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Decision 90-06-025 June 6, 1990

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

Investigation on the Commission's own motion into the regulation of cellular radiotelephone utilities.	I.88-11-0[illegible] (Filed November 23, 1988)
And Related Matters.	Application 87-02-017 (Filed February 6, 1987) Case 86-12-023 (Filed December 12, 1986)

(See Appendix A for appearances.)

I N D E X

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INTERIM OPINION

Summary

This opinion reflects the result of a comprehensive review of the cellular regulatory framework which has undergone little change since it was established in 1984. The changes to the cellular regulatory framework adopted in this interim opinion are made to enhance cellular competition and to encourage innovative and quality cellular services. The major regulatory changes adopted in this interim opinion are:

a. Classifying cellular service as a discretionary service.

b. Detariffing enhanced cellular services.

c. Relaxing facilities-based carriers' and resellers' tariff requirements.

d. Adopting new pricing flexibility for duopoly carriers and resellers.

e. Requiring carriers to pay access charges for only the actual components of the local loop they used to initiate and/or to complete a call.

f. Eliminating mandatory margin between wholesale and retail rates.

g. Classifying resellers not associated with a facilities-based carrier as nondominant telecommunications carriers.

h. Establishing a "large-user" tariff for organizations and entities not intending to use cellular service for their own use or for resale.

In addition, five issues are deferred pending further analysis from interested parties. These issues are:

a. The ability of resellers to perform switching functions currently provided by the local exchange companies.

b. A streamlined certification process for facilities-based carriers located in the rural service areas (RSAs).

c. The preemption of retail restrictions by the Federal Communications Commission (FCC).

d. Duopoly carriers reporting requirements that will enable us to assess their utilization and expansion of the cellular radio spectrum.

e. Modify the Cellular Uniform System of Accounts (USOAs) to include cost-allocation methods for a carrier's wholesale and retail operations.

This decision reflects a basic philosophical direction to rely on competitive forces to set prices for cellular service and to promote the most rapid expansion of service and use of new technology that is reasonably possible. Regulatory protections sufficient to control the potential harmful effects of the duopoly market structure are adopted and will be enforced. In particular, a requirement that carriers expand their systems as rapidly as possible and price low enough to fill that capacity will assure substantial decreases in the price of cellular service when digital technology is put into use, and should continue to force price decreases as continued advances in technology make more and more service available.

This decision also adopts a series of protections to assure fair competition in the retail cellular market without raising prices to consumers to protect any particular class of service providers.

Background

This investigation was opened on November 23, 1988 to determine whether the cellular radiotelephone regulatory framework established in the 1983 Los Angeles and San Francisco cellular market certificate proceedings is meeting Commission objectives and to determine whether the cellular regulatory framework should be changed. All facilities-based cellular radiotelephone utilities, cellular resellers, and local exchange carriers (LECs) providing interconnection with local exchange networks for cellular carriers were named respondents to this investigation.

Pursuant to the investigation, Application (A.) 87-02-017 and Case (C.) 86-12-023 were consolidated into the investigation because they raised generic issues. These generic issues are whether cellular carrier affiliates should be prohibited from reselling in markets in which the cellular carrier provides retail service (A.87-02-017), and whether the payment of commissions prohibit cellular resellers from entering the cellular market and operating a viable resale business (C.86-12-023).

This investigation was bifurcated into two phases, both of which are addressed in this opinion. The first phase addresses generic regulatory goals and the second phase addresses specific regulatory policies for cellular wholesalers and resellers. In each phase, respondents and interested parties (parties) were requested to comment on specific questions. In all, there were 62 specific questions. Although this opinion will not address each individual question, responses to these questions are considered and incorporated in the generic issue, as deemed appropriate.

Parties may note a certain degree of overlap between issues discussed both in Phase I and Phase II. In each case, the more specific policy discussion and conclusions will be found in the Phase II sections in the latter half of this decision.

It is worth revisiting the broad background of this industry and its regulation to set an overall context for the policies set forth in this decision. When the FCC licensed the original cellular carriers in California, we faced a broad strategic choice. On the one hand, we could have treated cellular carriers as monopolists and set and enforced strict cost of service rates. However, we were uncertain as to the actual competitiveness of the duopoly, the likely progression of technology and our potential impact upon it, and whether or not cellular would be more than an expensive and unimportant adjunct to other services. On the other hand, we could have offered carriers the maximum pricing flexibility allowed by law. However, the possibility of monopoly-like profits and the prospect that cellular would become an important service deterred us from that course. Our resulting pattern of regulation, initial rates based on cost projections but left largely unexamined since, was reflective of this uncertainty regarding cellular's role as a service and our role in overseeing it.

In this decision we aim to provide a sounder and clearer philosophical basis for our regulation of cellular. We intend to clarify a consistent set of policies on which carriers, resellers, customers, and others may rely with some assurance. Some of our initial uncertainty has been clarified with time and experience, while the advancing pace of technology and market development has posed new questions. We intend to promulgate a flexible and forward-looking regulatory framework that will meet customer needs while accommodating some of the changes that appear likely in the near future.

In considering these issues we will bear in mind the continuing essential fact of this industry--the duopoly wholesale carriers licensed by the FCC. Were it our choice, we would license additional carriers to assure the public the full benefits of a well-working competitive industry without a need for substantial regulatory intervention. We do not have the choice of certificating additional carriers, but we will seek to provide the benefits of competition to the extent they are achievable under the FCC's market structure.

Phase I

Comments and reply comments to the Phase I issues were filed by approximately 20 entities represented by 45 utilities and interested parties, as shown in Appendix B.

The first phase addresses:

a. The future of cellular radiotelephone service.

b. Regulatory goals and framework.

c. Service quality and consumer protection.

d. New ratemaking and regulatory issues.

The Future of Cellular Radiotelephone Service

Many of our telecommunications systems today have the capability to offer "toll free" calling over large geographic regions of the state through their tandem interconnections with interexchange carriers (IECs). A stated goal, through microwave and other types of switching arrangements, has been to offer subscribers inexpensive interLATA (Local Access and Transport Area) service from one end of the state to the other. We are concerned how the cellular network will develop and whether it will develop into an alternative telephone network.

Impact on Conventional Service

At present, cellular service is not an important substitute for landline local exchange service. Given the high cost of cellular equipment, rapid technological changes, and network access and usage, Redwood Cellular Communications, Inc. and other parties concur that cellular service will continue to be a discretionary service complementing conventional wireline service. However, Cellular Resellers Association, Inc. (CRA) and GTE California Incorporated (GTE) assert that as the cost of cellular service approaches that of conventional wireline service, cellular service will be the preferred service and become a direct competitor to conventional wireline service.

The optimum market size for cellular service has not been reached. Although the present market size is based on analog radio technology, it is difficult to predict the optimum size because of the ability to place additional cell sites in a given area and the ability to split cells. Currently, the optimum size is restricted based on individual capacity, coverage needs of each cellular market, and desire to maintain quality service. For example, one of the largest cellular systems in California, Los Angeles Cellular Telephone Company's (LA Cellular) present system has a maximum capacity of 200,000 to 250,000 subscribers. However, with the implementation of second generation technology, or digital technology, LA Cellular expects to increase its capacity by 3 to 4 times, or to about 600,000 to 700,000 units dependent on the technical standards to be established for digital service and the associated cost to implement.

Parties concur that cellular service is a discretionary service and that cellular service will not replace or directly compete with conventional wireline service in the near future. Therefore, we should not set a "basic service" goal for the cellular industry at this time. However, it is apparent that continued technological advance could make cellular or other radio-based systems competitive with landline basic service in the coming decade. While we do not face this issue today, parties should recognize that this development would change the essential fact on which much of our regulation of local exchanges is now based, that of the local loop being a monopoly.

For the near term, our regulatory framework must be flexible enough to accommodate the substantial increases in capacity that digitalization will permit along with concomitant price decreases for customers. There is also the issue of the likely obsolescence of the customer premises equipment (CPE) or cellular telephone sets that now function on analog technology and are unusable for digital. While it is illegal to bundle the sale of unregulated CPE with utility services, carriers may wish to offer introductory digital services at discounts sufficient to attract customers despite the cost of purchasing a new telephone set. Our framework should be flexible enough to permit such discounts as an impetus towards more efficient use of all-digital networks.

Low-Cost Portable Phones

Another issue is how improvements in cellular telephone sets have affected the overall market. In the first four years of cellular service in California, a catalyst in the penetration of the telecommunications market was the decline in the price of mobile telephones from an average of $2,500 in 1984 to an average of about $500 in 1989. CRA concurs that low-cost phones have arrived. Improvements in the phones as to weight, size, and talk time restricted by battery technology have also helped increase market penetration.

However, the development and enhancement of low-cost phones is not the only force affecting the overall growth of cellular service. Price sensitivity to cellular access and usage is another important component. As shown in GTE's illustration of a customer's monthly bill in the Los Angeles market[1] with the availability of low-cost phones, the primary avenue for enhanced

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1 Assuming a phone price of $3,000 in 1984 and $500 in 1988 amortized over 3 years at 18 percent interest, and 200 minutes of monthly usage.

	1984	1988
Amortized Phone Cost	$106.85	$ 17.81
Monthly Network Access	50.00	45.00
Network Usage	70.00	70.00
Monthly Bill	$226.85	$132.81

market penetration for the future will be in reduced access and network usage costs.

Changes in Conventional
Landline Regulatory Policies

In addition, regulatory policies and technological changes in other sectors of the telecommunications industry may affect cellular service. Some of the near future changes which may impact the cellular industry are a reduction in landline toll rates, increased intraLATA competition, and marketing of a noncellular digital portable phone. Parties concur that customer penetration will not be significantly impacted by lower landline toll rates or by an increase in the growth of the intraLATA toll market because such charges are already being passed through to the cellular customer.

Related issues include whether cellular calls represent uneconomic bypass, and the appropriate status of enhanced services offered on cellular systems. Although CRA believes that all cellular carriers offer intraLATA toll and interLATA service, GTE Mobilnet of California Limited Partnership and GTE Mobilnet of Santa Barbara Limited Partnership (GTEM) clarify that the Cellular Geographic Service Areas (CGSAs) approved by the FCC and this Commission never intended to conform to or coincide with existing landline boundaries.

As LA Cellular points out, rather than providing toll service, the cellular carriers generate traffic for the landline carriers because nearly all cellular calls are carried in part over wireline facilities. It is because of this complementary or incremental service that there is no bypass of the LECs' or IECs' network. Because the LECs and IECs charge compensatory rates for their facilities on a tariffed or contractual basis, these charges are passed directly through to the cellular subscriber when the call is terminated outside the CGSAs. There is no uneconomical bypass because these rates are included in the cellular carrier's basic access and airtime charges when the call is terminated within a CGSA.

Parties also concur that enhanced services[2] such as voice mail, will expand the role of cellular phones with efficient 24-hour communication capabilities. Voice messages and other advanced communications services generate additional traffic for the network, because when a caller does not reach a desired party, the caller is able to leave a message, hence a completed call. The latter makes periodic calls to check for messages, and then makes additional calls as a result of recording these messages.

U S West Cellular of California, Inc. (U S West) and other facilities-based carriers argue that the regulation of enhanced services is not necessary because enhanced features are both competitive and discretionary services.

On the other side, CRA and Cellular Dynamics Telephone Company of Los Angeles (Cellular Dynamics) argue that enhanced services should be cost based and that resellers should be accorded equal access to such services with a wholesale/retail margin commensurate with that provided for basic cellular service.

The regulation of enhanced services has been an issue in LECs proceedings since the FCC-preempted state regulation of enhanced services approximately two years ago. This Commission, along with a number of other parties, appealed the FCC's enhanced

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2 As defined by the FCC in the Second Computer Inquiry, these are services offered over transmission facilities which employ computer processing applications that act on the format, content, code, and protocol or similar aspects of the subscribers' information, provide the subscriber additional, different or restructured information, or involve subscriber interaction with stored information.

services preemption. The United States Ninth Circuit Court of Appeals[3] has heard oral argument, and an opinion is pending.

Currently, LECs enhanced services are not required to be tariffed. However, procedures on billing and consumer rights impacted by enhanced services are tariffed, as identified in Decision (D.) 89-09-049. As discussed in this opinion, cellular service is a discretionary service, and as such, warrants less stringent regulation than the LEC's monopoly which provide basic service. Irrespective of the outcome of the Commission's appeal, we may decide that carriers' enhanced services need not be tariffed. However, CRA's comment on a carrier's refusal to offer resellers enhanced services currently offered to the carrier's end users substantiates the need to require those carriers who offer enhanced services to all wholesale customers, including resellers, on a nondiscriminatory basis at the wholesale level as a condition of allowing nontariffed enhanced services.

Regardless of whether enhanced services are or are not tariffed, end user rights to tariffed services need to be protected. Therefore, end users rights, similar to those adopted for LECs end users in D.89-09-049, should be adopted.

Carriers may not disconnect any tariffed services solely for nonpayment of enhanced service charges and should notify end users receiving bills for enhanced services of this rule when the end user receives the first such bill. Any end user complaints about enhanced services should be tracked by carriers as to the number and nature of complaint and be made available to the Commission Advisory and Compliance Division (CACD) upon request.

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3 People of the State of California v Federal Communications Commission, Case Nos. 87-7230 et al., Ninth Circuit Court of Appeals.

Regulatory Goals and Framework

An integral part of this investigation is to assess the regulatory goals for the cellular industry prior to our consideration of alternative regulatory frameworks for the cellular industry. These goals encompass universal service, economic efficiency, technological advancements, utilization of the LECs, anticompetitive behavior, and financial and rate stability.

Universal Service

Universal service, or the availability of basic telephone service at affordable prices to all Californians, is a basic goal for landline services by the LECs. Recognizing the high cost of providing basic service to the rural areas, comments were requested on whether or not cellular service should be considered a cost-effective alternative to landline service in the rural areas.

CRA believes that a universal service policy must be incorporated into cellular regulation to assure that Californians have equal opportunity for service. However, GTEM maintains that cellular service is a complement to wireline business service, rather than a substitute for conventional wireline service business and residential service.

To the extent that cellular service may displace landline service in the rural areas, GTEM represents that such service will be provided by LECs as part of their Basic Exchange Telecommunications Radio Service (BETRS).[4] However, McCaw Cellular Communications, Inc. (McCaw) and its affiliates do not believe that this will occur because the FCC specified that BETRS is the radio-based service designed specifically to provide

4 By FCC Report and Order, CC Docket No. 86-495, released January 19, 1988, the FCC granted rural radio service licenses "co-primary access" to certain cellular frequencies to provide BETRS in rural areas. Cellular carriers were authorized to provide only fixed installations of cellular service on an incidental basis.

telephone service to rural subscribers who have no other telephone service. The FCC prohibits the provision of fixed cellular service by cellular carriers except on an incidental basis. Cellular service is not presently an economically viable alternative to landline service. High-quality landline service is already widely available in most rural areas at reasonable prices because of numerous assistance programs and policies established for rural landline telephone companies to ensure continued affordable telephone service.

Cagal Cellular Communications Corporation (Cagal), Santa Barbara Cellular Systems, LTD. (Santa Barbara), Santa Cruz Cellular Telephone Company (Santa Cruz), LA Cellular, and other interested parties concur with GTEM. As PacTel Cellular (PacTel) and its affiliates shows in its comments, there are approximately 400,000 cellular units in service compared to approximately 17 million LEC access lines.

We conclude that universal service is not an appropriate goal for the cellular industry at this time because cellular is a high-cost developing industry undergoing rapid technological changes. It is expected to serve only about five percent of the population in the next five years.

Economic Efficiency

We are interested in goals which may enhance economic efficiencies via cost-based rates and which may encourage cellular providers to minimize their cost of service.

CRA asserts that economic efficiencies can be obtained through cost-based regulation of wholesale rates and oversight of anticompetitive practices. Although Cellular Dynamics believes that competition is the best driver of economic efficiency, it recognizes that meaningful competition is not present in the cellular industry because the wholesale level is dominated by a duopoly. It also believes that cost-based rates for the wholesale level will promote efficiency.

GTEM and U S West disagree that cost-based regulation is necessary to promote economic efficiency because competitive and economic efficiencies already exist in the cellular industry and are driven by market forces. They do not believe that price regulation will enhance economic efficiencies.

McCaw concurs with GTEM and U S West. It points out that cellular carriers must establish prices above marginal costs to maximize their system because of the high percentage of inherent fixed costs. It recommends the marginal cost approach because of pressures from the existence of an alternative cellular system provides an incentive to keep costs as low as possible and at the same time encourages high-quality service.

McCaw believes that economic efficiency can best be derived from a competitive marketplace free of regulation. Although it concurs that a regulated market can lead to economic efficiencies, it believes that such intervention can only enhance economic efficiency when regulation properly and completely allocates applicable costs, accurately establishes rates based on cost without any social subsidies, and fully monitors and adjusts all behaviors that result from artificial regulatory intervention.

We can distinguish economic efficiency concerns relating to the underlying duopoly from those related to competitively-provided aspects of cellular service such as equipment sales.

There are two issues related to the FCC's decision to license only two wholesale carriers and create a duopoly market. The first is how we should view the scarcity of electromagnetic spectrum that can be allocated to this or any other economic activity. The second is how we should view the fact that only two carriers have been licensed in each market to use the limited spectrum, with additional market entry possible only if the FCC either takes spectrum away from the incumbents or reallocates it from some other use.

As the demand increases for goods and services that require the use of the spectrum, so increases the rents that its owner will earn.

There is an economic efficiency reason for permitting an owner to keep revenues derived from the use of radio spectrum because it encourages investment that will permit more intensive use of that spectrum (for example, more calls or subscribers on a given set of frequencies). The result is a greater supply of service for the public. Limits on the profits that can be earned or kept will diminish the incentive to expand the use of the spectrum, and the public will receive less service. For these reasons we recognize that profits earned due to the scarcity of available radio frequencies are best left to the carriers.

By contrast, we should not permit carriers to keep profits due solely to a failure to compete in a duopolistic market. There is an incentive to fail to compete vigorously when new entrants cannot join the market to undercut monopoly-type prices. The result would again be a type of economic inefficiency, for noncompetitive pricing would lead to excess capacity on cellular systems (where a lower, competitive price would stimulate increased consumer demand and fill up the system).

It is efficient to permit carriers to earn revenues from owning the FCC license, but not from a failure to compete that reduces the demand for cellular through overpricing. In other words, we should become concerned if carriers keep prices high enough to discourage the full use of their systems, or if carriers fail to invest in system expansion when it is economically justified.

On the other hand, cost of service regulation of wholesale prices is problematic in a competitive industry like cellular that is undergoing rapid technological change. By way of reference, D.89-10-031 articulated at some length our findings that technological innovation and cost cutting are hindered by such regulation. The competitive duopoly market structure introduces other complications that would make it even more difficult to achieve efficiency through cost of service regulation. Carriers differ in their numbers of customers, precise service areas, equipment, and in numerous other characteristics that affect costs. We would be faced with setting different prices or different allowed rates of return; the former would artificially bias the market towards one carrier while the latter could be attacked on fairness grounds. Some carriers serve our markets only by virtue of having purchased FCC licenses for substantial sums. Making no recognition of these acquisition costs would cause immediate cash-flow crises for some of our carriers, while accounting for them directly would create substantial rate disparities compared to other carriers that received their licenses directly from the FCC. To promote economic efficiency, some value for the license would probably need to be imputed into rates, yet we are uncertain as to how such a calculation could be made or whether it would prove obsolete thereafter due to market dynamics. Regardless of the method used, if cost-of-service calculations produced prices that did not account for the scarcity value of the license, then systems would become overburdened with subscribers; the resulting degradation in service quality and potential need to ration the service would impair economic efficiency.

In sum, we find that rate of return regulation would be neither efficient nor workable for cellular carriers. We will use other means to assure that duopoly rates are just and reasonable.

While the duopoly is the centerpiece of the cellular market, many related activities or service components are not limited by the duopoly. Resellers offer competitive marketing and billing and collection services, and propose to go further by offering certain facilities-based enhancements to cellular service (by means of the reseller switch proposal, to be the subject of an upcoming hearing). Equipment sales are deregulated and competitive. To the extent that aspects of cellular service are fully competitive, we can be assured that customers are receiving the lowest possible prices from efficient suppliers. However, we must be mindful of protecting competition rather than particular competitors, because the public can also be harmed by the extra cost of maintaining preferred market positions through regulation. Where competition exists, we should encourage its continuance through fair and limited measures intended only to prevent harm to consumers.

In conclusion, efficiency concerns suggest that profits accruing to carriers because of their FCC licenses should be permitted, while profits related to a failure to compete should not. Full competition should be encouraged and continued in as many market segments of the cellular industry as possible.

Technological Advancement

Because the cellular industry is a new industry, the encouragement of technological advancement is a vital goal that ensures this industry's ability to develop and maintain innovative and high-quality service. We seek a regulatory framework that will continue to encourage innovative and high-quality cellular service.

Cellular Telecommunications Industry Association (CTIA) asserts that regulation of the cellular industry has the potential to retard innovation. In support of its conclusion, CTIA cites a FCC competitive carrier decision[5] which determined that regulatory burdens do in fact retard innovation and reduce efficiency. The present regulatory requirement that tariffs must be authorized prior to implementation provides competitors advance notice of business strategy and enables competitors to use the

5 FCC's Competitive Carrier, First Report and Order, supra n. 1, at 5, citing C. W. Needy, "Regulation-Induced Distortions," 1978; Second Report and Order, 91 FCC 2d 59, 60-01 (1982).

regulatory forum to challenge and delay a competitor's service introduction. CTIA believes that it is important to provide carriers the ability to operate without regulatory intervention so that digital technological improvements, expected to occur in 1991, can foster a new technological and service generation in the cellular industry.

