthy demand for its product.

Pacific asserts that its demand forecast is reasonable and updated. Pacific used national projections of PPS demand as a basis for estimating demand of its own product. Its survey also indicates strong demand for PPS. It agrees that a price increase could affect its customers' decisions to buy, stating that it needs 24 months to determine whether revenues will materialize as projected for the product.

We concur with DRA and Tymnet/Telenet that Pacific's revenue forecast methodologies do not demonstrate that PPS services offered by Pacific are likely to be viable. Pacific's use of national projections does not appear to have accounted for the fact that Pacific's product is not comparable to those of other firms because it has a limited number of protocols and is not offered statewide. Pacific's customer surveys also fail to account for the potentially critical effects of higher prices on customer demand. This shortcoming notwithstanding, we hesitate to rely on the results of these surveys because Pacific could not produce the original survey documents. Finally, Pacific's cost studies fail to include items which are directly attributable to PPS services. Because Pacific's cost studies appear to underestimate costs and its demand forecasts appear to overestimate revenues, we must conclude that PPS is unlikely to be a viable service. For that reason, ratepayers may be exposed to unreasonable levels of risk if they are to assume liability for PPS revenues and costs.

Expansion of PPS into the
Sacramento and San Diego Areas

Pacific's application seeks authority to expand into the Sacramento and San Diego areas. No party protested this expansion. Pacific testified that the expansion will be inexpensive and will

make its product more attractive. We will grant Pacific's request for service expansion into the Sacramento and San Diego areas.

Ratemaking Treatment for PPS

DRA argues that ratepayers should receive any "profits" realized from the sale of PPS services, since ratepayers have, according to DRA, funded their development. Pacific assumes the same ratemaking treatment that DRA proposes. Tymnet/Telenet suggest that, if PPS does not perform as Pacific expects by November 1990, the entire PPS investment be moved "below-the-line," exposing Pacific's shareholders to the risk associated with the product. ✓

Decision (D.) 89-10-031 provided guidelines for prospective ratemaking treatment of competitive services which are pertinent to our decision today. The issuance of that decision, in fact, obviates the need for an extensive review of this proceeding. Had it been issued prior to hearings in this proceeding, we believe the parties may have reached the same conclusions we reach in this decision.

D.89-10-031 included PPS as a basic monopoly, or "Category I," service subject to the sharing mechanism. We stated, however, that we might reconsider this treatment in this proceeding. More generally, we stated we would consider whether a service should be part of the sharing mechanism in light of certain goals. One of those goals was to assure that revenues from basic services would not subsidize nonbasic services. We also found that including new services in Category I may provide two benefits. The first of these is higher shared revenues for ratepayers and shareholders when services appeared to be profitable. The second possible benefit is the encouragement of new technologies and services.

In considering whether PPS should continue to be included "above-the-line," as DRA recommends, we consider whether the

service is likely to be profitable, and whether such treatment will promote product development.

Clearly, Pacific does not need to be encouraged to develop PPS. The service has already been offered for several years, and Pacific intends to expand the service. As importantly, other vendors already offer PPS services.

As for profitability, we are not convinced that PPS revenues are likely to recover costs. As we discussed earlier, Pacific's cost and revenue forecasts appear unrealistic. Although DRA urges the Commission to treat PPS costs and revenues "above-the-line," it also argues on brief that the PPS services are unlikely to be profitable before the year 2000, and that Pacific has overestimated demand and underestimated costs. It is unclear why DRA proposes the ratemaking treatment it does. It appears that DRA would have ratepayers shoulder the liability for a very risky product.

We conclude in this case that Pacific's ratepayers should not assume the risk associated with PPS services. Pacific is likely to make better investment and marketing decisions if PPS is treated "below-the-line," that is, not included in regulated accounts. Under our new regulatory framework adopted in D.89-10-031, PPS services would therefore not be subject to the "sharing" mechanism under which ratepayers and shareholders share the profits and losses when Pacific's returns fall outside a designated band.

We also believe that PPS services should be considered a Category III service. As defined by D.89-10-031, a Category III service is one that is afforded the maximum pricing flexibility allowed by law. PPS is suited to such treatment since, as the record shows, it is one over which Pacific has no market power. ✓

Another related issue is that of past expenditures on PPS. DRA argues vociferously that the costs of developing PPS have been included in rates. In support of its contention, DRA comments

that Pacific's witness testified that "the costs for public packet switching have gone into the regulated accounts." DRA notes that the Commission did not explicitly disallow PPS capital costs or operating expenses. It cites Commission Resolution T-13026 which found that "much of the new (PPS) plant was in rate base and was being paid for by the California ratepayers."