Cagal, LA Cellular, Santa Barbara, Santa Cruz, and CRA do not believe that the present regulatory environment will hinder technological advancement. However, the smaller cellular providers such as Cagal want us to be aware that they are unlikely to generate sufficient funds to put into new technology.

PacTel recommends that market forces continue to provide the incentives to encourage technological innovations.

As GTEM points out, technological advancement can best be encouraged by providing cellular carriers the means to attract capital necessary to make investments in research, development, and commercialization of innovative technology. As the economic efficiency discussion pointed out above, technological advancement will lead to more efficient means to increase the use of the available spectrum and bring service to more and more Californians. Carriers should be given a full and appropriate incentive to use new technology to expand capacity and reduce cost. The ability to attract capital is impacted by the cellular carriers' rate structure discussed in the second phase of this investigation.

<u>LECs Network</u>

Parties concur that the existence of cellular technology increases use of the LECs' network through interconnection charges and call-originating charges. However, such use does not require a policy to fully utilize the LECs network because, as Cagal states, the bulk of cellular calls that interconnect with the LECs are calls that would not otherwise have been made had cellular technology not existed.

McCaw and other parties concur that regulatory steps should be taken to ensure that reasonable and efficient interconnection is promptly provided to cellular systems by the LECs. Cellular carriers' interconnection with the LECs is addressed in the second phase of this proceeding.

<u>Anticompetitive Behavior</u>

The LECs have experienced anticompetitive behaviors through subsidization of unregulated operations and unregulated affiliates. It is because of such behavior that we are considering setting a regulatory anticompetitive goal within the cellular industry.

Because cellular carriers must interconnect with the LECs network (the LECs have a monopoly control over these bottleneck facilities), cellular companies, such as McCaw, recommend that we adopt general principles applicable to cellular interconnection and that we provide assistance to ensure that interconnection agreements between cellular and LEC companies are cost based, reflect the different forms of interconnection and their costs, and reflect reciprocal nature of interexchange traffic. We conclude that such additional controls are not necessary because sufficient regulatory oversight already exists for the the LECs operating as a monopoly.

In all other respects, McCaw represents that the provision of cellular service is a competitive business which precludes independent cellular companies like McCaw from subsidizing its cellular operations. It believes that no regulatory oversight is needed to avoid anticompetitive behavior within the cellular industry.

Parties recognize that the USOAs, promulgated by the Commission, plays an active role in discouraging anticompetitive behavior. To the extent necessary, LA Cellular, Cagal, and other parties believe that anticompetitive concerns are best addressed through established antitrust laws in the state and federal courts.

PacTel concurs that the current regulatory oversight is sufficient to prevent LECs from providing a subsidy to their affiliated wireline cellular carriers and that the cellular carriers have no economic incentive to subsidize their resale operations.

CRA and Cellular Dynamics argue that the FCC-mandated duopoly for each cellular market results in anticompetitive behaviors by the facilities-based carriers against the cellular resellers through subsidy of their retail operations. CRA also asserts that such subsidies will continue and will stifle the resale market unless we oversee the cellular operations between the wholesale and retail market.

Such an observation is not valid. We have taken several steps to deter any facilities-based carrier from subsidizing its retail operations by its wholesale operations. By D.84-04-014, a policy that facilities-based carriers' wholesale operations should not subsidize their retail operations was established. By D.86-01-043, a USOA segregating wholesale and retail operations was established for facilities-based carriers. Currently, there is no USOA for resellers. In addition, rates must be authorized prior to being implemented. These controls to deter anticompetitive behavior will continue, including rate oversight as discussed in Phase II of this decision. In addition to these controls, there remains federal and state antitrust laws. We believe there is already sufficient regulatory oversight to deter anticompetitive behavior. However, we will strengthen such controls by modifying the cellular USOAs to include cost-allocation methods for wholesale and retail operations, in the next phase of this investigation.

<u>Financial and Rate Stability</u>

Cellular is a new industry undergoing rapid technological changes. We are concerned with how the regulatory framework can provide the regulated industry adequate and stable financing capabilities so that cellular carriers can effectively deploy new capacities and services for their customers at reasonable rates.

We are interested in assuring reasonable financial stability for the cellular carriers, with the concomitant benefit of lower cost of capital.

The facilities-based carriers do not believe that financial and rate stability is an appropriate goal for a competitive market like the cellular industry. Although the cellular market does not guarantee financial stability, GTEM believes that it does provide a substantial incentive to operate efficiently and successfully, and that the absence of regulatory financial goals will allow service providers to compete on price and ultimately, result in a reasonable degree of rate stability without regulatory intervention.

Cellular Dynamics concurs with the facilities-based carriers if resellers are afforded adequate "margins" and permitted to conduct their business on a "level playing field" with the facilities-based carriers.

Division of Ratepayer Advocates (DRA) also acknowledges an interest in assuring reasonable financial stability for the regulated entities. However, it believes that economic efficiency should be promoted in order to provide a balance between the interest of the regulated entities and the interest of the end users. DRA recommends that this balance be accomplished through the gradual lowering of cellular rates.

The consensus is that only minimum regulatory oversight need be exercised to assure financial and rate stability. This is because, as McCaw states, the cellular carriers have a strong incentive to provide pricing structures and levels which will attract new customers and retain old customers. To do so will require the cellular carriers to operate efficiently.

Service Quality and Consumer Protection

Consistent with our regulatory responsibility to the end user, we requested parties to recommend service quality and consumer protection goals in their comments. We are primarily interested in goals associated with service standards, fraud, LEC billings, privacy, and agents' commissions.

Service Quality

Parties rate California's cellular service good and concur that cellular providers are willing to provide high-quality performance. The incentive for such willingness is the carriers' desire to keep the customer from switching to a competitor.

The measurement of service quality is the extent of customer satisfaction with service consistency, high-quality voice transmission, ease of placing and receiving calls, billing service and level of customer complaints. As Cellular Dynamics points out, the measurement of good cellular service is basically the same service measurement for landline service.

DRA confirms from its analysis of cellular customer complaints filed with the Commission, the quality of service is not the major reason for customer complaints. Only 10 percent, or 56 of the 545 complaints received in 1988 pertained to service complaints. The single largest complaint consisting of 32 percent, or 176 complaints, pertained to cellular customers' telephone bill.

The number of service complaints filed in comparison to total cellular complaints substantiates that the quality of cellular service in California is good and that the cellular carriers have a sufficient willingness to continue and to enhance quality cellular service without implementing any additional regulatory goals or policies. We expect the use of digital technology to improve service further, which is another reason that our policies should aim to encourage technological innovation and continued investment in system upgrades.

<u>Fraud</u>

Fraud is a prevalent problem in a start-up industry such as the cellular industry. We are interested in the cellular industry's experience with fraud and whether we should set regulatory goals to deter and minimize such fraud.

AT&T Communications of California, Inc. (AT&T) has experienced two types of fraud, subscription fraud and roamer fraud. Subscription fraud occurs via a customer providing incorrect billing information such as an incorrect mailing address or initiating multiple accounts with a different address when establishing service with the cellular carrier. Approximately seven percent of AT&T's billed cellular long distance revenues are uncollectible because of such subscription fraud. This is significant compared to AT&T's overall uncollectible rate of less than two percent for its 1988 California interexchange services.

AT&T's solution to subscription fraud is to require the cellular carriers to perform subscription information verification checks for each new customer prior to service. Although AT&T acknowledges that the cellular carriers do conduct such checks, it represents that the cellular checks are not executed effectively and that we should establish specific guidelines for such checks.

Roamer fraud exists when end users utilize an unauthorized subscriber telephone number or alter the electronic serial number (ESN)[6] on their cellular terminal while roaming in remote areas. Although AT&T did not quantify the extent of roamer fraud, Santa Barbara represents that 10 percent to 15 percent of its roamer traffic is fraudulent.

Whenever a call is placed from a cellular telephone instrument a unique ESN is transmitted to the carrier's switch, as

6 A unique number assigned to each individual cellular telephone instrument.

part of the call sequence. Based on the transmitted ESN, the switch is capable of determining exactly which instrument is being used to place the call, and is capable of blocking all calls from the specific instrument.

U S West represents that it and other carriers have expended considerable amount of time and effort to develop and implement positive roamer verification systems (PRVs) to reduce fraud. PRVs enable a carrier to verify positively that the combination of a roamer's mobile number and ESN is active and in good standing on the "home" carrier's switch at the moment the first roamer call is made.

GTEM represents that since the development of PRVs in late 1988, roamer fraud has been minimized. Use of PRVs has been a business decision for each carrier based on an individual carrier's assessment of its own risk of fraud related to the cost needed to minimize such fraud. Several of the carriers negotiate PRVs in their roaming agreements with other carriers.

Other than AT&T, carriers and DRA see no need for us to implement specific guidelines to prevent roamer fraud. They have taken the initiative to solve the fraud problem on an industry-wide basis and believe they can act more expeditiously without regulatory oversight.

Industry efforts to control roamer fraud appear adequate and do not require any further intervention from us at this time. However, the ESN blocking issue is more complicated and requires that we set rules that utilities should implement in their tariffs regarding ESN blocking.

Three types of utilities are potentially involved when an ESN may be blocked. The first is a reseller that may be serving a customer or may wish to serve a customer. The second is the facilities-based carrier whose system is now serving a customer either at wholesale (through a reseller) or at retail directly.

The third is the other facilities-based carrier that is not serving the customer.

Further, ESN blocking is different from ESN deactivation. In the latter, the cellular network no longer recognizes the ESN as active and will not accept calls from the instrument. In the former, the ESN is inactive and a utility has requested that other utilities refuse to activate it if requested to do so.

It is clear that ESN blocking is appropriate in cases of lost or stolen CPE or where ESNs have been counterfeited, provided that some verification of the circumstances is available.

In comments to the proposed decision, both McCaw and LA Cellular identified several other circumstances where it is not so clear whether ESN blocking is consistent with a fully competitive market or with consumer protection. One is where a carrier or reseller wishes to block an ESN until all customer charges incurred have been paid. As LA Cellular points out, the practice of billing calls in arrears means that several weeks may pass before the customer is even rendered a bill; and, the length of that period of time is under the control of the reseller or carrier that is losing a customer. It is unfair to permit the utility that is losing a customer to require ESN blocking until that utility reports satisfaction with outstanding bills. Informally, we are also advised by our Consumer Affairs Branch that we have received numerous consumer complaints regarding this issue. Given that a utility has an opportunity to secure a deposit from a customer to cover a potential last bill, we will require that an ESN that is deactivated due to service discontinuation be reactivated at the time another certificated utility agrees to assume responsibility for service to that ESN.

In other words, the utility's appropriate action for a routine service disconnection is to deactivate the ESN rather than to go further and request that other carriers block the ESN pending payment of the final bill.

There is the related issue of nonpayment due to fraud, or a subscriber having no intention of paying the bill. The issue can arise when the subscriber seeks service through another utility and finds his ESN blocked due to alleged fraud. In that case, the subscriber may not be able to convince another utility to extend him credit and restore service. It is reasonable for utilities to request that other utilities block ESNs in case of fraud, but we must also recognize that a subscriber may see a billing dispute where a utility sees fraud. We need to preserve the rights of both parties.

Where a utility has requested an ESN block due to its belief that the subscriber intends to avoid payment for proper charges, we will permit the utility that would implement the ESN block to ask for indemnification from potential damages that might result. We will also require the utility requesting the block to inform the subscriber, in the course of any subsequent conversation or contact, that the block will be lifted immediately if the subscriber places the amount in question on deposit with the Commission's Consumer Affairs Branch pending formal or informal Commission resolution of any disputed charges. In this way utilities requesting ESN blocks due to fraud should face little if any liability for an inappropriate ESN block, because the subscriber will have an immediate remedy before us. The subscriber's rights are preserved because he can have service restored by committing to pay the amount of the disputed bill that we find reasonable.

The Commission's Consumer Affairs Branch is hereby directed to contact the utility or utilities involved immediately upon receipt of such deposits.

We will clarify that each utility should act in accordance with its tariffs in considering ESN blocking requests from other utilities, and that these tariffs should allow ESN blocking in the following circumstances:

a. Cases of instruments reported lost or stolen if verified by a police report or an affidavit.

b. Cases where ESNs have been counterfeited.

c. A utility may request that another carrier block an ESN for nonpayment of tariffed charges for bills that have been mailed or otherwise delivered to the subscriber. In

> that case the carrier that has been requested to block may require the utility requesting the blocking to indemnify it against any liability that may result. An ESN blocked for nonpayment shall be released immediately when another utility makes a bona fide request for activation and takes responsibility for subsequent service, or when the subscriber submits payment for disputed charges to the Commission pending formal or informal resolution of the disputed bill.

Carriers should activate, deactivate, and block ESNs in a nondiscriminatory manner; i.e. perform these functions just as quickly and reliably in response to a bona fide reseller request as would be done in the case of a carrier's own retail customer. Carrier tariffs should contain an affirmation of this nondiscrimination policy.

Finally, we would like to clarify our policy regarding customer deposits. Because this is a competitive market for a discretionary service, we will not set specific limits for deposits or require that interest be paid. For example, some customers might prefer to pay higher rates in exchange for a lower deposit, or lower rates with a high deposit. However, any utility requiring a deposit to initiate cellular service shall supply the customer with written notification as to the size of the deposit received, whether interest will be paid and on what terms, and specific terms under which the deposit will be returned including any processing time. Policies for determining creditworthiness and the size of the deposit to be requested should be included in the utilities' tariffs. We will rely on our Consumer Affairs Branch and the complaint process to identify utilities that do not provide full and fair disclosure of deposit terms to consumers. We will also authorize CACD to reject tariff filings concerning ESN blocking and deposits that do not meet these standards, or to recommend investigation and suspension proceedings for such noncomforming tariffs that are already in effect and not brought into compliance within 90 days of the effective date of this order.

LECs Billing

Currently, landline callers do not need to worry about the possibility that a number they wish to call may, unbeknownst to them,[7] involve cellular service and may be charged at much higher rates than conventional landline service. This is because cellular customers are charged for all cellular calls, whether they are on the originating or terminating end of the call, similar to WATS (wide area telecommunications service) calls in conventional telephone service. Parties' response to our inquiry of whether LECs should bill cellular rates to landline customers who originate calls to cellular customers were divided.

U S West and CRA recommend we permit the LECs to bill the landline customers who originate calls to cellular customers. However, CRA's recommendation is contingent upon the LECs being required to tariff the revenue requirement associated with the call and upon the LECs passing through to the appropriate reseller any revenue generated from the call.

Other parties such as Cellular Dynamics question whether landline customer cellular rates would discourage use of the cellular service because of the higher service costs. Pacific Bell (PacBell), having been requested by cellular companies to develop such a billing arrangement, is exploring the feasibility of billing the landline customer who calls a cellular number. This arrangement is referred to as "calling party pays."

PacBell and CP National are concerned that the landline customers may not be adequately informed about the additional charge for cellular airtime prior to attempting a call to a cellular phone.

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7 Presently, the landline customer has no way of knowing whether the number dialed is a cellular telephone number.

Absent careful planning, consumer education, and a method to alert a wireline caller of the extent of usage charges inherent in a particular call to a cellular telephone, CP National, and other small independent telephone companies believe that LECs should not be allowed to bill for cellular calls based on the "calling party pays" principle at this time.

We concur that the LECs should not be allowed to bill the calling party at cellular service rates at this time. However, PacBell and other parties may share the results of any billing feasibility study based on the "calling party pays" principle for our consideration, and comment by other cellular carriers. Any such billing proposal should be made by formal application.

<u>Privacy</u>

The invasion of privacy is an important consumer protection issue which needs to be addressed, particularly since it is known that cellular calls can be monitored by a third party without the cellular customers' knowledge.

Parties concur that cellular customers' privacy of calls is not seriously compromised because of Commission action in D.87-06-029 on cellular privacy and because, as GTEM stated, it is difficult for a person to eavesdrop on a specific call because of the number of times that particular cellular call is changed (handed off) from one cellular frequency to another.

Cellular Dynamics reminds us that those customers who need strict privacy can purchase encryption devices to scramble cellular signals at a reasonable price. International Mobile Machines Corporation also concurs that the replacement of cellular analog technology with digital technology, projected to occur in the near future, will enable cellular customers to obtain strict privacy.

Although cellular privacy is an important goal, all parties who commented on this issue agree that there are sufficient safety procedures in place to protect individual subscribers' conversations and that additional regulatory oversight or controls are not necessary at this time.

<u>Agents</u>

Commissions paid to agents of cellular carriers have been a major issue in resale complaint proceedings before us. We asked whether such complaints could be minimized if we required agents to publish the commission rates they received from carriers and resellers and also if such a requirement would result in lower retail rates.

U S West represents that agents are an effective addition to the carriers' sales network and have proven to be an important distribution channel for cellular service. It also represents that if agents are required to publish the commissions they receive from wholesalers and resellers, cellular rates will increase because the cellular providers will compete for the best agents. Other carriers such as Fresno Metropolitan Statistical Areas Limited Partnership (Fresno) feel that such a proposal will only drive up a carrier's marketing expense.

CRA represents that commission payments must be eliminated or reduced to no more than $50 per activated customer, consistent with PacTel's and GTEM's commission payments proposed in their respective certificate proceedings in 1984.

The focus of CRA's position regarding commissions is that the carriers are using them to subsidize the acquisition of new customers; the new customer receives an actual or effective discount on equipment from the agent, and the resellers are disadvantaged because their sources of cash flow cannot support similar payments. We address the specific facts of this argument in the Phase II discussion that follows.

The above comments demonstrate that the end users will not receive any benefit, and may even be adversely affected, if agents are required to publish the commission rates they receive from carriers and resellers. Absent any end user benefit, agents should not be required to publish their commission rates.

Additional Ratemaking
<u>and Regulatory Issues</u>

The issues identified in this category are directed towards whether a fair and equal treatment doctrine exists in the cellular industry. Components of this concern include whether: wholesale rates are set to discriminate against bulk-rate users, the rural cellular market regulatory treatment should mirror the metropolitan market regulatory treatment, the wireline carriers have a head start advantage over nonwireline carriers, the casual cellular users are being overlooked for regular cellular users, and tariffs should reflect roaming costs.

<u>Bulk Rates vs. Wholesale Rates</u>

Currently, the facilities-based carriers' bulk rate is set at the same rate or at a slightly higher rate than its wholesale rate. The bulk rate refers to the rate that large users pay to facilities-based carriers for service used for the large users' own business purposes and the wholesale rate refers to the rate that resellers pay to the facilities-based carriers for service.

CRA argues that the nominal difference between the bulk rate and the wholesale rate discriminates against the resellers because the facilities-based carrier does not incur the costs of service that the resellers must incur such as credit checks, billing, collection, bad debt risk, and marketing. Absent a wider gap between the bulk and wholesale rate, CRA argues that the facilities-based carrier is able to use wholesale profits to compete on the retail level with the resellers and preclude the resellers from competing profitably for the large-user market.

Roseville Telephone Company (Roseville) concurs with CRA and also asserts that such a practice discriminates against both the reseller and the end user because such pricing limits the number of service providers in the marketplace and minimizes carrier choice.

GTEM and U S West, whose bulk rates are equal to their respective wholesale rates, dispute CRA's and Roseville's assertions. Similar to other facilities-based carriers, GTEM's and U S West's bulk rate is equal to their wholesale rate because their cost of service to the bulk rate and wholesale user is identical. Both rates attract large users who enable the facilities-based carrier to gain economies of scale not available from the small customer. Without setting the bulk rates at the same level as its wholesale rates, the facilities-based carriers believe that they would be discriminating against either the bulk rate or wholesale user.

U S West also justifies its identical rates to bulk and wholesale customers on the basis that it costs more to provide service to individual small users and the economies of scale gained from large users should not be used to subsidize rates to the small users.

We concur with U S West that cellular users should not be provided service below the facilities-based carriers' cost to provide service.

Because there are substantial fixed costs associated with the provision of service, U S West does not believe that it is economical to cultivate casual users, or recreational users at this time. However, it is exploring alternative rate structures for these potential customers in its cellular markets outside California. We concur that the cellular industry should be given flexibility to attract casual users so long as such flexibility is cost-effective.

Although CRA does not dispute that the facilities-based carriers' cost are equal and/or similar for providing bulk rate and wholesale rate service, it argues that the facilities-based carriers' pricing policy precludes resellers from participating in the large-user market.

CRA may be correct. However, as LA Cellular points out, whether a facilities-based carrier or a reseller is the successful solicitor of a large-user account, the carrier will enjoy economies of scale through volume usage and lower bad debt losses, marketing and billing costs, and a lower churn rate which should be passed back to the class of service providing the economies of scale. The facilities-based carrier should not be precluded from flowing through economies of scale to their bulk-rate users.

As shown by interested parties' comments, there are two separate issues associated with bulk-rate pricing. The first concerns the facilities-based carriers' passing through economies of scale to their bulk and wholesale customers, and the second concerns participation in the large-user market by both reseller and wholesalers. There is no dispute that bulk-rate users should benefit from the economies of scale. It is the balance between the level of economies of scale that should be passed back to the bulk-rate user and the extent of reseller competition for the large user, that must be considered. This regulatory issue is addressed in the Phase II issue of retail operations and resellers operations.

One other customer service question bears discussion here. Cellular telephony is still a utility service, and one where bills for substantial usage run into the hundreds of dollars per month. Ratepayers have a reasonable expectation that such billings will be correct, will be rendered in a timely and understandable fashion, and will be subject to a formal forum for resolving disputes. Where the customer's bill is rendered by a certificated carrier or reseller, the Commission clearly retains jurisdiction and can resolve formal or informal complaints about billing and service.

However, bulk-user tariffs may involve an intermediate party (such as an affinity group or professional association) between the utility and the ultimate customer. In that case the Commission's jurisdiction to settle disputes may be somewhat in question if an individual customer takes issue with the intermediate party's billing or service provision. Further, individual customers may be at risk for the intermediate party's handling of payments, so that moneys lost, stolen or otherwise misplaced by the intermediate party might lead to the individual customer losing service despite having paid the bill.

In this decision we are developing a procompetitive policy that offers the ability to make available margins from buying in bulk and reselling individually. We prefer to see bulk-user tariffs conditioned not by the characteristics of the purchaser, but by the particular business functions the purchaser is willing to assume (such as credit guarantees or billing). However, the ability for a customer to seek redress before the Commission is one characteristic of a reseller-provided service that is not necessarily present in a bulk-user arrangement. To date, various restrictions have limited the use of bulk-user tariffs; however, this decision may permit a substantial expansion of such service and its potential for leaving customers without recourse to the Commission.

Bulk-user tariffs are also employed by energy utilities, such as in the case of master meters. There the individual customers lose service if the landlord does not pay the bill. The disputes we have become aware of regarding these services typically involve energy diversion or the manner in which tenants pay for their share of the energy. However, tenants are entitled to order individual service from the energy utility by paying appropriate service initiation or line extension fees. Informed tenants are thus able to consider a tradeoff between potentially cheaper master-meter service and the possibility of a dispute occurring with the landlord.

Cellular utilities breakout calls by individual telephone numbers in rendering bulk bill. Thus, disputes about the allocation of usage among customers should be minimized. The informed cellular customer is able to choose between participation in a bulk-user group and service offered directly by a certificated carrier or reseller. We have previously found that bulk-user customers need not be certificated if they do not markup the charges rendered to them by the utility. This policy permits professional or affinity groups to procure less expensive service for their members, and we are willing to continue it provided that subscribers are fully informed about their options and rights.

We will require that bulk-user tariffs contain the following consumer protection provisions, to apply when bulk services are purchased by those other than certificated resellers or carriers. The bulk user must notify individual subscribers that:

1. It is not a public utility.
2. The Commission will not resolve disputes between the bulk user and individual subscribers.
3. Small claims court and other similar forums are available to resolve disputes if necessary.
4. The service is provided under a bulk-user tariff from a utility and all service may be discontinued if the bulk-user does not pay its bills.
5. The bulk user is not permitted to markup the service billed by the utility or charge special cellular service fees of any kind.

Notice must be provided in writing to individual subscribers of the large user at the commencement of service. Also, an additional copy of this notice must be provided at least twice a year to each individual subscriber by the bulk user.

Rural Markets

The FCC established 12 RSAs in California. Similar to the 18 metropolitan statistical areas (MSAs) which the FCC established in California, the FCC permits a duopoly structure in each RSA comprised of one nonwireline (Block A) carrier and one wireline (Block B) carrier. Although the FCC has awarded all RSA licenses in California, licensers have only recently filed applications for authority to operate.

The major issue facing the RSAs is whether they can construct and operate a cellular system on an economical basis. For the most part, the RSAs are located in remote areas with sparse populations. It is because of the remoteness and sparse population that interested parties question whether there will be sufficient demand for cellular service in the RSAs. To encourage the rapid deployment of cellular service and competitive cellular service in the RSAs, parties such as GTEM and McCaw recommend minimal regulatory oversight.

Santa Barbara has a particular concern with the development of the RSAs adjacent to its service areas, which may prove to be common to MSAs adjacent to other RSAs. Santa Barbara's wireline facilities-based carrier has been awarded the right to provide service in the adjacent RSA. Given the competitor's financial resources, technical expertise, and ability to tie the new system to its own switch in the Santa Barbara MSAs at a relatively low price, Santa Barbara's competitor will be able to establish the adjacent RSA operation in a short period of time and be able to promote service in the Santa Barbara area and adjacent RSA, well before Santa Barbara and the nonwireline RSA carrier.

McCaw recommends streamlined certification procedures for the RSAs and encourages the use of flexible and innovative arrangements between the RSAs and established cellular carriers such as joint management and operational contracts, facility-sharing agreements, and marketing programs. However, it does not believe that any such arrangements should be subject to Commission approval.

Based on McCaw's experience with wireline facilities-based carriers, McCaw believes that the wireline facilities-based carriers will exploit the RSA market by restricting roaming arrangements to one particular carrier, such as an affiliated company. However, because we will require all facilities-based carriers to provide roaming arrangements to all cellular carriers, this should not be a problem in the future. Should any cellular carrier experience such a problem, it may file a complaint against the facilities-based carrier.

We concur with McCaw that the RSA cellular carriers should be given flexible and innovative arrangements so that the RSA cellular markets can develop rapidly. However, absent an understanding of the specific types of activity or regulatory flexibility the RSAs cellular carriers will need, we will not give the RSA cellular carriers blanket authority to enter into flexible and innovative arrangements. RSA cellular carriers are encouraged to request specific flexible and innovative arrangements when they file for their certificate of public convenience and necessity (CPCN). The request should include specific guidelines that minimal regulatory review to insure that such arrangements are not discriminatory and that the end users are not adversely affected by such arrangements.

Wireline Head Start

Responses to the question of whether wireline carriers have an unfair advantage over the nonwireline carriers are based on whether the carrier is a wireline carrier or not. The nonwireline carriers such as Santa Cruz, Cagal, and McCaw argue that the wireline carriers have an unfair advantage over the nonwireline carriers. CRA and the wireline carriers such as Fresno, U S West, GTEM, PacTel, and GTE represent that there is no unfair advantage.

Those parties who argue that wireline cellular carriers enjoyed a head start period represent that such advantage is the result of the FCC licensing procedure.[8] Although LA Cellular concurs with the nonwireline carriers, it recognizes that the head start advantage diminishes within four years of competition between the wireline and nonwireline carrier. It also recognizes that the FCC policy of unrestricted resale[9] mitigates the head start advantage, but believes that the second carrier suffers from certain disadvantages, not identified in its comments.

The wireline carriers argue that the nonwireline carriers had the opportunity to operate as a reseller pending the construction of their system. U S West represents that if the nonwireline carriers took advantage of the resale opportunity, they were able to recognize and improve upon the competitive wireline carriers' weaknesses, reduce their capital expenditure needs, and engineer greater quality control. Fresno also points out that the FCC required the wireline carriers to accommodate the use of the nonwireline carriers' discrete NXX Code where technically and economically feasible; thus, nonwireline carrier customers would not have to change their telephone number when they became operational as a facilities-based carrier.

GTEM and PacTel argue further that the wireline carrier is disadvantaged by the head start, not the nonwireline carrier.

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8 The FCC granted cellular permits under a lottery system. The wireline permits were issued first because the number of applicants interested in the wireline permits was smaller than the number of applicants interested in the nonwireline permits.

9 Wireline carriers were required to allow resellers, including nonwireline carriers while their system was being constructed, to resell their service on a nondiscriminatory basis.

This is because the wireline carrier, or first carrier must rely entirely on market projections of a new industry based on demographic analyses which may leave the first carrier with significant excess capacity for a period of time. The first carrier must also build a system to accommodate the resale customer base of the nonwireline carrier during the head start period causing excess investment, and degradation of service quality due to overloading incurred by the nonwireline carriers' delay in implementing its own service.

This head start issue impacts only the facilities-based carriers. As discussed above, parties do not dispute that the wireline carriers, via the FCC permit process, have been given a head start to begin cellular operations. The dispute lies in which carrier has been disadvantaged.

Both the wireline and nonwireline carriers' arguments are valid. However, there is no evidence to show that either carrier has been "unfairly" disadvantaged. The FCC foresaw the head start issue when it began its cellular licensing process. It attempted to mitigate any head start by issuing policies on resale use and discrete NXX Codes, as discussed above. Absent any finding that either the wireline or nonwireline carrier has been unfairly disadvantaged, this problem requires no regulatory remedy.

<u>Resellers Roaming Cost</u>

Roamer service is a service whereby a cellular customer of a carrier in one CGSA travels to another CGSA in which another cellular carrier provides cellular service to the visiting cellular customer.

Fresno explains that facilities-based carriers negotiate roamer and toll-interconnected arrangements/contracts with other cellular and long distance carriers, and that the facilities-based carriers are responsible for payment of roaming and toll-interconnection services rendered to their retail subscriber as well as a reseller's retail subscriber.

At present, the serving cellular carrier bills the facilities-based carrier operating the end user's home system who, in turn, bills the appropriate end user or reseller for roaming charges. The reseller, in turn, bills its end user, without any markup for cost incurred by the reseller.

CRA recommends that roaming tariffs reflect resellers' roaming cost such as the cost to bill and collect the charge from the end user, as well as a markup cost to compensate the reseller for roamer fraud, previously discussed.

Cellular Dynamics not only concurs with CRA's recommendation, it recommends that resellers should receive a share of the facilities-based carrier roaming revenues.

Although Santa Barbara argues that the billing function associated with roamer traffic is a financial burden, it does not agree with CRA and Cellular Dynamics that resellers should receive extra compensation for roamer service. Santa Barbara and other facilities-based carriers incur cost associated with the roamer service which resellers do not incur.

Santa Barbara spends approximately $4,000 a month to participate in a "roamer verification scheme," the cost of which is not passed on to resellers. Since the resellers do not perform any of the special billing functions with respect to roamer traffic and do not participate in the cost of verification of roamer traffic, Santa Barbara does not recommend that resellers receive extra compensation for roamer service. McCaw concurs with Santa Barbara that facilities-based carriers incur charges with respect to managing roaming programs not borne by resellers.

Although Cellular Dynamics believes that resellers should be allowed a markup as compensation for risk associated with roamer fraud, such a procedure will not encourage cellular carriers to implement preventative controls to reduce and/or eliminate roamer fraud. If we implement a policy that will encourage cellular carriers to utilize present technology to alleviate such risk, the end result will be lower roamer cost to the end users. Resellers and facilities-based carriers should negotiate for a PRV system in their respective roamer agreements.

Although CRA and Cellular Dynamics represent that resellers incur costs associated with roamer service, the bulk of roamer billing and collection costs is handled by the facilities-based carriers. Resellers costs associated with roamer services are incremental, as compared to the facilities-based carriers roamer costs. Resellers are not precluded from marking up their tariff rates to end users for roaming services.

Therefore, we will monitor these rates as part of the monitoring program discussed on page 60. We encourage a carrier to share with another carrier some portion of the revenues it receives as a result of roaming by a customer of the other carrier. This would be accomplished through the roamer contract negotiated between the respective carriers. Resellers will benefit as the reduced roaming charges are passed through to them through the billing carrier, allowing resellers greater latitude in marking up their roaming charges to their end users to cover the costs of billing and collecting roaming charges. For example, discounts based on time-of-day usage or the volume of roamer calls billed would be consistent with reflecting the economies that may be present in roamer usage.

Motion for a Phase I Order

Subsequent to the receipt of reply comments, on April 13, 1989, LA Cellular filed a motion for a Phase I order on undisputed issues. A response to LACTC's motion was filed by McCaw, DRA, CRA, PacBell, PacTel, and U S West.

LA Cellular filed a reply on May 4, 1989. LA Cellular revised its proposed Phase I findings of fact to incorporate minor changes proposed by the other interested parties. However, because the Phase I issues are discussed in this opinion and because the findings on those issues are consistent with LA Cellular's motion, the motion need not be addressed further. LA Cellular's motion is denied.

PHASE II

Background

Comments and reply comments to the Phase II issues were filed by approximately 23 entities represented by 43 utilities and interested parties, including Advantage Group, as shown in Appendix C. Advantage Group, comprised of ten agents of PacTel, filed a motion to accept its late-filed comments on September 18, 1989.

Advantage Group represents that its comments should be accepted for filing because it can provide the only retail agent or dealer perspective to the investigation. Its comments were tardy because it was not aware of the September 1, 1989 deadline until after it received copies of other parties' comments in the mail.

The only opposition to Advantage Group's motion was filed by the San Jose Real Estate Board (SJREB) on September 29, 1989. SJREB opposes the motion because Advantage Group's comments were tendered for filing approximately six weeks after comments were due and three weeks after reply comments were due.[10] SJREB represents that it and other parties will be disadvantaged if Advantage Group's motion and comments are accepted because there is no opportunity to respond to Advantage Group's comments.

We concur with SJREB that parties may be disadvantaged if they are not able to respond to Advantage Group's

10 Phase II comments were due on August 11, 1989 and reply comments due on September 1, 1989.

comments. However, the agent's perspective in this investigation is important. To alleviate SJREB's concern and to protect other parties' rights, Advantage Group's comments will be considered only to the extent that its comments corroborate other parties' comments. Advantage Group's comments will not be the sole consideration for setting regulatory policy in this investigation. Advantage Group's motion is granted to the extent discussed above.

The second phase of the proceeding is divided into three categories, the duopolistic wholesale market, LECs interconnection arrangements, and the reseller market.

Motion to Seal a Document

CRA filed a motion to seal Attachment D to its Phase II comments which contain PacTel's and LACTC's wholesale and retail divisions' cost-allocation policies. Since PacTel and LACTC considered the policies to be proprietary, CRA entered into a stipulated agreement to file the attachment under seal and to hold the information confidential pursuant to General Order (GO) 66-C. Copies of the attachment were provided to all parties who stipulated to the agreement and to unnamed "Commission personnel" pursuant to the agreement. CRA's motion to accept Attachment D under seal should be granted.

Duopolistic Wholesale Market

The duopoly market structure for facilities-based carriers has led to many concerns discussed in the investigation. To assess these concerns, parties were requested to comment on the competitiveness of the duopoly market structure and on the need to regulate the duopoly carriers' rates.

Duopoly Carriers Competitiveness

The major concern with the duopoly market structure is whether there is sufficient competition among the carriers to maintain fair and efficient pricing of cellular services.

DRA, CRA, and Cellular Dynamics do not believe that effective price competition can flourish in the cellular market without regulatory oversight.

Cellular Dynamics promotes the need for additional regulatory oversight of the duopoly carriers because it believes that the duopoly carriers' pricing of services is not constrained by any potential for competitive entry into the cellular market. This is because a pure duopoly arrangement precludes additional competitors from entering the market and from creating strong price competition at the retail level, which encourages duopoly carriers to behave as if they share a monopoly service.

It concludes that cellular resale, in a supportive and unrestricted market, will provide the necessary incentive for duopoly carriers to keep from coordinating price and market power and encourage efficient cellular service pricing. This conclusion is consistent with CRA's position.

DRA also concurs that the duopoly structure doesn't provide effective pressures to move the cost of cellular services toward competitive levels. It believes that such pressures are absent because competition decreases as the number of competitors decreases.

DRA also believes that the duopoly structure impedes competition because each competitor recognizes that any price reduction will be either matched or undercut by the other carrier resulting in a neutral dependence on each other. Absent price competition, DRA doubts that the end user will receive any competitive benefits.

None of the carriers concurs with these competitive concerns. GTEM reminds parties that each duopoly carrier faces competition not only from its direct rival but from providers of alternative telecommunications services. These alternative services come from providers of landline telephone service, paging, conventional mobile telephone, mobile data services, and in the future from stationary cordless CT2 (cordless telephone, second generation) technology.

LA Cellular and other cellular carriers dispute any inference of collusion among the duopoly carriers. They point out that any collusion to suppress competition is a violation of antitrust laws, and they dispute the need for additional controls.

GTEM acknowledges that the cellular industry is not perfectly competitive. This is because rivalry among a small number of carriers reaches an equilibrium where price is somewhere above the competitive level but below the level that would result from collusion.

U S West argues that competition flourishes in the duopoly market because two key conditions exist. The first is that the cellular market continuously offers end users an opportunity to choose from alternative solutions and the second, that the market continuously affords carriers with current or new solutions an economic opportunity to offer them to their end users.

In response to the investigation's request to provide specific evidence to support statements on the competitive pressures that exist in the duopoly market structure, Cellular Dynamics, CRA, and DRA contend that the evidence to date substantiates that the duopoly carriers do not provide effective competition. In support, they cite the MSAs wholesale prices of the competitive carriers which are substantially the same, if not identical, and point out that there has been very little price change activity since the establishment of cellular service in 1983.

CRA also represents that there is no evidence of price competition. As shown in Appendix B to its comments, the weighted average rate of return on net book plant of the duopoly cellular carriers operating for at least three years exceeded 45 percent. Although CRA does not define an excessive rate of return, it believes that 45 percent is excessive and that such excessive returns clearly demonstrate the existence of monopoly profits in the cellular markets.

Again, the duopolistic carriers disagree and argue that the evidence demonstrates that competition has already developed in the cellular market both with respect to price and to service.

GTEM substantiates its competitive claim by identifying various price and service activities that have been undertaken by the various duopoly carriers. Price activities include discounts for multiple-unit accounts, lower rates for volume resellers and bulk users, special rates for occasional and off-peak users, cooperative advertising, lower rates for long-term users, and promotional discounts resulting in free airtime, and waiver of activation fees.

Service activities include increased coverage of areas, increased quality of service, and the offering of enhanced service options. Such enhanced services options identified by PacTel include roaming services, automatic call forwarding, coverage in underground tunnels, data transmission services, custom calling features, and voice mail and freeway call boxes.

Arguments of DRA, CRA, and Cellular Dynamics all lead to the conclusion that the FCC-mandated duopoly market structure inherently precludes the existence of a perfectly competitive market between the duopoly carriers. However, this market structure represents the status quo until such time that the FCC decides to expand the market. Even GTEM acknowledges the existence of limited competition. Controls are in place via the antitrust laws to discourage collusion among carriers, but these do nothing to encourage or stimulate future competition.

Additional controls to encourage duopoly competition within a discretionary market can and should be implemented through regulatory oversight to enhance competition among the carriers and to protect the basic rights of end users. This is substantiated by the arguments discussed above and by the number of cellular complaints identified in DRA's Phase I comments.

As a corollary to the competitive pressures, parties were requested to comment on whether the carrier's wholesale rates were too high. Again DRA and CRA assert that high returns on net cellular plant substantiate that rates are excessive. CRA's analysis of the LA, San Diego, and San Francisco/San Jose market operations for the 1988 year show that wholesalers' investment returns in these markets ranged from 25.3 percent to 123.1 percent. DRA believes that such a high level of profits substantiates that cellular rates are above competitive levels.

On the other side, LA Cellular represents that the reasonableness of cellular rates must not be considered solely from the viewpoint of the resellers. Consideration should also be given from the viewpoint of the wholesaler and from the customer.

LA Cellular believes that the relevant issue from the reseller perspective is whether there is a sufficient rate spread between wholesale and retail rates to permit resellers to be competitive. LA Cellular believes that this is currently the case. It cites continual reseller requests for certification and increased reseller activation on the cellular system. For example, the Los Angeles market, characterized as the most difficult reseller market, has steadily increased since March 1987 to the point where nearly 50 percent of all system activation originates with resellers.

LA Cellular also believes that the relationship between demand and price should be balanced; i.e., rates should not be so high as to dampen demand and not so low as to discourage the investment of large sums of money to expand system coverage or capacity.

Assuming rates are high, parties were requested to address the reasons for such high rates. Scarcity of radio spectrum was suggested as a possible reason. However, all parties concur that it has no impact at present. The Phase I discussion substantiates this consensus. However, as the prior discussion regarding economic efficiency stated, the wholesale market structure is limited by the amount of radio spectrum the FCC has licensed for cellular to use. Further, the FCC's initial decision to allocate 20 megahertz to each cellular carrier was followed by a later decision to allow each an additional 10 megahertz based on growth in the number of customers outstripping the capacity of the original allocation. In reviewing our regulatory framework's oversight of rates, we need to create incentives for the efficient and full use of spectrum and to consider how its limited availability affects the dynamics of the industry.

Thus, while parties agree that spectrum limits are not now significant, they have been in the past and may well become so again given the continuing dramatic growth in the number of customers. This is why it is important for our policies to encourage the most intensive and efficient use of the allocations the FCC has made, for they are the limiting factor in the availability of service.

McCaw reminds us that cellular is not an essential service, and that the service is used by only a small portion of the public. Unlike a monopoly which is given a fair rate of return commensurate with risk, and the opportunity to attain it, a cellular carrier is not assured any return or recovery of risk.

GTE concurs with McCaw and believes that the notion of high profits is an illusion. It reminds us that the cellular market is still a start-up industry requiring high construction costs and franchise acquisition costs to obtain a market share.

The record shows that cellular returns-on-investment are substantially higher than the monopoly telecommunications market. However, this is not a valid comparison to determine price competition among duopoly carriers or the reasonableness of rates. This is because risk is substantially different between the markets. No quantitative analysis of this risk has been undertaken to date. Not only is the cellular industry in a start-up mode requiring substantial amounts of money to invest in facilities, it is already facing technological obsolescence because of enhanced digital technology. Further, we have no ready way to evaluate the competitiveness of the individual markets directly by observing patterns of pricing or profits. In a fully competitive market, the prices of individual firms track closely and may even be identical. In a collusive oligopoly, the same pattern of pricing occurs, but at a higher level. It is apparent from the prices being paid for acquisition of cellular licensees that the FCC license itself has considerable market value. Substantial earnings could indicate a lack of competitiveness or could reflect the market value of the scarce licenses. Neither pricing patterns nor profits can indicate directly whether or not cellular carriers are competing fully with each other.

Because of the factors discussed above, we conclude that current earned rates of return on book investment do not in and of themselves directly indicate whether rates are reasonable or unreasonable.

Again, cellular service as a discretionary service with rates was first set at a level where discretionary customers would choose to subscribe cellular service in 1984 by D.84-04-014. Although rates have not dramatically changed since 1984, the parties to this investigation concur that demand for cellular service has increased far above expectation.

On balance, we conclude that the duopoly market structure does not necessarily foreclose sufficient competitiveness to maintain fair and efficient pricing of cellular services. However, we believe that a form of continuing regulatory oversight is necessary to help promote this competitiveness. We therefore turn to an analysis of how our regulation has been affecting the market and how it may be improved.