Pacific contends that the expenses have not been included in rates. It admits that PPS was a project Pacific had included in its estimates for funding requirements. It argues on brief, however, that the Commission disallowed funds associated with the accounts in which PPS costs were entered. It also argues that shareholders are at risk for costs incurred between rate cases.

It appears that PPS costs have been included in rate base. Pacific has not demonstrated to our satisfaction that associated costs were disallowed. It has presented no evidence to show that we did not consider PPS costs unworthy of funding during the last general rate case or that PPS was even an issue at the time. There is no dispute that PPS costs were included in regulated accounts. As Pacific is aware, it does not follow that because shareholders are at risk for revenue recovery between rate cases that project costs are not included in rates.

Having determined that ratepayers have funded PPS development costs, we turn to the question of how that circumstance should be treated for ratemaking purposes. D.89-10-031 addressed the issue of past expenditures for competitive services. The decision rejected DRA and TURN's proposal to identify and return to ratepayers such expenditures. In this case, no party has proposed that Pacific's rates be reduced to reflect the past expenditures associated with PPS which may have been included in rates. It is an option we would hesitate to adopt in light of the new regulatory program put into place by D.89-10-031. Further, PPS plant should not be greatly depreciated at this point, so that past ratepayer

contributions are unlikely to significantly distort current cost estimates or prices.

Although we decline to require Pacific to reimburse ratepayers for past expenditures, we will require Pacific to reduce its rates so that ratepayers do not subsidize PPS services going forward. Pacific should, in its first advice letter filing to update basic monopoly service rates pursuant to D.89-10-031, adjust its revenue requirement to reflect the removal of PPS costs. The adjustment shall be based upon the cost estimate included for PPS in Pacific's "true up" proceeding which was resolved in D.89-12-048. Pacific shall annualize the eight months of 1989 cost and revenue data in estimating total annual costs. The PPS cost adjustment shall be included in the "Z Factor" established in D.89-10-031. The procedure we apply to PPS for removing costs from rates is adopted in recognition that this issue and the PPS accounts existed prior to D.89-10-031. In the future, we may consider other ways to treat costs and revenues when a service is moved out of the "sharing" mechanism. We will consider proposals by the parties if and when such circumstances arise. ✓

Our grant of authority is conditioned upon Pacific's acceptance of two other conditions. Consistent with our treatment of enhanced services, Pacific shall not disconnect any local telephone service for nonpayment of PPS charges. Pacific shall also keep accounts which track the fully-allocated costs and revenues associated with PPS, consistent with our directives for Category III services presented in D.89-10-031, including adopting as final the tracking and regulatory requirements ordered in D.88-11-027 and the use of the FCC's Part 64 methodology for allocation of costs to below-the-line accounts.

Finally, because we consider PPS a Category III service, Pacific may offer PPS within its franchise areas at will subject to the conditions in this decision. Pursuant to Public Utilities Code § 489, public packet switching services must be offered

pursuant to tariffs, as we established in D.88-08-059 which resolved Phase I issues in our investigation into regulatory frameworks for Pacific and General Telephone.

Treatment of Proprietary Information

During the hearings, Pacific objected to the public disclosure of several documents it considers proprietary. The documents were filed under seal. DRA argues that Pacific's desire to retain the proprietary nature of the exhibits in question is "corporate recidivism at its most extreme," and contrary to D.86-01-012 in which we established standards for keeping materials under seal. Pacific replies that it should not be burdened with having its financial details and marketing strategies made available to the public. Pacific is especially concerned that competitors would benefit to Pacific's detriment by obtaining information which would allow competitors to counterbalance Pacific's marketing plans.

In this case, we do not need to divulge the contents of the sealed exhibits in order to reach our conclusions. We therefore believe that the documents should remain under seal for purposes of this proceeding. We remind Pacific, however, that as a regulated utility it has a responsibility to present any and all documents which would assist this Commission in serving the public interest. We will not hesitate to require public disclosure of the information in question or any other information needed to assure that public interest goals are served.

Findings of Fact

1. The Commission, in Resolution T-13026, provisionally approved Pacific's PPS services pending hearings on the issues of product viability, product expansions, and the appropriateness of prices.

2. For certain uses, PPS technology makes more efficient use of facilities than traditional technology.

3. Pacific's revenue forecasts using customer surveys fail to account for the effect of current prices on demand.

4. Pacific's revenue forecast using national projections does not appear to have accounted for the fact that Pacific's product is not comparable to those of other firms because it has a limited number of protocols and is not offered statewide.

5. Pacific's cost studies fail to include certain cost items directly attributable to PPS services.

6. Pacific has not demonstrated that PPS is a viable service, the risks for which should be borne by ratepayers.

7. No party objected to Pacific's proposal to expand its PPS services into the Sacramento and San Diego areas.

8. D.89-10-031 provided pricing guidelines for competitive services. That decision tentatively classified PPS services as "Category I" services, subject to reclassification in this proceeding.