Absent a risk analysis and a mechanism to measure a reasonable return on cellular investment, there can be no finding that cellular carriers are earning an excessive return on their investment. However, the appearance of high returns on investment and the lack of price variability since 1984 leads us to the question of whether our regulatory policy on cellular carriers promotes competition.

In rejecting rate of return regulation for duopoly cellular carriers, we are not abdicating our responsibility to assure that cellular rates be just and reasonable. For the various reasons articulated throughout this decision, we believe that rate of return or cost of service calculations are not a representative basis for calculating the cellular rates that will best meet our goals of fairness to consumers and the most rapid increase in availability of high-quality service. Again, increased competitiveness among cellular carriers and resellers is the most direct and appropriate means for achieving reasonable rates as the technology and the markets continue to change.

Most parties concur that regulatory oversight has encouraged competition. Specific encouragement occurred through policies requiring carriers to receive Type 1 or Type 2 interconnection with the LECs, which discourages direct and indirect cross subsidization and requiring the wireline facilities-based carrier to provide the nonwireline facilities-based carrier an opportunity to resell. The Commission also acts as a lead agency in California Environmental Quality Act issues and affords local parties opportunities for input.

However, CRA does not believe that regulatory policy has promoted competition because we have not yet applied cost of service tests to the rates of wholesale service. Cellular Dynamic also asserts that the duopoly carriers will have no incentive to compete on price unless there is a regulatory policy promoting unrestricted resale of cellular services by independent retailers.

Cellular carriers believe that competition can be enhanced with the undertaking of additional regulatory policies which reduce regulatory requirements; such as, the current need to require lengthy advance notice of tariff changes and protest procedures, the regulation of the margin between wholesale and retail rates (addressed in the reseller market section of this opinion), and streamlined certification process for future RSA carriers. We concur in principle with the streamlined certification process and invite RSA carriers to submit a specific procedure during the third phase of this investigation.

Currently, all tariff changes must take place through the advice letter procedure. Absent any protest, such a filing can take between 30 and 40 days to become effective after submission to the Commission. If a protest is filed, the proposed tariff may be delayed even longer. Carriers believe that this lengthy requirement precludes them from gaining any competitive advantage through the introduction of innovative price and service offerings.

In 1987, similar tariff concerns resulted in a rulemaking investigation to determine the need for revision of GO 96-A tariff requirements (Rulemaking 87-08-017). A copy of the rulemaking investigation was mailed to 53 cellular carriers. Responses were received from six wireline facilities-based carriers, three nonwireline facilities-based carriers, two resellers affiliated with facilities-based carriers, and CRA. Many of these respondents are also respondents to this investigation.

The carriers' comments to the rulemaking proposed either a 30-day or 40-day tariff notice requirement for wholesalers and resellers. Two additional proposals outside the scope of the rulemaking investigation were made. The first proposal was to develop a minimum-maximum rate structure to allow cellular providers flexibility to adopt tariff revisions within a range previously approved and to be effective upon publication of the revised tariffs. The second proposal was to adopt a procedure where the Commission would review tariff protests to determine whether substantial grounds exist to warrant a suspension of the tariff so that the mere filing of a protest would not result in a de facto suspension of an advice letter.

D.88-05-067 amended GO 96-A to require a 40-day notice requirement for wholesale carriers and a 30-day notice requirement for retail carriers. The opinion recognized that while the adopted tariff changes were timely and appropriate, further changes in the context of a broader review of the cellular industry might be warranted.

This investigation has undertaken the broader review of the cellular industry discussed in D.88-05-067. Although a number of comments filed in this investigation make reference to the apparent existence of limited competition among the carriers because of the similarity of the wholesale carriers' tariffs, carriers have substantiated that the two-tier notice period and comment period discussed above does not enhance the effectiveness of competition between carriers, a stated goal of this investigation. Carriers' comments confirm that the current tariff provisions require carriers to provide competitors advance notice of marketing strategy so that the competitors may offer similar, if not identical programs, thereby encouraging carriers to file identical tariffs.

The tariff process can be an effective regulatory tool to encourage carriers to promote effective competition within the discretionary market and should be utilized. However, any changes to the tariff process must acknowledge the primary purpose of a notice period before a tariff change is implemented which is to protect end users from unfair discrimination and unjustified rate increases.

We will modify our existing advice letter process to make it more responsive. A new procedure, as described below, should be adopted for expedited approval of relatively small rate changes that can be effective immediately when filed. Carriers will have available both the modified version of the old process and this new expedited procedure.

To balance the interest of competition among carriers and end users' rights to a reasonable period of time to file comment or protest, GO 96-A's 40-day notice requirement should be reduced for wholesale carriers. The wholesale carriers' notice requirement should be similar to the reseller's current 30-day notice requirement. The 20-day protest period provided in GO 96-A should remain in place for both wholesale and retail carriers. However, any tariff filing which does not decrease a carrier's average customer bill by more than a nominal percentage, ten percent, should be identified as a temporary tariff and effective on the date filed. Absent a protest within the 20-day period, the temporary status of the tariff should expire and become permanent. If a protest is filed, the tariff should remain as a temporary tariff until the protest has been resolved or by order of the Commission. Utilities may file multiple ten percent rate reductions during any calendar year. These GO 96-A exemptions are allowable under GO 96-A(XV) and do not require modification of the existing GO.

The ALJ's proposed decision contemplated the use of temporary tariffs for rate increases and decreases. This decision provides that temporary tariffs be used only for rate decreases, and that increases be filed by advice letter for approval by Commission Resolution. Carriers may file temporary tariffs for promotional offerings with a set expiration date; the expiration of such a tariff will not require additional approval. In reviewing rate increase advice letters, we will also be mindful that allowing increases that merely counteract a portion of a previous decrease may be less contentious than considering increases beyond current rate levels.

Cellular utilities that wish to use temporary tariffs will be required to make an annual filing to establish how large a range they should have for temporary tariff filings. Otherwise, the question of whether or not temporary tariffs fall within the ten percent limit could become contentious. The ten percent is the limit as to how the total revenues expected from a given customer may be reduced in a temporary tariff. For example, a waiver of activation fees would be acceptable so long as the activation fee waiver and any other discounts established in the temporary tariff amount to less than ten percent of what a customer is expected to pay over the life of his service from the utility (average bill times number of months).

Naturally, we will expect that promotions or special service offerings will continue to be available throughout each carrier's entire service area.

Each utility wishing to use temporary tariffs shall file an advice letter containing calculations sufficient to support the requested range of flexibility. Utilities can request less than ten percent of the expected customer revenues as the allowed range, but must file a further advice letter if they wish later to expand the range. Competitively-sensitive information such as average customer bills and expected service life may be afforded proprietary treatment under GO 66-C. The initial filing by each utility requesting temporary tariff authority shall be effective only upon Commission Resolution; subsequent filings to renew this authority shall be 40-day effective advice letters. These filings shall be served on all respondents in this proceeding by summary, including the range of flexibility desired; the Director of CACD will be authorized to modify this service list to include other parties requesting such notice or to delete parties appearing to be inactive.

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U S West concurs with Santa Cruz because it believes that such a mechanism will provide increased competitive incentives, and reduced legal and regulatory costs as benefits to rate bands. No other party recommends the rate band mechanism.

Carriers oppose any simplified index rate mechanism because of the difficulty in determining baseline rates and the impracticability of indexing the myriad pricing packages and options currently available, and expected to increase. Carriers assert that any indexing method will stifle innovation and discourage efficiency.

DRA and CRA propose alternative rate setting mechanisms because they do not believe that the duopoly market structure by itself provides effective pressures to move prices toward competitive levels. DRA recommends a benchmark/sharing approach and CRA recommends a form of cost-based rate regulation.

The benchmark/sharing method requires the setting of rates and setting a return on investment. Initially, the carrier's rates would be set at their current level and a return on investment would be set at a level commensurate with the individual carrier's risk. The carrier's actual return would be reviewed on a yearly basis and compared to a benchmark level. This benchmark level would be set from returns of firms with comparable risks. If the carrier's return exceeds the established benchmark level, the carrier would be required to share the excess between the ratepayers and stockholders.

DRA believes that its proposal is workable because it gives carriers a strong incentive to operate efficiently, and to be responsive to their customers. In addition, it is not a costly time-consuming process because rates start at the carrier's current level.

McCaw does not believe that DRA's rate proposal will work without materially reducing competition and imposing unnecessary costs because DRA's assumptions, methods, and conclusions ignore all of the indirect costs of regulation. Indirect costs components identified by McCaw are the impact of delayed market entry, loss of flexibility, additional cost to the end users due to the lack of alternatives, and lessened service quality. It also disputes whether DRA's proposal can be applied equitably to each carrier because of each carrier's unique operations and cost. For example, terrain and coverage areas require varying system designs. Even within one MSA the two systems have been constructed at different times, with different characteristics.

McCaw believes that DRA's proposal will seriously reduce the continued investment in cellular system improvements and impede technological advancements such as digital conversion.

CRA's method requires each duopoly carrier's operations to be monitored for the first three years of operation. The three-year period is used because initial cellular service in a MSA is less profitable than in a MSA that has established cellular service. Also, the financial performance of each carrier varies.

On every subsequent third year the composite rate of return of the two carriers within the same MSA is compared to a return on equity set at a rate above the minimum required rate for monopoly utilities. The difference between the actual and allowable rate is treated as a rate adjustment. If a carrier disputes the rate adjustment, the carrier is required to show cause why its rates should not be adjusted thereby resulting in a comprehensive review of the carrier's operations.

McCaw disputes the validity of CRA's proposal because the proposal utilizes artificial and hypothetical costs, ratios, capital structures, and capital costs that will not reflect a cellular carrier's operations; rather, it will penalize the higher-cost carrier and encourage a carrier to underinvest in its system in the hope that its capital investment will be less than the composite, thereby increasing its potential earnings and stymie competition.

CORRECTION

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dispute that resellers should be entitled to compete fairly. However, LA Cellular and GTEM do not believe that stand alone or start-up resellers should be insured profitability through the enforcement of a specific percentage spread between individual elements of a carrier's wholesale and retail tariffs. The need for a spread between wholesale and retail rates affect how resellers should be regulated, therefore, this issue is addressed as a component of the resellers market discussion.

Duopoly Carrier Rate Regulation

Some of the duopoly carriers recommend that their rates should be regulated only to the extent that nondominant interLATA long distance carriers rates are regulated. Other carriers recommend that no rate regulation should be imposed because the duopoly competitive forces are sufficient. However, as discussed in this opinion, competition within the cellular industry needs to be enhanced. Such enhancement cannot take place without some form of rate regulation.

Concerned with the extent of continued rate regulation, parties were requested to comment on the need for general rate case (GRC) proceedings, simplified index methods, rate bands, a historical cost-lower limit, and a statewide rate.

All parties who commented on the historic cost-lower limit, and statewide rates concurred that they are either not necessary or inappropriate for California. Except for Cellular Dynamics, there is agreement that GRC proceedings are not appropriate. Cellular Dynamics recommends the GRC because it does not believe that the duopoly structure has produced a competitive environment.

A rate band procedure is endorsed by Santa Cruz. However, Santa Cruz's approval is conditioned upon a mechanism whereby the individual carriers set the rate bands. Santa Cruz believes that such a mechanism will enable individual carriers to respond to customer demands and to the needs of the marketplace.

U S West concurs with Santa Cruz because it believes that such a mechanism will provide increased competitive incentives, and reduced legal and regulatory costs as benefits to rate bands. No other party recommends the rate band mechanism.

Carriers oppose any simplified index rate mechanism because of the difficulty in determining baseline rates and the impracticability of indexing the myriad pricing packages and options currently available, and expected to increase. Carriers assert that any indexing method will stifle innovation and discourage efficiency.

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The benchmark/sharing method requires the setting of rates and setting a return on investment. Initially, the carrier's rates would be set at their current level and a return on investment would be set at a level commensurate with the individual carrier's risk. The carrier's actual return would be reviewed on a yearly basis and compared to a benchmark level. This benchmark level would be set from returns of firms with comparable risks. If the carrier's return exceeds the established benchmark level, the carrier would be required to share the excess between the ratepayers and stockholders.

DRA believes that its proposal is workable because it gives carriers a strong incentive to operate efficiently, and to be responsive to their customers. In addition, it is not a costly time-consuming process because rates start at the carrier's current level.

McCaw does not believe that DRA's rate proposal will work without materially reducing competition and imposing unnecessary costs because DRA's assumptions, methods, and conclusions ignore all of the indirect costs of regulation. Indirect costs components identified by McCaw are the impact of delayed market entry, loss of flexibility, additional cost to the end users due to the lack of alternatives, and lessened service quality. It also disputes whether DRA's proposal can be applied equitably to each carrier because of each carrier's unique operations and cost. For example, terrain and coverage areas require varying system designs. Even within one MSA the two systems have been constructed at different times, with different characteristics.

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GTEM also disputes the validity of CRA's proposal and questions whether the carrier's due process is violated by imposing LECs rates-of-return as a basis for a carrier's earnings level.

Although DRA and CRA did not endorse GRC procedures, it is apparent that their alternative proposals will result in such a procedure in order to set a rate of return based on risk. Currently, the energy and major telecommunication utilities have comprehensive cost of capital proceeding to set a rate of return on a yearly basis. D.89-10-031 established an alternative regulatory framework for PacBell which calls for a sharing of profits above a benchmark level and which requires a comprehensive reporting and review process. It is difficult to imagine that if either DRA's or CRA's proposal is adopted, parties will not question the reasonableness of a carrier's cost to operate, resulting in lengthy proceedings.

Both DRA's and CRA's alternative methods are based on a form of cost-based monopoly regulation; i.e., to provide carriers an opportunity to recover their costs and to restrict the carriers' opportunity to earn a profit on their investment. This may be a reasonable procedure to regulate monopoly carriers, however, in the cellular market our regulatory goal is to enhance competition. Neither DRA's or CRA's method will provide the necessary incentive to promote competition, efficiency or encourage new investments.

Further, parties need to be reminded that carrier rates have been set on what the market will bear since 1984. The market rates established in 1984[11] resulted in a projected negative return on equity of 12.17 percent in the preoperative year, a negative 3.31 percent in the first full year of operation, and 18.44 percent and 19.19 percent in the third and fourth year of operation, respectively. The return on equity was a coincidental

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factor to the development of market rates. We recognized that these returns of equity were based on wholesale operations only and that such returns will be enhanced by retail operations.

For the reasons discussed above, regulation of carriers rates based on a rate of return is not appropriate and the proposals of DRA and CRA should not be adopted. Keeping in mind the intent to promote competition for a discretionary service, rates should continue to be based on the market.

Indeed, in D.89-10-031 we cited fundamental concerns regarding the rate of return approach for local exchange utilities, where the dynamics of competition and new technology were substantial reasons for abandoning our traditional regulation in favor of incentive regulation. In the cellular industry, there is no bottleneck monopoly, this is a discretionary service, and technological change and service expansion are key issues. By the same principles we are even less interested in conducting traditional rate cases here.

As discussed earlier, we recognize that profits may be earned by wholesale carriers due to their FCC-granted right to use scarce radio frequencies or spectrum. It is economically efficient and an appropriate spur to system and service expansion for wholesale carriers to keep those profits. However, it is neither efficient nor appropriate for wholesale carriers to earn additional profits due to a failure to compete. As we indicated, such a failure would be demonstrated clearly by the observation that a wholesale carrier's system was operating substantially below the limits of its capacity despite charging prices that more than cover out-of-pocket costs of operation (excluding the amortization of any premium paid to acquire a license). Similarly, the wholesale carriers in a given market could also reap such failure-to-compete profits by failing to expand their system capacity when such expansion was both feasible and economic with respect to current cellular service rates. In that case, the artificial limitation on capacity would keep prices higher than they would be if the systems were properly expanded.

There is also an intuitive reasoning to these scenarios that does not require sophisticated economic analysis. If a cellular carrier is keeping prices high to discourage demand when capacity is clearly available, then the public is losing some of the service it ought to enjoy. If a carrier is refusing to expand capacity because the additional supply would depress prices, then the public is losing the service it ought to enjoy due to the new investment. In either case the cellular wholesaler would be abusing the public trust placed in it by the FCC in its licensing decision and by this Commission in its grant of a CPCN to serve the public.

As we have discussed, it is the proper public policy to forebear from any rate of return or profit-based regulation of cellular wholesalers that are pricing their services competitively. However, we would be disposed quite differently towards a cellular wholesale carrier that violated the public trust by withholding service to make extra profits. If such an instance occurred, we would initiate an investigation of the rates of the carrier in question and impose an appropriate and punitive constraint on its profits.

There is no evidence to convince us that such an investigation should be opened at this time. However, a monitoring program should be devised to keep us apprised of market developments and to give carriers some reasonable expectations of the performance we seek. In essence, we need to be able to answer two questions on an ongoing basis: (1) Is the system reasonably full? (2) Is the system being expanded at a reasonable pace? To answer these questions we will need to understand measures of capacity and utilization, how to evaluate the economics of a decision to expand a system, and how the advent of new and improved technologies matters impact the system, prices, customer complaints, profitability, and the viability of resellers. We will also need to understand "lumpiness" problems in system expansion, where large capacity increases (such as through digitalization) may not be absorbed by the market for some time even with competitive pricing.

Specific methods for performing this monitoring should be an additional subject for the next phase of this investigation through either the workshop or hearing process.

We would emphasize that this monitoring will not be an empty act. The record generally indicates that limits on the spectrum are not a constraint on carriers at the present time. Given the rapid growth in consumer demand for cellular service, that circumstance may change for at least some systems. However, for underutilized systems we will expect rates to fall substantially and quickly following our grant of pricing flexibility in this decision. Further, California's major markets should be converting to digital service as soon as that technology is commercially available. Digital conversion will provide three to four times the present capacity. Carriers will need to cut prices sharply to fill that capacity. If they do not, then we will do it for them based on the results of our monitoring. We will also expect the geographical scope of service availability to continue to expand, with corresponding service quality improvements for the more rural or outlying areas in each service territory.

Duopoly carriers seeking an increase in rates should be required to substantiate their request with market studies specifically based on data within their MSAs. If a carrier wishes to support its request for an increase based on financial hardship, then cost support and income data of a form specified by CACD should be supplied, and carriers should be prepared to respond to other PUC staff requests for supporting financial data. The carrier should also describe the utilization of its system relative to its current engineered capacity. Although a return on investment is not a driving force in setting rates, the carrier should be required to show its actual return on investment and projected return on investment based on proposed rates. Any major increase in return on investment from a three-year recorded average should be supported with specific reasons for the change. Any decrease in rates need not include a market study. Duopoly carriers should file such requests via the advice letter procedure.

LECs Interconnection Arrangements

Facilities-based carriers interconnect subscribers' calls to the LECs network through a Mobile Telephone Switching Office (MTSO). The MTSO originates and terminates calls between the cellular carriers' subscribers and the LECs' conventional wireline customers. As DRA points out, there are three types of interconnection arrangements, Type 1 interface, Type 2A interface, and Type 2B interface. Type 1 interface provides for a trunk level connection between a cellular mobile system (CMS) and a LEC end office. Type 2A interface provides a trunk level connection between a CMS and a LEC tandem switch system. Type 2B interface, similar to a Type 1 interface, provides a trunk level connection between a CMS and a LEC end office. However, the Type 2B interface may be used in conjunction with the Type 2A interface to serve high-volume traffic.

The cost for cellular carriers to interconnect to the conventional wireline service is based on agreements negotiated between the cellular carriers and the LECs. Although some of these agreements are filed with the Commission, none is presently tariffed. Concerned that the negotiated interconnect agreements may place the market power of a LEC monopoly against that of the duopoly purchasers, we requested comments on whether or not a regulatory policy on interconnection arrangements should be imposed.

Need for Uniform Tariffs

All parties concur that similar treatment should be afforded to each cellular carrier. However, as PacTel points out, specific interconnection costs and services vary for each cellular carrier because of the unique network characteristics of each cellular carrier's system and competitive strategy. It is because of the unique network characteristics that the cellular carriers do not recommend a uniform tariff.

The LECs, PacBell, and GTE recommend that the arrangements be tariffed to ensure equitable treatment of all cellular carriers and to establish the proper relationship between interconnection costs and rates. However, they do concede that negotiated agreements will still be necessary for unique interconnection needs.

U S West asserts that current arrangements between LECs and cellular carriers have not been satisfactory because LECs do not provide any cost basis for the rates the LECs charge the cellular carriers and do not offer arrangements within the same time frame that the same arrangements are offered to the LEC's affiliate. McCaw concurs. McCaw and other cellular carriers are also concerned that current arrangements do not compensate cellular carriers for their cost of terminating land-to-mobile calls; i.e., mutual compensation.

Absent mutual compensation, the cellular carriers argue that the arrangements unfairly favor the LECs by containing rates which do not enable the cellular carriers to recover their costs to terminate land-to-mobile calls.

PacBell disagrees with the mutual compensation argument. Contrary to the LECs' franchise requirement to provide basic telephone service, the cellular carriers provide discretionary telephone service. PacBell does not believe that LECs ratepayers should be required to contribute to the existence of a system which provides discretionary services and whose rates are based on what the market will bear.

There are disputes on some aspects of the arrangements. However, parties' comments confirm that there is no need to require LECs to tariff these arrangements. To do so will only result in burdensome tariff filings and modification of the tariffs to provide for unique arrangements, which may turn out to be the norm because of distinct network arrangements. Rather, minimum regulatory oversight on these arrangements can continue to exist by implementing controls to assist the LECs and cellular carriers in good faith negotiations.

The dispute on whether the LECs actually incur the cost to provide an arrangement to a cellular carrier should be resolved between the LECs and cellular carrier in the good faith negotiation process. The LECs should be required to support their costs to provide such service to the cellular carrier. The LECs' cost should consist of the LEC's actual cost to provide an arrangement and provide the LECs a marginal contribution based on the LECs' opportunity cost. Opportunity cost represents that return on investment that the LEC could earn if its funds were invested in its other regulated operations.

We are mindful of the concerns expressed by McCaw when one of the wholesale carriers is also an affiliate of the LEC. Although the LEC charges the same interconnection prices to both wholesale carriers, revenue from the LEC affiliate may flow from one arm of a holding company to another. In that case the fact the LEC charges the same price to its affiliate as to the unaffiliated carrier may not serve as an effective protection against overpicing of interconnection. This is a further reason for us to state that cellular interconnection should be cost based.

As discussed in this opinion, LECs' customers have no advanced knowledge that they are calling a cellular number, a discretionary service. Absent a means of identifying cellular numbers and educating the basic telephone customers about high-cost cellular service, any mutual compensation will increase the cost of basic telephone service. Also, should such compensation be authorized, equal treatment should be afforded to other types of entities that terminate a basic telephone call such as telephone answering services, PBX (Private Branch Exchange) owners, shared tenant service providers, and IECs with direct connections to their customers.

To require LECs ratepayers to compensate cellular carriers for call termination will unnecessarily increase the cost of basic telephone service for the provision of discretionary cellular service. Mutual compensation should not be incorporated into arrangements at this time.

To alleviate the anticompetitive discrimination concern against cellular carriers that are not affiliated with a LEC, we will adopt DRA's proposal requiring all future interconnection agreements to include a mandatory nondiscriminatory clause. The clause shall state that the terms and conditions of the agreement shall be nonexclusive and shall be offered on a nondiscriminatory basis to other cellular carriers.

The controls discussed above are intended to provide the LECs and cellular carriers sufficient incentive to negotiate arrangements in good faith and to reach a reasonable settlement. Absent such a result, as Santa Cruz discusses in its comments, Public Utilities (PU) Code § 762 provides us the necessary authority to intervene in interconnection negotiations as needed.

Comments on whether the cellular carriers are building their own access and toll networks to avoid LECs rates and on the offering of toll free rates to cellular subscribers calling across LATAs, substantiate that neither situation is occurring. These concerns are therefore moot unless evidence emerges to the contrary.

However, CRA's comments contain a proposal whereby cellular wholesale utilities should be required to offer unbundled access to resellers so that the resellers could perform call-switching functions. By a December 11, 1989 ruling, the assigned Commissioner ruled that hearings would be set after this interim opinion so that resellers may present a detailed proposal for consideration.

Access Charges

An access charge is a tariff charge imposed on either an end user or an IEC to compensate a LEC for the origination and termination of a call; i.e., the connections between end users and the non-LEC carriers via LECs provided facilities. Access charges were established to compensate LECs for costs incurred for originating and terminating interexchange traffic. (D.83-12-024, p. 6, et seq. and citations therein.) Access charges for switched access are comprised of several rate elements. (See, for example, PacBell's Schedule Cal. P.U.C. 175-T, Sec. 6.1.3; 6.8.) One of these elements, the carrier common line charge or "CCLC", is based on an assignment of nontraffic sensitive ("NTS") cost recovery. NTS costs include costs of providing and maintaining the local loop. (D.83-12-024, D.85-06-115, D.87-08-048.)

Some of the Type 2A interconnection agreements between PacBell and the cellular carriers contain a single mobile-to-land minute of use (MOU) rate element which was developed, in part, from cost studies for the switched access rates PacBell charges to IECs. This MOU rate does not reflect any assigned recovery of NTS costs or the CCLC access charge rate element. PacBell does not include in contracted interconnection rates for cellular interconnection any discrete assigned recovery of NTS costs.

PacBell and GTE charge cellular carriers and IECs an access charge for Type 2 connections based on MOU. MOU cost elements consists of a local/switch transport component, an end office switching component, a line-termination component, and an intercept component. An additional component, common line MOU, is charged only to the IECs for the use of the LECs network between the LECs end office and customer premise.

Both the cellular carrier and the LECs provide telephone service in a specific geographical area. The cellular carriers provide discretionary cellular radio service and the LECs provides basic telephone service. Cellular carriers provide discretionary local service, and are capable of providing end-to-end service to their subscribers and interchange traffic with each other, similar to the LECs. Therefore, cellular carriers should be classified as a LEC co-carrier, as proposed by DRA and other cellular carriers.

Cellular carriers argue that as a LEC co-carrier, they should not be required to subsidize the LECs' landline network nontraffic costs via access charges.

On the other side, PacBell asserts that although cellular carriers are not IECs, they do access and benefit from the LECs' local loop. Since interconnected companies, including cellular carriers, obtain the benefits of local loop access, PacBell asserted that the cellular carriers should contribute towards the recovery of the NTS loop costs.

While the co-carrier argument is not strong enough to argue for reciprocal access charges at this time, it does persuade us not to levy a contribution requirement on cellular access charges. Unlike IECs, cellular carriers do supply an end user infrastructure that completes calls. LEC customers can complete calls to end users on cellular networks just as cellular customers can complete calls to end users on LEC networks. Thus, we will not require that cellular carriers pay a NTS contribution, but only the actual interconnection costs.

These determinations regarding interconnection and access charges may be revisited in the future if in fact cellular carriers and landline LECs become much more equal in terms of the co-carrier status suggested by McCaw. We would look to statistics such as relative numbers of customers served and the relative origination and termination of calls to make such a judgment.

<u>Resellers Market</u>

The retail market was created in 1984 by the same decision which granted Los Angeles Statistical Metropolitan Service Area Limited Partnership, California's first cellular wholesale certificate. D.84-04-014 authorized a resale plan to provide a viable business opportunity for the resellers and to mitigate any adverse effects of the early entry of the wireline carrier into the cellular market. The decision also required each entity desiring to enter the retail market to obtain a CPC&N. However, the decision emphasized the ease of entering the reseller market by stating that reseller CPC&Ns should be authorized on an ex parte basis to the maximum extent possible. Retail rates were based on market determined prices.

Today the reseller market is comprised of duopoly carriers, affiliates of duopoly carriers, and independent resellers. A DRA survey shows that 14 facilities-based carriers, 3 duopoly carrier affiliates, and 44 independent entities had CPC&Ns to provide retail services in 1988. It also shows that the independent resellers' market share[12] was 16 percent in 1988, an increase of 6 percent from 10 percent in 1985. For the comparable time period, the duopoly carriers market share diminished to 70 percent from 76 percent while the duopoly carrier affiliates maintained a 14 percent market share.

A major concern of this investigation is to determine whether the current retail price regulation is appropriate. Therefore, parties were requested to comment on the current retail

12 DRA utilized cellular service revenues to derive its market share ratios.

market conditions, the need for a wholesale/retail rate spread, and on subsidization between the wholesale/retail market.

Current Market Conditions

Parties were requested to comment on how the current retail market is working. CRA believes that the retail market is not working "as well as it should" because of the lack of competitive pricing. Absent an increase in the duopoly carriers' rate spread between wholesale and retail rates, CRA asserts that resellers will be a short-lived phenomenon lacking significant opportunity to compete.

Although CRA offers a bleak picture for the retail market, Cellular Dynamics concurs with carriers that the wholesale and retail margins are adequate. However, Cellular Dynamics restricts its concurrence to the markets where the duopoly carriers support adequate margins, such as in the Los Angeles market where Cellular Dynamics obtains approximately one out of every five new subscribers.

Cellular Dynamics contends that a healthy retail market reduces the ability of the duopoly carriers to coordinate wholesale pricing and therefore to exercise market power. It concludes that a healthy retail market will produce lower and creative pricing for the end users.

The duopoly carriers represent that the retail market is functioning well. McCaw substantiates this conclusion by emphasizing that the resellers' revenue share has increased from nothing in 1983 to over $86 million in 1988 and its recognition that several resellers report substantial net incomes without being required to provide the substantial amount of investments that the duopoly carriers are required to provide.

PacTel concurs with McCaw. The results of a PacTel survey show that of the approximately 30 retail carriers entering the market since 1986, 40 percent entered the market in 1988 and a additional 40 percent in 1989, or 10 new retail carriers in 1988 and 14 in 1989. PacTel attributes this rapid entry to the relatively low regulatory barriers to entry and the minimal capital requirements that retail carriers need to obtain an efficient and profitable business.

PacTel also represents that 5 of the 7 certificated resellers who recently left the market sold their customer list to other resellers, four of which sold their business for more than $600 per subscriber. More recently, by A.90-03-010, Cellular Dynamics proposes to acquire a portion of California Cellular Communication Corporation's (another reseller) customer accounts. The terms of the agreement includes a provision that Cellular Dynamics will assume a $30 monthly payment per customer account for a 13-month period, or $390 per customer account.

DRA also conducted a study. Its study, based on data requests to resellers, shows that resellers function adequately during their initial start-up period as well as during subsequent periods of time. Although resellers complained about duopoly carriers' high commission rates causing excessive churn rates, the resellers believe that their own expectations for customer growth are reasonable. Thus, DRA believes that, in terms of customer growth, the market is functioning reasonably well. However, DRA does believe that rates to end users should be lower.

DRA is concerned that a substantial increase in the number of independent resellers through regulatory action will merely redistribute wholesale profits to the additional resellers. As long as entry into the reseller market is relatively easy, DRA sees no need for a great number of active resellers for competition to function at the retail level.

Carriers', CRA's, and Cellular Dynamics' comments on the possibility of retail rates being high, parallel their comments on high wholesale rates. Therefore, such comments will not be repeated. Those parties who represent that retail rates are high, such as CRA, argue that the cause of such high rates is ineffective competition between the duopoly carriers.

GTEM acknowledges that retail rates are a function of wholesale rates. However, it argues that comparisons of prices charged in various markets throughout the state are limited because consideration must be given to the relevant cost of providing service in each market and to the risks associated with such capital investment.

To the extent that retail rates in some California markets are higher than retail rates in other markets throughout the country, GTEM reminds parties that there are valid reasons for such differences. Some of the reasons offered by GTEM are the cost of land and switching facilities, unique and varied topography, CEQA requirements, and the extent of state regulation.

Similar to the wholesale market concerns previously discussed, parties are at odds about whether or not there is sufficient price competition within the (resellers) market. To address this concern, parties commented on the spread between the duopoly carriers wholesale and retail rates alluded to by GTEM's comment that retail rates are a function of wholesale rates.

Wholesale and Retail Rate Spread

The current regulation of retail rates and the margin between retail and wholesale rates has not enhanced price competition. McCaw demonstrates in its comments that a margin between the wholesale and retail rate only encourages resellers to price their services at the same level as the facilities-based carriers. For example, in the Los Angeles market, both facilities-based carriers charge a $50 customer activation fee, a $45 monthly access fee, and a $0.35/$0.27 peak/off-peak rate for basic service. In addition, the 35 resellers in the same market area identified by McCaw charge the same rates for basic service as the facilities-based carriers. Although the rates are different in other MSAs, the results are similar to that of the Los Angeles market.

CRA recommends a larger spread between the wholesale and retail rates so that the resellers may compete profitably within the retail market. This is because 74 to 79 percent of the retailers' cost to furnish retail services represents the cost a retailer must pay to the facilities-based carrier. However, DRA believes that any increase in the retail margin from the facilities-based carriers will only increase resellers' profitability in the short run.

In the long run, DRA believes that any increase in the margin will only encourage more firms to enter the retail business because of the resellers' increased profitability. Therefore, it recommends that a volume discounting procedure be adopted that does not guarantee resellers financial viability in place of the current wholesale/retail margin.

McCaw's data substantiates that the margin method has not enhanced price competition in the retail market. Therefore, should such a procedure continue, there is no reasonable basis to assume that retail price competition will occur if the margin is required to be increased. Absent such assurance there should be no mandatory margin, let alone an increased margin between the wholesale and retail rates. The facilities-based carriers should be responsible for innovative pricing schemes if true competition is to exist. Although DRA's volume discounting proposal is not specifically being adopted, facilities-based carriers are encouraged to consider DRA's proposal in developing innovative tariffs for retail services. The only restriction to such innovative tariffs should be to preclude the facilities-based carriers from setting wholesale rates that discriminate in favor of their own retailers.

Consistent with DRA's logic, we do not see the need to maintain a particular margin between volume discounts and individual customer rates. The wholesale carriers have the incentive to offer bulk discounts to the extent that such arrangements reduce the costs of functions such as advertising and the servicing of customer accounts. Resellers that can perform these functions more cheaply or better will have a continuing place in the market.

The argument concerning the retail margin parallels that concerning the reasonableness of commissions paid to agents, which is the next section of this decision. Resellers are arguing that they cannot be profitable given both the current margins and the competitive business practices that have become commonplace among both carrier retail operations and resellers. Resellers ask either that the competitive activities of carriers be limited or that the retail margins be increased.

As DRA points out, increased margins or earnings for resellers do not necessarily benefit consumers, and could cause the public to pay higher prices. On the other hand, the resellers claim that the carriers are unfairly subsidizing their retail operations and that a resulting loss of competitive resellers would harm consumers by limiting choice. . The resellers characterize the situation as anticompetitive behavior that the Commission should control.

We will move to control any potential cross-subsidy problem directly. Rather than imposing specific margins or price limits on carrier retail operations, we will require that they at least break-even on a rational business basis. If a carrier's retail operations are covering all of the costs directly associated with that business, then the carrier is not cross-subsidizing retail out of wholesale revenues or earnings. In that case, the carrier is not pricing predatorily towards the resellers, and the cellular retail market can function like any competitive market with the customer base and earnings going to the firms that offer the best service at the lowest cost. Given these circumstances, we are indifferent as to whether resellers serve any or all of the market, or whether the carriers continue to provide retail service or even seek to leave that end of the business.

We will therefore provide that the cellular USOA be revised to incorporate cost-allocation methods for the carriers' wholesale and retail operations in the next phase of this proceeding. We can draw on the record before us to identify some of the issues that will occur in that process and to offer guidance to the parties. First, the purpose of this USOA will be to police predatory pricing. From the rational business perspective, costs that the carrier must incur due to offering wholesale service are properly allocated or assigned in their entirety to the wholesale side if those costs could not be avoided if the carrier discontinued retail service. Second, commissions to agents should be included on the retail side unless the carrier pays them to all who deliver new customers (including resellers). In the next section we say more about the proper accounting treatment of commissions. Finally, retail costs should include a rate of return on investment dedicated to retail service that would not be needed for wholesale-only operations.

Retail profitability will be monitored on a service-area wide basis. We recognize that start-up costs to serve new areas or markets may be offset for some period by profits from more established parts of the business. As long as the overall carrier retail operation is not subsidized, carriers will be in compliance with this requirement.

Until this revised USOA is put in place by further Commission decision, carriers shall not use temporary tariffs to make rate changes that reduce the current margins between wholesale and retail rates. Instead, rate changes that would reduce margins shall be filed as rate changes have been up to now, that is as advice letters for approval by Commission resolution. Resellers or other interested parties may protest these filings; to gain our approval, the carrier must make a showing that the reduction in retail margin will still be profitable.

Once we approve the new USOA, we will begin monitoring carriers' retail profitability and carriers may use temporary tariffs to make rate changes that reduce retail margins.

We will require carriers to report on their retail revenues and expenses each six months. If retail revenues do not equal or exceed retail expenses, then the carrier will lose its ability to reduce the retail margin through temporary tariff filings. If a carrier's retail expenses exceed its retail revenues for two consecutive six month periods, then we will open an OII in which the carrier will have the burden of explaining why its retail operations have not been compensatory. If we find that the carrier has in fact cross-subsidized its retail operations during that period, we will impose sanctions that will potentially include but not be limited to a partial refund to resellers of wholesale rates they paid to the carrier. A reseller would be refunded a part of the wholesale rates it had paid, calculated in proportion to the amount of money the carrier's retail operation lost divided by the total dollars paid by the carrier's retail operation for wholesale service.

In other words, we would calculate what the wholesale tariff price would have to have been for the carrier's retail side to have broken even. It would be as if the carrier's wholesale tariff had been at a price at which the carrier's retail operations would not have been subsidized, and as if the resellers had been paying that lower wholesale price during the period in question. This would assure that both resellers and carrier retail operations are in effect buying out of the same tariff. To the extent that carrier retail operations can sustain continuous losses, the retail operations must be receiving an effective cross-subsidy from other carrier revenues.

A carrier whose retail operation loses money during one six-month period but makes money during the subsequent period would regain its pricing flexibility if the losses in the prior period (on a per-customer basis over the average number of customers in each period) were equalled or exceeded by the profits in the subsequent period. Otherwise, a carrier would need two consecutive break-even or better periods to regain its pricing flexibility.

Procedurally, we will enforce this monitoring requirement through periodic filings to be provided to CACD. We will delegate to the Director of CACD the ministerial duty of verifying the carriers' calculations and certifying, by letter, their current status of either unrestricted temporary tariff authority or restricted temporary tariff authority. The Director of CACD will also recommend the issuance of OIIs should they be necessary. Carriers should have their compliance with their allocation methods verified annually by external auditors. A precise schedule for this monitoring will be included in our decision adopting the new retail cellular USOA.

By this opinion, other steps are being implemented to enhance competitive pricing between the facilities-based carriers and to encourage retail price flexibility. The most common concern among facilities-based carriers is the time period before a tariff can be implemented. With the new tariff guidelines adopted in this opinion, carriers will be able to implement innovative tariffs without providing advance notice to their competitors. Similar types of regulatory incentives are being afforded to the retailers with the intent of enhancing retail price competition.

Although some tariff changes have already been addressed, it is important to note that resellers have, on a case-by-case basis, been determined to be a nondominant telecommunications carrier. An example of such determination can be found in D.85-06-015, Advanced Cellular Phone Co. U-4030-C. To date there is no generic proceeding in which this nondominant status has been determined.

Comments filed in this investigation confirm that the reseller market is a competitive service with minimal market power and has limited ability to influence cellular prices. Rather than continuing to review reseller applications on a case-by-case basis, we conclude, based on the comments filed in this investigation, that retail cellular carriers not associated with facilities-based carriers should be classified as nondominant telecommunications carriers. This nondominant status should not be applicable to entities which either have or are applying for a FCC facilities-based license. As nondominant telecommunications carriers, the resellers should be exempt from PU Code §§ 816-830 and exempt from Section 851 with respect to transfers or encumbrances made for the purpose of securing debt or customers.

Similar to other nondominant carriers, nonfacilities-based retail cellular carriers should be authorized to file tariffs applicable to cellular services, including rates, rules, regulations, and other provisions necessary to offer service to their end users. Such filings should be made in accordance with GO 96-A, excluding Sections IV, V, and VI, and should be effective upon filing if rates will not decrease a carrier's customers average bill by more than ten percent. With respect to rate increases, or decreases in excess of ten percent, nondominant carriers will be subject to the advice letter process applicable to similar rate increases sought by facilities-based carriers.

We are aware that the tariff rules for nondominant carriers are under review and may be made less flexible. With respect to all tariff matters except rates, we will provide that cellular resellers may use the more flexible of the procedures provided to cellular carriers in this decision or those we ultimately require for other nondominant carriers.

Wholesale/Retail
<u>Market Subsidization</u>

Since the inception of the wholesale/retail market in 1984, resellers have filed numerous complaints against carriers subsidizing their operations with commission schemes. C.86-12-023, consolidated with this investigation so that such subsidy issues could be addressed on a generic basis is only one of the complaints.

CRA asserts that exorbitant commission payments permit agents to sell customer terminal equipment below cost, a perverse anticompetitive market incentive to the end user so that the end user will subscribe to a particular carrier's cellular service.

With the artificially low price of equipment, CRA believes that the agents are able to obtain sizeable commission payments for certain carriers while requiring an end user to subscribe to a specific carrier's service, without the benefit of making an independent selection of a carrier for service quality or rates for the end user's service needs.

In an attempt to resolve the issue of artificially low price of equipment, parties to C.86-12-023 agreed to the following guidelines.

a. No provider of cellular telephone service may provide, cause to be provided, or permit any agent or dealer or other person or entity subject to its control to provide cellular telephone service at any rate other than such provider's tariffed rate. No such provider may permit any agent or dealer or other person or entity subject to its control to pay for all or any portion of the cellular service which it provides to any customer.

b. No provider of cellular telephone service may provide, either directly or indirectly, any gift of any article or service of more than nominal value (e.g., permitted gifts would be pens, key chains, maps, calendars) to any customer or potential customer in connection with the provision of cellular telephone service.

c. No provider of cellular telephone service may provide, cause to be provided, or permit any agent or dealer or other person or entity subject to its control to provide to any customer or potential customer any equipment price concession or any article or service of other than nominal value which is paid for or financed in whole or in part by the service provider and which is offered on the condition that such customer or potential customer subscribes to the provider's cellular telephone service.

D.89-07-019 pertaining to an agent's practice of selling discounted cellular equipment so that end users would agree to purchase cellular service from a specific carrier, concluded that cellular equipment discounts, contingent upon the purchase of tariffed cellular services, violate PU Code §§ 532 and 702 if those discounts are offered by utilities or their agents. Similarly, conditions on cellular services that differ from those in effective tariffs are unlawful if they are imposed by carriers on their agents.

We will adopt the above guidelines and reemphasize our intent to enforce the provisions of D.89-07-019.

The second cross subsidization issue is whether the payment of commissions to carriers' agents prevent resellers from entering the cellular market and maintaining a viable cellular resale business. A related issue in C.86-12-023, consolidated with this investigation, is whether commission payments to agents should be restricted to no more than $50 per cellular telephone number activation.

PacTel and other carriers acknowledge that commission payments of up to $350 per activation are made to agents. However, the carriers represent that they do not cross subsidize their own retail systems or compete for agent patronage with alleged excess profits from their wholesale operations.

On the other side, CRA argues that the facilities-based carriers' commission rates are high and that such rates are contrary to the viable resale program mandated by the Commission. Absent commission rates of $50 or less, CRA asserts that a stand alone reseller cannot compete in the resale market profitably.