9. Pacific does not have market power in the market for PPS services.

10. Pacific's PPS services are likely to be risky, and their development does not need to be encouraged.

11. Costs and expenses associated with PPS are currently included in rates.

Conclusions of Law

1. Pacific should be granted authority to continue to offer PPS services, subject to the condition that it be treated as a Category III service, consistent with D.89-10-031.

2. Pacific's PPS services should be accounted for "below-the-line" and not subject to the sharing mechanism adopted in D.89-10-031. ✓

3. Pacific's request for authority to offer PPS services in the Sacramento and San Diego areas should be granted.

4. Pacific should not be required to refund to ratepayers past expenditures associated with PPS services.

5. Pacific's offering of PPS should be granted subject to the condition that Pacific shall not disconnect local telephone service for nonpayment of charges for PPS services.

6. Pacific's offering of PPS should be granted subject to the condition that Pacific shall keep accounts which track the costs and revenues associated with PPS consistent with the treatment of Category III services set forth in D.89-10-031.

7. Pacific should be required, in its first advice letter to update basic monopoly service rates pursuant to D.89-10-031, to adjust its rates to reflect the removal of costs associated with PPS as set forth in this decision.

8. Pacific should not be required to make public the contents of sealed exhibits in this case, for purposes of resolution of this application.

O R D E R

1. The application of Pacific Bell (Pacific) for authority to continue offering its public packet switching (PPS) services are granted subject to the condition that the service shall be treated as a Category III service as defined in Decision (D.) 89-10-031 and:

- a. Pacific shall continue tracking and reporting PPS as set forth in D.88-11-027 and D.89-10-031 for Category III services, including the use of the FCC's Part 64 methodology for allocation of costs to below-the-line accounts.
- b. Pacific shall not include any costs associated with PPS in its calculation of sharable earnings.
- c. Pacific shall not disconnect any local telephone service for nonpayment of PPS services charges.

2. Pacific shall, in its first advice letter to update basic monopoly service rates pursuant to D.89-10-031, reduce its revenue requirement to reflect costs and expenses associated with PPS services, as set forth in this decision. Pacific shall make this filing notwithstanding its decision regarding whether or not to continue to offer PPS services.

3. This grant of authority shall expire within 30 days of the effective date of this order unless, prior to that time, Pacific files tariffs and tracking account information with the Commission Advisory and Compliance Division, consistent with the provisions set forth in this decision.

4. Pacific is authorized to offer PPS services on a tariffed basis within its service areas, at will, as of the effective date of this decision.

This order is effective today.

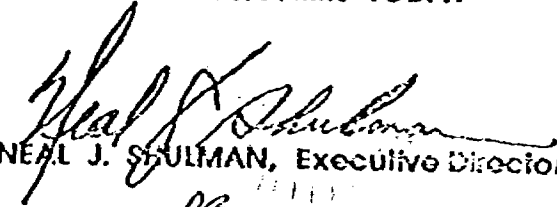
Dated MAY 4 1990, at San Francisco, California.

G. MITCHELL WILK
President
FREDERICK R. DUDA
STANLEY W. HULETT
JOHN B. OHANIAN
PATRICIA M. ECKERT
Commissioners

I will file a written concurring opinion.

/s/ JOHN B. OHANIAN
Commissioner

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


NEAL J. SHULMAN, Executive Director

John B. Ohanian, Commissioner, Concurring:

I concur with my fellow Commissioners about the appropriateness of moving Pacific Bell's Public Packet Switching (PPS) service from Category I to Category III. However, all parties should be noticed that the Commission can also move PPS out of Category III into either Category I or II if future conditions warrant.

There can be no doubt that an all-digital public telephone network will be at hand in the not too distant future. In such an environment, PPS may become increasingly important for the transmission of voice, data and video services throughout the public network, including to and from residences and businesses of every sort. Already, Pacific Bell is offering PPS as a feature on its new ISDN Centrex product offering. Pacific and other RBOCs will soon begin trials of switched multimegabit data services, a packet-switch service, for customers with large bandwidth needs. Fiber-optic networks will increasingly be based on SONET transmission standards, an advanced form of fast packet switching.

Given the great number of services available through packet-switching technologies, from today's E-mail and gateway services to tomorrow's "fiber-to-the-home" services, it is not inconceivable that PPS may well take on many or all of the characteristics of Category I and II services. Should PPS begin to resemble either Category I or II services, I will not hesitate to recommend that the Commission reconsider today's classification of PPS as a Category III service.


/s/ John B. Ohanian

John B. Ohanian, Commissioner

May 4, 1990
San Francisco, California