D.84-04-014, which established the Los Angeles market wholesale and retail rates, defines a viable resale program to be a program which provides a potential nonwireline reseller an opportunity to enter the cellular marketplace as a bona fide competitor. It also explained that a viable resale plan is needed to foster competition and is needed to mitigate any adverse effects of the wireline carrier's entry into the cellular marketplace in advance of a nonwireline carrier.

Based on a "hypothetical reseller with 60 percent of the market," a resale rate with an 8 percent profit margin was established to provide a viable business opportunity for two nonwireline entities competing for FCC authority to provide cellular service within the Los Angeles market. One of the hypothetical reseller's cost components used to determine the profit margin was a $50 commission rate per cellular telephone number activation.

Although CRA relies on D.84-04-014 for its reason to restrict commission rates to $50, the opinion does not address the viability of resellers other than future facilities-based carriers or the viability of such carriers during the "head start" period.

CRA argues that if commission rates are higher than $50 per activation, resellers cannot compete at a profit. Its brief filed in C.86-12-02 demonstrates that a reseller paying a $300 commission rate with a 33 percent customer churn rate will operate at a loss in its first year of operation, will not break-even until its third year of operation, and will not earn a 12 percent cumulative profit until its ninth year of operation. The 33 percent churn rate means that each customer obtained via the commission practice will remain on a reseller's system for 3 years.

CRA represents that a 50 percent churn rate is a more realistic rate. Given a 50 percent churn rate a reseller will not only not break-even but will lose money.

However, resellers response to a DRA inquiry shows that the resellers churn rate ranges from a low of 2 percent to a high of 35 percent, an average of 19 percent. If this simple average is applied to CRA's analysis discussed above, a reseller should break-even in its second year of operation, even with $300 commission payments.

Although a reseller may not turn a profit in the first year of operation, it has easy entry into the market and has an opportunity, not a guarantee, to earn a profit. Not even is a monopoly entity expected to earn a profit in its first year of operation. The realization of a profit should not be dependent on the level of agents' commission payments. Rather, profitability should be based on an individual resellers' ability to manage its business in a competitive environment.

Comments do not demonstrate that commission payments preclude resellers an opportunity to enter the market or to earn a profit. Rather, comments show that there is sufficient incentive for resellers to enter the market and to operate a viable business. By this opinion regulatory changes are being made to further enhance the resellers' viability. Two examples are the nondominant telecommunications carrier status for resellers and the implementation of agent guidelines. Therefore, commission payments to agents should not be restricted.

Consistent with our prior discussion regarding the monitoring of carriers' retail profitability, including commissions as a retail expense will further protect resellers; carriers will report losses if commission payments exceed the contribution that customers supply. In other words, commissions will appear as an expense against carriers' retail operations. If the customers that carriers obtain by paying commissions do not produce enough contribution to offset the commission payments, then the retail carrier operations will show losses and be subject to corrective action by the Commission. This protects resellers by assuring that carriers pay commissions only to the extent that is justified by rational business decisions. To maintain the rational business perspective, the USOA for carrier retail expenses should permit commissions to be amortized over the expected life of a customer. Otherwise, the reported ratio of revenues to expenses would not necessarily indicate whether carriers were making rational business decisions in determining the level of commissions paid.

Aside from the competitive issue between resellers and wholesale carriers, we are concerned that commissions not become a de facto method of practicing price discrimination in favor of new customers. While bundling of cellular equipment with regulated service is illegal, agents can still be expected to discount equipment substantially in the expectation that most customers will sign up for service. While this is a benefit to the consumer, we would also like to see discounts more generally available, and we will monitor the results of this decision to determine whether we are satisfied with the progress towards lower rates.

The wholesale carriers have argued that commissions are a necessary marketing expense needed to counteract the loss of customers through churn. This is consistent with the nontariffed long-term service agreements that we also have found to be illegal. However, tariffed discounts for long-term service arrangements or high volumes of usage would be acceptable, and we will encourage carriers and resellers to offer them. Such tariffs should be available on a nondiscriminatory basis to any customer willing to fulfill their terms. For tariffs that impose an affirmative obligation on the customer (minimum volumes or length of service), carriers should provide a written disclosure of the tariff's terms in plain language for each prospective customer, and retain a signed copy of the terms by which the customer affirms an understanding of them and a willingness to comply in exchange for the discount.

Any carrier offering these discounts must also offer a "plain" tariff that does not impose special length of service or volume requirements on the customer.

A second aspect of the subsidization issue which parties were requested to comment on is whether or not a facilities-based carrier's affiliate should be prohibited from reselling in markets where the facilities-based carrier provides retail services. PacTel's A.87-02-017 was consolidated with this investigation because of just such an issue.

By D.85-04-014 (Bay Area Cellular Telephone Company's (BACTC) A.85-02-034), the Commission established a policy under which nonwireline facilities-based carriers may resell cellular services off the wireline carrier's system until such time as the nonwireline carrier's facilities are constructed and made operational. The opinion specifically stated that when the facilities became operational and the carrier began wholesale services, the carrier would not be allowed to compete with itself in the same market area. This policy has remained in effect since D.85-04-014 to discourage anticompetitive and cross-subsidization practices.

LA Cellular does not oppose affiliated competition as long as the end users are not misled as to the ultimate source of service. LA Cellular also believes that the imposition of any such restriction violates the FCC's cellular resale policy.

DRA's Phase I comments corroborate LA Cellular's interpretation of the FCC resale policy. DRA informs us that the FCC currently prohibits any resale restrictions pending the results of a rulemaking proceeding opened to determine whether its prohibition of all resale restrictions should continue under all circumstances.[13]

McCaw concurs with LA Cellular providing the affiliate subscribes to the cellular services of both facilities-based carriers within the market area. However, McCaw acknowledges that granting such authority will reduce the facilities-based carriers' incentive to expand and to improve its system.

PacTel believes that a facilities-based carrier's affiliate should not be prohibited from reselling in markets where it provides retail services so long as the affiliate does not resell the facilities-based carrier's competitor's service. PacTel asserts that if the affiliate can place a large customer base on the other carrier's system, the affiliate has the ability to injure the other carrier with the threat of withdrawing its resale customers.

There is no concurring position on this issue. Although McCaw's and PacTel's comments substantiate the underlying reason we implemented the restrictive retail policy; i.e., to discourage anticompetitive and cross subsidy practices, there is nothing in the record for us to consider whether the FCC has preempted us in this matter. Absent such a record, we cannot resolve this issue or the disputed application of this issue in A.87-02-017. Parties should address the issue of FCC preemption in the next phase of this investigation.

Wholesale Rates for Large Organizations

Duopoly carriers tariffs for wholesale service, as currently authorized, enable large organizations who purchase cellular services for their own use to benefit from economies of

13 Memorandum Opinion and Order, FCC 88-308 (released October 7, 1988).

scale via reduced rates. Such reduced rates have been afforded to large organizations since 1984 by D.84-04-014.

The definition of a large organization has not been an issue until several resellers filed a complaint (C.89-03-016) against BACTC in March 1989. The complaint pertained to a large organization, SJREB, obtaining wholesale rates from BACTC. SJREB, a professional real estate organization consisting of approximately 6,930 realtor members, acquired cellular services at a wholesale rate to pass through to its members and to be used for each member's individual use without seeking a reseller CPCN. BACTC's wholesale rates were available to SJREB if it satisfied conditions specified in BACTC's wholesale tariff.

D.89-05-024 concluded that BACTC should be precluded from expanding its wholesale cellular services to the unserved members of SJREB pending a determination of large organizations as applied to wholesale rates. SJREB members who received wholesale services from BACTC prior to the issuance of the decision were provided "grandfather" wholesale status.

All parties involved in the BACTC complaint were invited to present proposals to resolve the issue of which large organizations should be eligible for wholesale cellular services. SJREB, DRA, and CRA filed comments on the large organization issue.

SJREB believes that price competition can be enhanced if large "bona fide" professional trade organizations such as SJREB are recognized and made eligible for wholesale service where certain conditions exist. Specifically, it recommends that eligibility be based on the following conditions:

a. The organization must be a professional organization with a recognized professional, trade, or commercial purpose with at least 500 members. The organization must have a minimum of 200 customers sign up for service.

b. Members of the organization must be engaged in for-profit activity directly germane to the professional purpose of the organization.

c. The organization must serve as the master customer and guarantee payment for all usage by its members.

d. The organization must perform marketing activities for the wholesale service provider.

DRA believes that the definition of a large organization is irrelevant in determining whether organizations like SJREB are eligible for wholesale rates. It believes that the proper focus is on the purchase of cellular services in the quantities prescribed in the applicable tariffs, whether by an individual or an organization, and on the purchaser's intended use of the services.

Since SJREB purchases wholesale service for its members' own use, and not the organization's use, DRA does not believe that SJREB can obtain wholesale service without becoming a certificated reseller under current tariff provisions.

DRA concurs with SJREB that price competition can be enhanced by providing a form of wholesale rates to large users of cellular service. However, it does not believe that SJREB's proposal should be adopted. Rather, it recommends that individual facilities-based carriers adopt alternative pricing plans to satisfy their customers needs, such as SJREB, and that such proposals be reviewed on a case-by-case basis.

CRA also opposes SJREB's proposal. It objects because the proposal is anticompetitive on the retail level, invites carrier abuse on both the wholesale and retail level, and is unfair to members of the general public who also desire lower retail cellular rates. CRA argues that SJREB's proposal, if approved, will enable large organizations such as the Chamber of Commerce, medical associations, and bar associations to receive preferential cellular rates.

CRA believes that the proper solution to the large organization issue is to let carriers offer large organizations discounts that are below the carriers retail ceiling but above their wholesale compensatory level. This recommendation stems from CRA's recommended cost-based regulation of the duopoly carriers. CRA asserts that its proposal will give resellers access to the large-user accounts and will result in discounts for volume users.

SJREB points out that the impact of wholesale usage on resellers has been addressed in Resolution T-13052, regarding U S West's "multiple phone" tariff. By that resolution, U S West was authorized to provide tariff rates above its wholesale rates, but below its retail rates, to organizations similar to SJREB. Specifically, the multiple phone rates are available to any individual or entity that guarantees the payment of underlying individual bills sent to employees, officers or members, or to a entity which fulfilled various requirements relating to promoting U S West's service.

U S West's proposed tariff was approved because U S West substantiated that its cost of serving an identified group of users is less than its cost of serving other customers thereby justifying its passing through cost savings to the identified group of customers.

There is no dispute that facilities-based carriers enjoy economies of scale from large users and that such economies of scale should be passed through to the customers. However, if SJREB's wholesale proposal is adopted, organizations which are not-for-profit and/or nonprofessional organizations will be excluded.

Even if such organizations were included, the proposal may be construed as anticompetitive to the resellers because such organizations would be entitled to the same rates as the resellers but not be required to be a certificated or be required to provide nondiscriminatory services which is required of a reseller. Such a proposal may encourage discriminatory cellular services and stifle competition.

On the other side, DRA's and CRA's proposal merits serious consideration. Economies of scale are recognized through volume usage and as such, a form of wholesale rates should be afforded to those individuals or entities, irrespective of professional affiliation, who contribute to volume usage and intend to offer cellular services to a restricted group of end users.

Because rates are based on the market, it is difficult for carriers to determine the economies of scale they expect to receive from large-volume users. Therefore, absent any definite price support, carriers should implement a large-user tariff if there is a demand for such service within their statistical metropolitan service areas (SMSAs). To qualify for this large-user tariff the organization or entity must serve as the master customer, guarantee payment for all usage by its members, and not apply any additional charges to its members for such service. In particular, carriers should not bill and collect from individual customers of the bulk-user group or organization.

For purposes of monitoring carrier retail expenses and revenues under the revised USOA, bulk-user service will be considered retail.

As previously discussed, a large user is not public utility and is not accountable to us for consumer safeguards like a reseller is. A reseller, as a public utility, incurs certain regulatory costs not applicable to large users. Some of these costs associated with regulation are financial reporting requirements, tariff filings, rate and complaint proceedings, consumer safeguard procedures, and user fees. To grant a duopoly carrier authority to charge a large user the same rate that it charges a reseller may be anticompetitive for the reasons discussed above and should not be granted unless the resale market is deregulated. Since we are not prepared to deregulate the resale market at this time the duopoly carriers should set their large user rates at least five percent above the rates they charge resellers. The percentage difference is necessary to enhance cellular competition by providing resellers an opportunity to compete for large user business. The five percent margin should not, however, affect any rate offered by a carrier to a government agency. The consumer protection disclosure provisions described in the Phase I discussion should also apply to large-users and be incorporated into the corresponding utility tariffs.

D.89-05-024's grandfather clause provides for those SJREB members receiving cellular services from BACTC at wholesale rates to continue to receive such rates until the individual members choose to terminate or leave the BACTC system. However, such grandfather provision can only be contingent upon SJREB meeting the specific BACTC's tariff provisions for wholesale service. BACTC should not be allowed to provide service at the same wholesale rates to SJREB for the use of SJREB members who were not grandfathered by D.89-05-024.

<u>Section 311 Comments</u>

The Administrative Law Judge's (ALJ) proposed decision on this matter was filed with the Docket Office and mailed to all parties of record on March 12, 1990, pursuant to Rule 77 of the Commission's Rules of Practice and Procedure.

Pursuant to Rule 77, comments were due on April 2, 1990. However, CRA requested that the comment period be extended four days to April 6, 1990 and that reply comments be due seven days later on April 13, 1990. The ALJ granted CRA's request because CRA's requested extension had no impact on the date that a final decision on this matter would be considered by the Commission. The extension was granted on condition that CRA notify all active parties to this matter, that no active party objected to the extension, and on condition that parties filing comments and/or reply comments serve a copy of their comments to the ALJ on the above-mentioned filing dates.

Comments from BACTC, Cellular Services Inc., CP National, CRA, DRA, GTE, LA Cellular, McCaw, Mission Bell Telecommunications Corporation (Mission Bell), PacBell, and PacTel were timely filed with the Docket Office and timely served on the ALJ. Although comments were timely filed with the Docket Office from Advantage Group, Cellular Dynamics, County of Los Angeles, Fresno, GTEM, SJREB, and U S West they were not timely served on the ALJ.

Reply comments from BACTC, Cellular Services, Inc., CRA, CP National, DRA, McCaw, Mission Bell, and Twentieth Century Cellular were timely filed with the Docket Office and timely served on the ALJ. Although reply comments were timely filed with the Docket Office from Advantage Group, Cellular Dynamics, LACTC, PacBell, PacTel, and SJREB they were not timely served on the ALJ.

Comments and reply comments identified above as not timely served on the ALJ should not be considered. However, for this proceeding only, we will consider the above-tardy served comments.

CRA filed a motion to strike LACTC's comments because the appendices attached to LACTC's comments included additional discussions regarding LACTC's proposed findings of fact and conclusions of law, contrary to Rule 77. CRA's motion also requests that LACTC's reply comments be rejected because LACTC's 19-page reply comment exceed the 5 page limit allowed under Rule 77.5. PacBell also filed a motion to reject LACTC's reply comments for the reason cited by CRA.

LACTC disputes CRA's assertion that appendices attached to comments should be restricted to only findings of fact and conclusions of law. LACTC believes that a "more generous 25-page restriction of Rule 77.3" applies. As to its reply comments, LACTC acknowledges that its reply comments exceed the five-page limit and requests that its reply comments be deemed withdrawn, and that we accept in lieu a five-page summary document attached to its response to CRA's and PacBell's motions. LACTC represents that acceptance of the five-page summary, which adds no arguments or citations to those set forth in the reply comments timely served on all parties, will not prejudice any party.

Contrary to LACTC's Rule 77.3, interpretation of a generous 25-page comment restriction, the rule specifically provides for a maximum of 25 pages of comments in major proceedings. We interpret 25 pages to be just that, 25 pages.

Although there are no page limits on appendices, Rule 77.3 does not provide for additional comments to be incorporated into appendices. To do so would negate the intent of restricting comments. Appendices are restricted for findings of fact and conclusions of law. Therefore, we reject LACTC's proposal to accept a generous 25 pages of comments and will not consider LACTC's comments included in its appendices. LACTC's comments which precede its appendices are valid and are considered.

No party has objected to LACTC's five-page summary which replaced its reply comments. Therefore, we have considered LACTC's five-page summary comments. In accepting the summary comments we note that LACTC has successfully submitted a generous five pages of reply comments by reducing the print size and almost doubling the number of lines per page. Any continuance of this procedure may result in rejection of comments.

Personal Cellular Services, Inc. (PCS), certificated as a cellular reseller 16 days after the proposed decision was mailed, filed comments on the proposed decision. Rule 77.2 provides parties to a proceeding an opportunity to file comments on the proposed decision. However, PCS was not a party to this proceeding. Therefore, PCS's comments will not be considered in this proceeding.

In summary, we have carefully reviewed the comments, but have not summarized them in this order. To the extent that they required discussion, or changes to the proposed decision, the discussion and changes have been incorporated into the body of this order.

Findings of Fact

1. Cellular telecommunications systems have the capability to offer "toll free" calling over large geographic regions of the state through tandem interconnections with IECs. Toll charges for mobile-originated calls terminated outside a specific geographical region are passed through to the customer.

2. Cellular service is a discretionary service complementing conventional wireline service.

3. A decline in the cost of cellular service to approximately that of conventional wireline service will be an important factor in the transformation of cellular service as a direct competitor to conventional wireline service.

4. The decline in the price of mobile telephones from an average of $2,500 in 1984 to an average of about $500 in 1989 enhanced cellular market penetration.

5. With the availability of low-cost phones, the primary avenue for enhanced market penetration will be in reduced access and network usage costs.

6. Customer penetration into the cellular market will have no significant impact from regulatory policy changes which may encourage lower landline toll rates or which encourage an increase in the growth of the intraLATA toll market.

7. The CGSAs approved by the FCC and this Commission were never intended to conform to or coincide with existing landline boundaries.

8. Enhanced services, such as voice mail, will expand the role of cellular phones with efficient 24-hour communication capabilities.

9. Universal service, or the availability of basic telephone service at affordable prices to all Californians, is a basic goal

imposed on the LECs. Cellular service is not a component of universal service at this time.

10. Cellular is a high-cost developing industry undergoing rapid technological changes. It is expected to serve only about five percent of the population in the next five years.

11. Effective competition will promote economic efficiency in the production and pricing of cellular service.

12. Parties agree that cellular prices would tend towards the marginal cost of service in an unrestricted, fully competitive cellular market and that such a result would be economically efficient and fair.

13. The FCC licenses held by wholesale carriers authorize the use of a limited amount of radio spectrum that can become a constraining factor in the amount of service that can be provided .

14. In the case where the available radio spectrum is a constraining factor in the amount of service provided, economic efficiency considerations argue for permitting wholesale carriers to retain profits due solely to this scarcity. These profits serve as an incentive to expand the capacity of the system as rapidly and efficiently as possible.

15. It is unreasonable for wholesale carriers to price in a noncompetitive or collusive manner or to retain any profits so earned.

16. Accounting rates of return for wholesale carriers do not in themselves reveal whether profits are due to a scarcity of available radio spectrum, uncompetitive pricing, or the ordinary returns on investment that may be earned due to the riskiness of the cellular industry.

17. The duopoly wholesale carriers in a given market have different system configurations and therefore different cost structures. Any regulatory approach to setting wholesale rates through cost of service calculations will necessarily produce

different prices for the two systems if the allowed rates of return are the same for each.

18. A regulatory requirement that competing carriers charge different prices would cause the higher-priced carrier to lose customers and deprive that carrier of a reasonable opportunity to earn the rate of return based on which its price was set.

19. The encouragement of technological advancement is an important goal.

20. Technological advancement can best be encouraged by providing cellular carriers the means to attract capital necessary to make investments in research, development, and commercialization of innovative technology.

21. Cellular carriers increase the utilization of LEC networks and provide revenue to LECs in the form of interconnection charges paid by cellular carriers and call-origination charges paid by LEC customers who call cellular service subscribers.

22. The Cellular USOA plays an active role in discouraging anticompetitive behavior.

23. D.84-04-014 set a regulatory policy that facilities-based carriers wholesale operations should not subsidize their retail operations.

24. There is no USOA for resellers.

25. The USOA for cellular carriers does not contain provisions for distinguishing wholesale and retail costs.

26. A regulatory requirement that the retail operation of cellular carriers at least break-even on a rational business basis would assure that carriers are not cross-subsidizing retail operation with wholesale revenues or profits. To enforce such a requirement will require that the cellular USOA be modified to distinguish between wholesale and retail costs.

27. Experience has shown that cellular providers are willing to provide high-quality performance.

28. Service quality measurements are service consistency, high-quality voice transmission, ease of placing and receiving calls from one location to another, customer complaints, and billing service.

29. Subscription fraud and roamer fraud exist in the cellular industry.

30. Subscription fraud occurs via a customer providing incorrect billing information.

31. Roamer fraud exists when end users utilize an unauthorized subscriber telephone number or alter the ESN on their cellular terminal while roaming in remote areas.

32. Approximately 10 percent to 15 percent of Santa Barbara's roamer traffic is fraudulent.

33. Facilities-based carriers have expended a considerable amount of time and effort to implement PRVs to reduce roamer fraud.

34. The ability for a cellular utility to request that the ESN for a customer's cellular telephone be blocked on a routine basis when the customer discontinues service can be used anticompetitively to restrict appropriate customer choice among service providers.

35. As described in the discussion section of this decision, more clearly-defined tariff provisions regarding ESN blocking and the disclosure of terms regarding customer deposits will promote greater competitiveness in the retail market and improved consumer protection while maintaining reasonable means for utilities to protect against fraud.

36. Cellular customers are charged for all cellular calls, whether they are on the originating or terminating end of the call.

37. PacBell is exploring the feasibility, from the standpoint of the LECs, of billing the landline customer who calls a cellular number, referred to as "calling party pays."

38. Local telephone company subscribers have no way of verifying whether a given telephone number is for a cellular phone,

and they have no expectation of paying cellular airtime charges for calling a cellular phone. Therefore, "calling party pays" billing plans are unreasonable at this time.

39. Cellular calls can be monitored by a third party without the other party's knowledge.

40. Cellular customers' privacy-of-calls is not seriously compromised because of Commission action in D.87-06-029.

41. Those customers who need strict privacy can purchase encryption devices to scramble cellular signals at a reasonable price.

42. The improved privacy that digital cellular technology will afford to customers is a reason for promoting the use of digital cellular technology.

43. Commissions paid to agents of cellular carriers have been a major issue in resale complaint proceedings before us.

44. Cellular rates will increase if agents are required to publish the commissions they receive from wholesalers and resellers.

45. The payment of commissions to agents by carriers and resellers is a legitimate business practice that substitutes for the expense that would otherwise be required to market service to customers directly.

46. Facilities-based carriers' bulk rate are set at the same rate or at a slightly higher rate than their wholesale rates.

47. It costs more to provide service to individual small users than to bulk users.

48. Economies of scale are gained from large users.

49. Large users that do not add any markup or additional charge to service they supply to members or individual subscribers are not public utilities.

50. Customers who purchase cellular service from large users that are not public utilities may be unaware that certain of the Commission's consumer protection procedures are unavailable to them

for resolving disputes between an individual customer and the large user.

51. Resellers incur regulatory costs that uncertificated bulk users do not, and provide corresponding Commission-overseen consumer protections.

52. A margin of at least five percent between the wholsale tariff price to resellers and the lowest available bulk-user discount offered by carriers would compensate approximately for the regulatory costs that resellers incur and bulk-user organizations do not.

53. There are substantial fixed costs associated with the provision of cellular service.

54. Facilities-based carriers enjoy economies of scale at the wholesale level through volume usage and lower bad debt losses, marketing and billing costs, and a lower churn rate.

55. The FCC established 12 RSAs in California and 18 MSAs.

56. The FCC permits a duopoly structure in each RSA comprised of one nonwireline (Block A) operator and one wireline (Block B) carrier.

57. The first RSA became operational in February 1990.

58. The RSAs are located in remote areas with sparse populations.

59. Some facilities-based carriers restrict roaming arrangements to one particular carrier.

60. The refusal by a facilities-based carrier to enter into roaming agreements with unaffiliated carriers in other markets is discriminatory.

61. Wireline cellular carriers enjoyed a head start to operate because of the FCC licensing procedure.

62. The nonwireline carriers had the opportunity to operate as a reseller pending the construction of their respective system.

63. The FCC required the wireline carriers to accommodate the use of the nonwireline carriers' discrete NXX Code so that

nonwireline carrier customers would not have to change their telephone number when the nonwireline carrier became operational as a facilities-based carrier.

64. The wireline carrier, or first carrier, must rely entirely on market projections of a new industry based on demographic analyses which may leave the first carrier with significant excess capacity for a period of time, and must build a system to accommodate the resale customer base of the nonwireline carrier during the head start period.

65. At this time there are no outstanding issues regarding the wireline head start that require Commission action.

66. Roamer service is a service whereby a cellular customer of a carrier in a CGSA travels to another CGSA in which another cellular carrier offers service and the latter cellular carrier provides cellular service to the visiting cellular customer.

67. Facilities-based carriers negotiate roamer arrangements with other cellular carriers. They also negotiate interconnection arrangements with wireline LECs and IECs.

68. Facilities-based carriers are responsible for payment of roaming and toll-interconnection services rendered to their retail subscriber as well as a reseller's retail subscriber.

69. Resellers do not perform any of the special billing functions with respect to roamer traffic and do not participate in the cost of verification of roamer traffic.

70. Reseller costs associated with roamer services are incremental, as compared to the facilities-based carriers' roamer costs.

71. LEC enhanced services are not required to be tariffed.

72. Advantage Group's Phase II comments were tardy because it was not aware of the September 1, 1989 deadline until after it received copies of other parties' comments in the mail.

73. Consumer protection would be advanced by applying the same billing safeguards to cellular enhanced services that have been applied to LEC enhanced services.

74. SJREB opposes Advantage Group's motion to accept late-filed comments.

75. The agent's perspective in this investigation is important.

76. Cellular Dynamics promotes the need for additional regulatory oversight of the duopoly carriers.

77. DRA believes that the duopoly structure impedes competition because each competitor recognizes that any price reduction will be either matched or undercut by the other carrier resulting in a neutral dependence on each other.

78. Carriers face competition not only from direct rivals but from providers of alternative telecommunications services.

79. Any collusion to suppress competition is a violation of antitrust laws.

80. DRA and CRA assert that high return on net cellular plant substantiates that rates are excessive.

81. LACTC represents that the Los Angeles market has steadily increased since March 1987 to the point where nearly 50 percent of all system activation originates with resellers.

82. Cellular risk is substantially different from the monopoly telecommunications market.

83. The cellular industry is in a start-up mode requiring substantial amounts of money to invest in facilities. The upcoming need to install of enhanced digital technology is facing the entire cellular industry.

84. All facilities-based cellular carriers in California lost money during their initial years of operation.

85. The profitability of facilities-based cellular carriers in California varies widely between markets and between carriers in given markets.

86. Some forms of regulatory oversight have encouraged competition.

87. Unlike monopoly local exchange telephone companies, cellular carriers have no captive market of monopoly ratepayers.

88. Allowing cellular carriers to retain all returns on investment earned through the competitive provision of service encourages technological advancement, the expansion of service to new customers, and reductions in unit costs.

89. If a cellular system is operating at or near the limits of its capacity, then a price reduction could increase customer demand and cause a degradation in service quality or the need to ration the availability of service to new customers.

90. The direct control of cellular prices through cost of service or rate of return regulation is inconsistent with the most important regulatory goals of promoting technological advancement, the expansion of service, and economic efficiency.

91. The most important goals for the cellular industry would be best sought through the indirect control of prices through regulatory requirements to expand cellular systems as rapidly as possible and to price so as to fill available capacity with customers.

92. Competition can be enhanced with the undertaking of additional regulatory policies.

93. D.88-05-067 amended GO 96-A to require a 40-day notice for wholesale carriers and 30-day notice for retail carriers.

94. D.88-05-067 recognised that further tariff changes in the context of a broader review of the cellular industry may be warranted.

95. The two-tier tariff notice period does not enhance the competition between carriers.

96. The current tariff provisions require carriers to provide competitors advance notice of marketing strategy.

97. Carriers oppose any simplified index rate mechanism.

98. Rate-indexing proposals are problematic because they determine price changes without reference to market conditions or technological changes occurring at a rapid and uncertain rate.

99. Both DRA's and CRA's alternative rate methods are based on a form of cost-based monopoly regulation.

100. The carrier return on equity has been an ancillary factor in setting market rates.

101. Carrier returns on equity have not been a primary factor in determing market rates for cellular service.

102. The combination of increased pricing flexibility for carriers and Commission oversight of cellular system expansion and utilization will produce just and reasonable wholesale rates through the competitive process.

103. Given the fully competitive nature of the retail cellular industry and the regulatory protections contained in this decision, the competitive process will produce just and reasonable retail rates.

104. Specific interconnection costs and services vary for each cellular carrier because of the unique network characteristics of each cellular carriers system and because of competitive strategy.

105. PacBell and GTE charge cellular carriers and IECs for access services.

106. Cellular carriers provide discretionary cellular radio service in geographical areas which overlap the exchange areas in which the LECs provide service.

107. Unlike IECs, cellular carriers provide a complete substitute for local exchange networks for originating and completing calls to end users. Unlike LECs, most cellular calls originate on the cellular network and terminate on the local exchange network. These facts argue for access arrangements for cellular carriers that are in between those provided by LECs to IECs and to other LECs.

108. Cellular carriers access and benefit from the LECs' local loop.

109. Tariffs for wholesale service enable large organizations who purchase cellular services for their own use to benefit from economies of scale.

110. SJREB, a professional real estate organization, acquired cellular services at a wholesale rate to pass through to its members and to be used for each member's individual use.

111. BACTC's wholesale rates were identical to its large user rates.

112. Price competition can be enhanced by providing wholesale rates to large users of cellular service.

113. CRA argues that SJREB's proposal will enable large organization such as the Chamber of Commerce, medical associations, and bar associations to receive preferential cellular service.

114. U S West's proposed tariff was approved because U S West substantiated that its cost of serving an identified group of users is less than its costs of serving other customers.

115. SJREB's wholesale proposal excluded organizations which are for-profit and nonprofessional organizations.

116. The resellers market is comprised of duopoly carriers, affiliates of duopoly carriers, and independent resellers.

117. The retail market is functioning well.

118. Rapid entry into the resellers market exists because of relatively low regulatory barriers needed for entry and minimal capital requirements.

119. Resellers function adequately during their initial start-up period as well as during subsequent periods of time.

120. Resellers have, on a case-by-case basis, been determined to be a nondominant telecommunications carrier.

121. Comments filed in this investigation confirm that the reseller market is a competitive service.

122. Resellers have filed numerous complaints against carriers subsidizing their operations with commission schemes.

123. Absent an approved tariff filing, cellular equipment discounts, contingent upon the purchase of tariffed cellular services, violate PU Code §§ 532 and 702 if those discounts are offered by utilities or their agents.

124. Conditions on cellular services that differ from those in effective tariffs are unlawful if they are imposed by carriers on their agents.

125. A facilities-based carriers's affiliate is prohibited from reselling in markets where the facilities-based carrier provides retail services.

126. The FCC currently prohibits any resale restrictions pending the results of its rulemaking proceeding.

127. Commission payments of up to $350 per activation are made to agents.

128. D.84-04-014 defines a viable resale program to be a program which provides a potential nonwireline reseller an opportunity to enter the cellular marketplace as a bona fide competitor.

129. CRA relies on D.84-04-014 for its reason to restrict commission rates to $50.

130. Resellers churn rates range from a low of 2 percent to a high of 35 percent.

131. Resellers are not precluded an opportunity to enter the market or to earn a profit.

132. Currently, wholesale carriers are required to provide a 40-day notice prior to any tariff change as compared to resellers' 30-day notice requirement.

<u>Conclusions of Law</u>

1. A "basic service" goal for the cellular industry should not be set at this time.

2. Universal service should not be a goal for the cellular industry at this time.

3. A regulatory monitoring program to assure that cellular carriers are not cross-subsidizing their retail operation should be established to deter possible anticompetitive behavior.

4. Although the quality of cellular service in California is not an issue at this time, continued regulatory oversight of service quality should be maintained.

5. Cellular carriers should perform subscription information verification checks for each new customer prior to service.

6. Regulatory controls to deter fraud should not be set so long as the cellular industry continues taking an active role in reducing consumer fraud.

7. LECs should not be allowed to bill the calling party for cellular service at this time.

8. Cellular privacy oversight controls should not be necessary because there are sufficient safety procedures in place to protect individual subscribers' conversations at this time.

9. Agents should not be required to publish the commission rates they receive from carriers and resellers.

10. Cellular users should not be provided service below the facilities-based carriers' cost to provide service.

11. The cellular industry should be given flexibility to price to attract casual users.

12. The facilities-based carrier should not be precluded from flowing through economies of scale to its bulk-rate users.

13. All facilities-based carriers should be required to provide roaming arrangements to any cellular carrier or reseller desiring to roam.

14. The RSAs cellular carriers should seek flexible and innovative arrangements in their CPC&Ns so that the RSA cellular markets can develop rapidly.

15. A carrier should share with other carriers some portion of the revenues it receives as a result of roaming by customers of the other carriers through negotiated roaming arrangements, taking into account individual carrier's costs and expected benefit to the carrier in whose territory the end user roams.

16. A carrier who chooses to offer enhanced services should be required to offer to provide them to its wholesale customers nondiscriminatory and on a nontariffed basis.

17. End user rights to tariffed services should be protected from nontariffed services.

18. Advantage Group's comments should be considered only to the extent that its comments corroborate other parties' comments.

19. Controls to encourage duopoly competition within a discretionary market should be implemented through regulatory oversight to enhance competition among the carriers and to protect the basic rights of end users.

20. The record does not substantiate that cellular carriers are earning an excessive return on their investment. A monitoring program to track the utilization of the spectrum by facilities-based cellular carriers should be established.

21. The combination of regulatory protections and competition-enhancing policies adopted in this decision will assure that cellular wholesale and retail rates are just and reasonable.

22. A streamlined certification process for RSA carriers should be authorized.

23. The rate proposals of DRA and CRA should not be adopted.

24. Cellular carriers' interconnect agreement with LECs should not be tariffed and should be based on a nondiscriminatory basis, standard terms and conditions which include options for various serving arrangements and pricing structures, and should negotiate cellular interconnection agreements based on these standard terms and conditions.

25. The LECs should be required to support their cost to provide interconnection service to the cellular carrier.

26. All future interconnection agreements should include a mandatory nondiscriminatory clause.

27. Cellular carriers should be classified as LECs co-carriers.

28. Cellular carriers should be required to pay for the use of the LEC facilities they order pursuant to nondiscriminatory interconnection agreements with LECs but should not be required to pay for NTS costs associated with the local loop.

29. SJREB's wholesale proposal should not be adopted.

30. Carriers should implement a large user tariff if there is demand for such service within their SMSAs. Such a large user tariff should contain retail rates which are at levels at least five percent above the wholesale rate but below retail rates. A "large user" should be uniformly defined in the cellular service providers' tariffs as either: (1) a bulk user that purchases cellular service for its own use, or (2) a large organization (such as an affinity group or professional association) that (a) purchases service in volume for the use of its members, officers or employees, and (b) passes through the cost of service to such members, officers or employees. Such a large user should not be considered to be engaging in cellular service resale.

31. CRA's motion to accept Attachment D in its Phase II comments should be granted.

32. The facilities-based carriers should be responsible for innovative pricing schemes for retail rates.

33. Retail cellular carriers should be classified as nondominant telecommunications carriers. This nondominant status should not be applicable to entities which sell cellular services at retail in markets where they either operate or have applied for a FCC facilities-based license.

34. The guidelines and D.89-07-019 adopted by carriers in C.86-12-023 should be adopted and applied to carriers as policy.

35. The issue of whether a facilities-based carriers affiliate should be prohibited from reselling in markets where the facilities-based carrier provides retail service should be considered in the next phase of this investigation.

36. Commission payments to agents should not be restricted.

37. Cellular carriers should include provisons in their large-user tariffs requiring parties buying service thereunder to undertake certain disclosures to individual users.

38. Cellular carriers should be authorized to file revised tariffs in accordance with the more flexible policies articulated in this opinion.

39. The notice period for tariff filings should be revised.

40. Revisions to the cellular USOA should be addressed in the next phase of this investigation.

INTERIM ORDER

IT IS ORDERED that:

1. Cellular service shall be classified as a discretionary service and shall not be considered a universal basic service until such time that the cost of cellular service approaches that of conventional wireline service and until it becomes a direct competitor to conventional landline service.

2. Cellular utilities are authorized to provide, at the wholesale level, nondiscriminatory enhanced services on a detariffed basis.

3. Cellular carriers shall not disconnect any cellular services solely for nonpayment of enhanced service charges and shall notify their customers receiving bills for enhanced services of this rule when the customer receives its first such bill.

4. Cellular carriers shall track all enhanced service complaints as to the number and nature of complaint. All complaints shall be made available to CACD upon request.

5. LECs shall not enter into a billing arrangement with cellular carriers to bill cellular rates to landline customers initiating a call to a cellular customer at this time.

6. A carrier should share with other carries some portion of the revenues it receives as a result of roaming by customers of the other carriers through negotiated roaming arrangements, taking into account individual carrier's costs and expected benefit to the carrier in whose territory the end user roams.

7. Cellular Resellers Association, Inc.'s motion to file Attachment D to its Phase II comments is granted.

8. Cellular utilities tariff requirements shall be modified as follows, pursuant to GO 96-A(XV):

a. The facilities-based carrier's 40-day tariff notice is reduced to 30 days.

b. A cellular carrier's or reseller's rate reduction tariff filing which will not impact a carrier's average customer's bill by more than 10 percent, whether it be a facilities-based carrier or a reseller, shall be classified as a temporary tariff and made effective on the date filed. The temporary tariff status shall also be applicable to advice letter filings not imparting any price changes.

(1) Absent any protest to the tariff filing within the statutory 20-day protest period, the temporary status of the tariff shall expire and it shall be classified as a permanent tariff pursuant to the terms of the tariff provisions.

(2) If a protest is filed, the tariff shall remain a temporary tariff until the protest has been resolved or by order of the Commission.

9. A cellular carrier seeking an increase in rates shall substantiate its request in an advice letter filing and shall provide:

a. Market studies based specifically on data within its respective MSA.

b. Actual return on investment data for its prior 3 calendar years.

c. Projected return on investment based on its proposed rates.

d. Explanation of any major change (50 basis points) in the projected return on investment over the prior 3-year recorded average.

e. Cost-support data as requested by Commission staff.

10. Interconnection arrangements between cellular carriers and LECs shall be offered on a nondiscriminatory basis and shall not be tariffed. LECs shall offer to cellular carriers, on a nondiscriminatory basis, standard terms and conditions which include options for various serving arrangements and pricing structures, and shall negotiate cellular interconnection agreements based on these standard terms and conditions.

11. The local exchange companies shall substantiate their cost to provide interconnection to a cellular carrier upon request of the cellular carrier.

12. LECs shall not provide "mutual compensation" to the cellular carriers at this time.

13. A cellular carrier shall pay access charges for the use of the LEC access facilities it orders pursuant to a nondiscriminatory interconnection agreement with the LEC, and shall not pay for NTS costs associated with the local loop.

14. A retail cellular carrier not associated with either a facilities-based cellular carrier or an entity applying for a facilities-based carrier permit before the FCC shall be classified

a nondominant carrier and shall obtain the same benefits as other nondominant telecommunications carriers.

15. There shall be no mandatory margin between the wholesale and retail rates of facilities-based carriers. However, individual facilities-based carriers shall not deviate from the current mandatory retail margin until cost-allocation methods are adopted and implemented as part of the cellular USOA unless they can demonstrate through an advice letter filing that the retail operation will continue to operate on a break-even or better basis with proposed rate changes that impact the mandatory retail margin.

16. Cellular carriers shall adopt the following guidelines regarding agent arrangements:

a. No provider of cellular telephone service may provide, cause to be provided, or permit any agent or dealer or other person or entity subject to its control to provide cellular telephone service at any rate other than such provider's tariffed rate. No such provider may permit any agent or dealer or other person or entity subject to its control to pay for all or any portion of the cellular service which it provides to any customer.

b. Unless authorization has been sought and obtained through an advice letter filing in accordance with the provisons of GO 96-A, no provider of cellular telephone service may provide, either directly or indirectly, any gift of any article or service of more than nominal value (e.g., permitted gifts could be pens, key chains, maps, calendars) to any customer or potential customer in connection with the provision of cellular telephone service.

c. Unless authorization has been sought and obtained through an advice letter filing in accordance with the provisons of GO 96-A, no provider of cellular telephone service may provide, cause to be provided, or permit any agent or dealer or other person or entity subject to its control to provide to any customer or potential customer any

> equipment price concession or any article or service other than nominal value which is paid for or financed in whole or in part by the service provider and which is offered on the condition that such customer or potential customer subscribes to the provider's cellular telephone service.

17. Commission rates that cellular carriers pay to its agents shall not be restricted.

18. Facilities-based carriers shall implement a "large-user" tariff for its customers if sufficient demand exists within a MSA. The large user tariff rate shall be set at least five percent (5%) higher than the carrier's retail rate. To qualify for the large-user tariff the entity must serve as the master customer, guarantee payment for all usage by its members, and not apply any additional charges to its members for such services. The five percent margin shall not affect any rate offered by a carrier to a government agency.

19. Cellular carriers who want to block cellular telephone instrument ESNs shall tariff their blocking procedures and requirements for releasing the ESN blocks consistent with the guidelines identified in this opinion.

20. C.86-12-023 is closed.

21. Within 90 days of the effective date of this decision, all certificated carriers shall file amended tariffs to reflect the policies regarding customer deposits identified in this opinion.

22. Cellular carriers shall implement consumer protection provisions in their respective large user tariffs for large users who do not use the service for their own personal use.

23. This investigation is kept open to address through either workshops, or evidentiary hearings:

   a. A streamlined certification process for RSA facilities-based carriers.

   b. The ability of cellular resellers to perform switching functions currently provided by the cellular carriers and the unbundling of the wholesale tariff rate element.

c. Whether or not a facilities-based carrier's affiliate should be prohibited from reselling in markets where the facilities-based carrier provides retail services.

d. Duopoly carriers' reporting requirements that will enable us to assess and monitor on a twice-yearly basis cellular capacity utilization, capacity expansion, development of cellular services in rural areas, and prices charged for cellular services.

e. Modify the USOAs to include cost-allocation methods for a carriers's wholesale and retail operations.

This order is effective today.

Dated June 6, 1990, at San Francisco, California.

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

I will file a written dissent.

/s/ FREDERICK R. DUDA
Commissioner

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

NEAL J. SHULMAN, Executive Director
DB

APPENDIX A
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List of Appearances

Respondents: Orrick, Herrington & Sutcliffe, by Ronald Aronovsky and Robert Gloistein, Attorneys at Law, for Fresno MSA Limited Partnership; Jackson, Tufts, Cole & Black, by William Booth, Joseph S. Faber, and Evelyn K. Mc Cormish, Attorneys at Law, for U S West Cellular of California, Inc.; Mary B. Cranston and Roger P. Downes, Attorneys at Law, for PacTel Cellular, PacTel Mobile Service, L.A. SMSA Ltd. Partnership, and Sacramento Valley Ltd. Partnership; Graham & James, by Martin A. Mattes and Richard L. Goldberg, Attorneys at Law, for Bay Area Cellular Telephone Company; Rod Johnson and Cynthia D. Scott, Attorneys at Law, for GTE Mobilnet, Incorporated; Bonnie Packer, Attorney at Law, for Pacific Bell; Alan Pepper, Attorney at Law, for Cellular Dynamics Telephone Company of Los Angeles, Inc.; Cooper, White & Cooper, by Mark P. Schreiber, E. Garth Black, and Alvin H. Pelavin, Attorneys at Law, for Roseville Telephone Company; Dinkelspiel, Donovan & Reder, by David A. Simpson, Attorney at Law, for Santa Barbara Cellular Systems, Ltd., Santa Cruz Cellular Telephone Company, Bakersfield Cellular Telephone Company, and Cagal Cellular Communications Corporation; Armour, St. John, Wilcox, Goodin & Scholtz, by James D. Squeri and Barbara Snider, Attorneys at Law, for GTE Mobilnet; Morrison & Foerster, by James M. Tobin and Marc P. Fairman, Attorneys at Law, for McCaw Cellular Communications, Inc. and Affiliates; and Dinkelspiel, Donovan & Reder, by David M. Wilson, Attorney at Law, for Los Angeles Cellular Telephone Company.

Interested Parties: Cooper, White & Cooper, by Mark P. Schreiber, E. Garth Black, and Alvin H. Pelavin, Attorneys at Law, for Calaveras Telephone Company, California-Oregon Telephone Company, Ducor Telephone Company, Foresthill Telephone Company, The Volcano Telephone Company, and Ponderosa Telephone Company; C. Hayden Ames, Attorney at Law, for Chickering & Gregory; Davis, Young, Beck & Mendelson, by Jeffrey F. Beck and Sheila B. Brutoco, Attorneys at Law, for CP National, Citizens Utilities Company of California, Evans Telephone Company, Happy Valley Telephone Company, Hornitos Telephone Company, Kerman Telephone Company, Pinnacles Telephone Company, Sierra Telephone Company, Inc., The Siskiyou Telephone Company, Tuolumne Telephone Company, and Winterhaven Telephone Company; John H. Engel, Attorney at Law, and A. J. Smithson, for Citizens Utilities Company of California; Peter A. Casciato, Attorney at Law, for Cellular Resellers Association, Inc.; Randolph W. Deutsch, Attorney at Law, for AT&T Communications of California, Inc.;

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Kenneth K. Okel and Robert N. Herrera, Attorneys at Law, for GTE California, Incorporated; Pierson, Ball & Dodd, by Judith St. Ledger Roty, Attorney at Law, for National Cellular Resellers Association; Kim C. Mahoney, for CP National Corporation; Jeffrey B. Cutherell, for Contel of California, Inc.; Mary Lynn Gauthier, for Gauthier & Hallett; William G. Irving, for County of Los Angeles; Thomas J. O'Rourke, for O'Rourke & Company; and Sidney J. Webb, for himself.

Division of Ratepayer Advocates: Janice Grau, Attorney at Law.

(END OF APPENDIX A)

APPENDIX B

PHASE I COMMENTS

AT&T Communications of California, Inc. (U-5002-C)
Bakersfield Cellular Telephone Company (U-3017-C)
Bay Area Cellular Telephone Company (U-3007-C)
Cagal Cellular Communications Corporation (U-3021-C)
Cellular Dynamics Telephone Company of Los Angeles, Inc. (U-4046-C)
Cellular Resellers Association, Inc.
Cellular Telecommunications Industry Association
CP National (U-11-C), Citizens Utilities Company of California (U-87-C), Evans Telephone Company (U-1008-C), Happy Valley Telephone Company (U-1010-C), Hornitos Telephone Company (U-1011-C), Kerman Telephone Co. (U-1012-C), Pinnacles Telephone Company (U-1013-C), Sierra Telephone Company, Inc. (U-1016-C), The Siskiyou Telephone Company (U-1017-C), Tuolumne Telephone Company (U-1018-C), The Volcano Telephone Company (U-1019-C), and Winterhaven Telephone Company (U-1021-C)
Division of Ratepayer Advocates
Fresno MSA Limited Partnership (U-3005-C)
GTE California Incorporated (U-1002-C)
GTE Mobilnet of California Limited Partnership (U-3011-C) and GTE Mobilnet of Santa Barbara Limited Partnership (U-3011-C)
International Mobile Machines Corporation
Los Angeles Cellular Telephone Company (U-3009-C)
McCaw Cellular Communications, Inc., Fresno Cellular Telephone Company (U-3014-C), Napa Cellular Telephone Company (U-3016-C), Oxnard Cellular Telephone Company (U-3010-C), Redding Cellular Partnership (U-3020-C), Sacramento Cellular Telephone Company (U-3013-C), Salinas Cellular Telephone Company (U-3018-C), and Stockton Cellular Telephone Company (U-3012-C)
Pacific Bell (U-1001-C)
PacTel Cellular (U-3001-C), and its affiliates Sacramento Valley Limited Partnership (U-3003-C), Los Angeles SMSA Limited Partnership (U-3003-C), and PacTel Mobile Systems (U-4023-C)
Radio Electronics Products Corporation, Inc. (U-2048-C)
Redwood Cellular Communications, Inc. (U-4062-C)
Roseville Telephone Company (U-1015-C)
Santa Barbara Cellular Systems, LTD. (U-3015-C)
Santa Cruz Cellular Telephone Company (U-3019-C)
U S West Cellular of California, Inc. (U-3008-C)

(END OF APPENDIX B)

APPENDIX C

PHASE II COMMENTS

Advantaged Group
Bakersfield Cellular Telephone Company (U-3017-C)
Bay Area Cellular Telephone Company (U-3007-C)
Cellular Dynamics Telephone Company of Los Angeles, Inc.
Cellular Radiotelephone Utilities
Cellular Resellers Association, Inc.
Cellular Service Inc.
Cellular Telecommunications Industry Association
CP National (U-11-C), Citizens Utilities Company of California (U-87-C), Evans Telephone Company (U-1008-C), Kerman Telephone Company (U-1012-C), Pinnacles Telephone Company (U-1013-C), Sierra Telephone Company, Inc. (U-1016-C), The Siskiyou Telephone Company (U-1017-C), Tuolumne Telephone Company (U-1018-C), and The Volcano Telephone Company (U-1019-C)
Division of Ratepayer Advocates
Fresno MSA Limited Partnership (U-3005-C)
GTE California Incorporated (U-1002-C)
GTE Mobilnet of California Limited Partnership (U-3002-C) and GTE Mobilnet of Santa Barbara Limited Partnership (U-3011-C)
International Mobile Machine Corporation
Los Angeles Cellular Telephone Company (U-3009-C)
McCaw Cellular Communications, Inc., Fresno Cellular Telephone Company (U-3014-C), Napa Cellular Telephone Company (U-3016-C), Oxnard Cellular Telephone Company (U-3010-C), Redding Cellular Telephone Partnership (U-3020-C), Sacramento Cellular Telephone Company (U-3013-C), Salinas Cellular Telephone Company (U-3018-C), and Stockton Cellular Telephone Company (U-3012-C)
Pacific Bell (U-1001-C)
PacTel Cellular (U-3001-C) and its affiliates Sacramento Valley Limited Partnership (U-3004-C), Los Angeles SMSA Limited Partnership (U-3003-C), and PacTel Mobile Services (U-4023-C)
Radio Electronic Products Corporation Inc.
San Jose Real Estate Board
Santa Barbara Cellular Systems, Ltd. (U-3015-C)
Santa Cruz Cellular Telephone Company (U-3019-C)
US West Cellular of California, Inc. (U-3008-C)

(END OF APPENDIX C)

FREDERICK R. DUDA, Commissioner, dissenting.

Although I agree with the majority's decision to grant downward only pricing flexibility, to reduce tariff change notice requirements, and to make a number of other necessary adjustments to the cellular marketplace, I am filing this dissent because I believe that present cellular rates are excessive and that by allowing these rates to continue into the indefinite future the majority has abdicated its responsibility to enforce the Public Utilities Code § 451 requirement that all utility rates be just and reasonable. I would have preferred a simple mechanism to true-up rates of carriers in the major metropolitan markets to a level commensurate with a fair and reasonable rate of return.

In 1989, CACD analyzed cellular rates of return on investment and found that, by their own calculations, 5 carriers in the 3 major markets earned returns on investment ranging from over 20 to more than 50% percent. The California Reseller's Association analysis of the Los Angeles, San Diego, and San Francisco/San Jose market operations in 1988 show that wholesalers' investment returns in these markets ranged from 25.3 percent to 123.1 percent. CRA's comments showed that the weighted average rate of return on net book plant of the duopoly cellular carriers operating for at least 3 years exceeded 45 percent.

When compared to the returns authorized for other utility sectors, which hover around 10 to 11%, rising to a ceiling level of 16.5% for General Telephone and Pacific Bell, cellular returns in excess of 50% are excessive.

I cannot agree with the majority's rationalization for these excessive rates.

I believe that cellular radiotelephone service is an essential public utility service that is furnished on a non-competitive basis by franchised carriers who, absent some regulatory constraints, have the ability to and in fact do exert significant market power in the setting of rates. The DRA, in its Phase I Comment, notes: "It appears that market-driven forces rather than the cost of providing service determines the actual prices charged and that there is collusion between the carriers who offer cellular services." Indeed, even in the absence of explicit collusion, the non-competitive character of the cellular market noted by the DRA is entirely consistent with the duopoly market structure adopted by the Federal Communications Commission (FCC) and under which this industry operates. Unfortunately, the majority decision, while generally dismissing the possibility of outright collusion, fails to appreciate the full impact of the FCC-mandated market structure and, as a consequence, has made erroneous findings as to the nature and extent of actual, effective, competition among the wholesale facilities-based carriers.

I will now address the fundamental misunderstandings as to the structure and competitiveness of the cellular market that, in my view, have misdirected the majority to erroneous policy conclusions.

Cellular service is not discretionary for many users. I agree with the County of Los Angeles that the perception of cellular service as discretionary is basic to the majority's proposal for reduced regulation of cellular carriers and is also fundamentally incorrect. For example, the use of cellular communications by agencies of the County of Los Angeles is for essential public safety and other public services the efficiency and effectiveness of which are facilitated by the availability of high quality mobile telephone communications. Cellular telephone service is a natural extension of and enhancement to the wireline telephone network, and is fast becoming no more discretionary to the efficient functioning of a government or business organization than any of a large number of "business telephone services," such as private lines, digital data services, and local and long distance calling. These facts rebut the majority's discretionary service concept.

In Fiscal Year 1990 the County of Los Angeles will spend some $325,000 on cellular services furnished by PacTel Cellular. Moveover, this expenditure is expected to increase to about $375,000 to $400,000 in FY 1991. Cellular communications is utilized to support and facilitate a variety of public safety and other essential public services, among which are:

- Maintenance of essential contact among Department heads and key management personnel when in transit between county facilities and/or their residences.
- Coordination of various County field services with local municipalities and communities.
- Field use by Department of Children's Services in connection with reported cases of child abuse.
- Coordination of agencies involved in clean-up of hazardous waste spills.
- Hostage negotiation.
- Undercover narcotics investigations.
- Coordination of security and other protocol arrangements incident to visits by various dignitaries.

I am convinced these are highly sensitive important governmental uses of cellular telephone service and are in no way discretionary. I believe it is both unfair and patently incorrect to suggest that cellular is some sort of a "luxury" that deserves less regulatory protection from excessive prices than other essential telecommunications services that, like cellular, are furnished on a monopolistic basis.

Further, cellular service will continue to become more of a basic service into the future <u>if</u> rates are reduced. As rates go down, more business and residential users will enter the market. This will spur the need for more capacity, which (after capital costs are sunk for digitalization) will likely lower the per-unit costs even further. Thus, rates should decrease even further. As cellular rates decrease, cellular service will become more competitive with landline service, especially if landline rates increase. As we are consistently told by the landline firms, basic landline rates are far below cost. Thus I envision the day soon when the costs and rates for cellular and landline telephony are not far apart. Of course, this is wholly dependent upon affirmative actions by this Commission to reduce cellular rates.

The majority concludes that the duopoly provides for a sufficient level of competition between the two suppliers. They conclude that only through collusive behavior could the two incumbents jointly monopolize the market, and that such behavior would be illegal. However, the duopoly market structure adopted by the FCC is incapable of assuring adequate price competition between the franchised facilities-based carriers. The majority appears to accept the arguments of the facilities-based carriers that the duopoly market structure provides a workably, if not perfectly, competitive market if only minor changes to tariff arrangements are made. I disagree. The duopoly market structure permits the two carriers serving each market to behave duopolistically with respect to their joint pricing policies.

Duopoly theory tells us that both firms will tend to keep prices above the competitive level and compete on service rather than price. Even without explicit collusion, both firms realize that reducing prices will result in lower profits since the other firm can match the reduction; both firms know it is better to limit demand but increase profits by independently avoiding any rate decreases not mandated by regulators. This is exactly what we have seen in California. In D.84-04-014, this Commission set rates in order to provide an adequate return for carriers, as well as a sufficient margin to create a viable business opportunity for potential resellers. Despite customer growth far beyond expectations, which should have reduced the per unit cost of cellular service, there have been almost no basic service price changes by either carrier in any market since rates were set over five years ago. Instead, cellular returns on investment have skyrocketed.

Wholesale cellular prices should be set on the basis of cost, excluding any economic premiums paid by the facilities based carriers for their acquisition of their cellular franchise on the open market. While cellular radiotelephone systems do in fact exhibit high fixed costs, these are often dwarfed by the substantial market-driven prices that have been paid by their owners to acquire the franchise from a previous holder. These acquisition premiums are not costs in the regulatory sense; they are nothing more than the present discounted value of the monopoly rents that the buyers of these franchises believed were available as a direct consequence of the facilities-based carriers' ability to set prices at monopolistic levels. In other words, these high acquisition costs are based on the assumption that no outside force -- either the market or the regulators -- will prevent the continuation of duopoly profits. The Commission should not permit these discounted excess profits to be transformed into "costs" that are in turn utilized as a basis for setting prices.[1]

History provides a key to understanding the cellular industry today. When the Federal Communications Commission (FCC) in 1979 initiated its efforts to create a regulatory framework for the yet to be established cellular radio service industry, it

1 The Commission presently excludes acquisition premiums from rate base in order to ensure that utilities earn a return only on plant used to provide utility service and not on unproductive profit motivated acquisition payments. If acquistion premiums were rate based, utilities would have an incentive to increase their rate base through frequent nominal ownership changes and sizable acquisition adjustments; this would exert substantial upward pressure on utility earnings and rates without any accompanying consumer benefits.

confronted the conflicting goals of creating a competitive industry structure while at the same time assuring rapid development and deployment of the new technology to the public. The FCC's response to this dilemma was to allocate half of the available frequency spectrum earmarked for cellular to an indigenous wireline telephone utility while reserving the other half for non-wireline applicants. The FCC thought that although the wireline carrier would be able to initiate service sooner than the non-wireline carrier the non-wireline carrier would eventually provide effective wholesale price competition which could help it overcome the wireline carrier's head start advantage. Unfortunately, the FCC's duopoly market structure creates a bottleneck, allowing suppliers to charge prices well in excess of actual cost.

The scarcity of cellular licenses, coupled with the absence of effective state regulation of cellular rates, made the licenses so valuable that they are now traded at figures many times greater than their original cost.[2]

In other utility sectors, monopoly franchises are granted because we believe that the development of duplicative utility infrastructure would be economically and socially wasteful. Public rights of way would be constantly torn up as redundant pipelines and wires were installed and repaired, and the utilities could not benefit from the full economies of scale associated with their massive investment if their facilities were underutilized because

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2 Wireline carriers in particular have realized an enormous economic windfall from the appreciation in the market value of the wireline cellular licenses which they received at no cost from the FCC. Bacause all of the RBOCs have since transferred these gifted assets to their non-price regulated cellular affiliates, all of the economic benefits associated with the windfall gains and profit opportunities that now exist within the cellular market because of the non-wireline price umbrella accrue in their entirety to stockholders of Pacific Telesis and GTE. There is no cellular cash flow to support basic services.

the demand was too thinly spread over competing systems. Because utility franchises granted for society's benefit could unjustly enrich their owners by giving them monopoly market power, however, the grant of such franchises is accompanied by the placing of limits on the rates those governmentally created monopolists can charge.

Today's decision, unfortunately, gives cellular carriers the opportunity to take advantage of their duopolistic market status with no effective price constraints. We have created an unregulated duopoly.

The magnitude of the monopoly rent, or excess profit, at issue is the discounted present value of future excess profits which is revenues less direct service-related costs, including return on the physical plant actually deployed in providing the service. In my opinion this is the basis for the market values of cellular franchises that have changed hands in California. The excess payment is instead a direct and inescapable consequence of the FCC's duopoly policy and the willingness of regulators such as ourselves to permit cellular carriers to impose prices for their services that include such economic rents. This is a fundamental mistake that must be corrected now.

The monopoly rent that we allow the wholesale carriers to extract from their subscribers is a windfall gain over and above any normal or "fair" return on the investment made in actual cellular plant in service. The earned rate of return on actual investment in cellular plant in service by the Los Angeles wireline cellular carrier, LA SMSA Partnership, was an incredible 41.56% for 1987. The fact that the market value of a cellular utility exceeds the cost of the physical equipment (towers, transmitters, etc.) is further evidence of the presence of a monopoly rent on the cellular capacity. In my view, the presence of these windfall gains is clear evidence of a fundamental failure of regulation of this service, and one that should be remedied now, before conditions become even more untenable.

I have urged my fellow Commissioners to regulate in a simple and straightforward manner to ensure fair rates for consumers and only reasonable returns to investors. I believe we must do this now. In particular, the regulated wireline telephone utilities who received "wireline set-aside" cellular licenses from the FCC have no more entitlement to benefit from the windfall gains associated with this franchise award in setting service prices than would any other public utility.

Utilities are not entitled to monopoly rents. Economic regulation is intended precisely to prevent utilities from earning such rents. Prices for bottleneck services furnished by franchised, facilities-based cellular wholesale carriers should be set on the basis of cost, defined for this purpose in the same fundamental way as it would be for any other telephone utility under the Commission's administrative jurisdiction. This imperative is the fundamental building block of a growing healthy, stable, universal cellular telephone infrastructure for California. There are alternate ways and means to accomplish this result. I have suggested the simple mechanism of a "true-up" of carrier's rates to a fair rate of return level (perhaps at the high end of that allowed in the Pacific Bell and GTEC sharing formula).

The current high rates cannot be justified by the need to encourage further utility investment. The use of high rates to stimulate investment is contrary to longstanding regulatory law and policy. In the past, telecommunications utility rates were designed to allow a utility to recover the costs of providing the utility service plus a fair return on its rate base investment. Rates of return were set at levels comparable to those earned by businesses facing similar risks; and were designed to maintain the financial integrity of the utility and allow it to continue to attract capital. These returns themselves provide the incentive for new investment in other utility sectors, which have had no trouble attracting adequate investment capital. None of these basic principles have changed under the new LEC regulatory framework; the added flexibility is intended to increase the LEC's incentive to operate efficiently while still providing service at reasonable rates. There is no reason to create an additional unique windfall incentive for cellular investment by allowing clearly excessive returns now and into the future.[3]

I find complaints about the difficulty of applying rate of return regulation to the cellular industry an unconvincing reason to adopt the pretense of a market based regulatory structure. I also note that my alternate did not advocate traditional rate of return regulation, but merely a simple true-up mechanism similar to that recently adopted in D.89-10-031.

I recognize that, as the majority points out, different carriers have different cost structures. The cost variations may result from the timing of entry into the market place, with variations in the technology utilized, with the acquisition price paid for the cellular franchise, and so on.[4] I note that the impact of these cost differences may be overwhelmed by other factors and that our review of the relationship between the wireline and nonwireline carriers ultimately concluded that neither

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3 Especially since the majority considers cellular service discretionary.

4 Unfortunately, since the wireline licenses were awarded at no cost, while the non-wireline licenses were awarded through a lottery approach that inspired those who were not awarded licenses to bid for licenses from those who originally received them, non-wireline carriers generally paid more for their franchise license than wireline carriers. If all other costs were equal, non-wireline carriers would have to charge more than wireline carriers to recover their investment. Faced with a competitor with an incentive to charge higher rates, the wireline carrier in a market need only charge slightly less in order to compete succesfully. This creates a "price umbrella" for wireline carriers.

had a clear competitive advantage over the other. This conclusion is further supported by evidence that nonwireline carriers often earn a much greater return on their cellular investment than do their wireline competitors.

In any event, I believe that the cellular provider who can provide quality service at the most reasonable price should be allowed to benefit from its economic efficiencies. After all, we are not in the business of offering a safe economic haven for noncompetitive competitors. If we keep rates high simply so the higher-priced provider did not need to take the steps necessary to bring its costs down to a truly competitive level, we are not meeting our obligation to California's cellular consumers. Further, the majority opinion allows downward only pricing flexibility; I support this provision. With this flexibility, the carrier with the higher rates resulting from basing rates more on costs could lower its rates to the levels of the more efficient carrier. This has the additional benefit of giving a strong incentive to the higher cost carrier to become more efficient.

The majority's belief that the current high rates serve the useful purpose of discouraging new demand which might overwhelm the capacity of cellular systems is not supported by the record and leads to an elitist distinction between rich and poor consumers. All parties to this proceeding agreed there were no present constraints on cellular capacity. At worst, there are a few locations in Los Angeles where a temporary bottleneck exists because cell site development lags demand during peak traffic hours. Even if there was a real reason to fear future capacity constraints, a "first come, first served" rationing plan would make more economic and social sense than one which uses price to indirectly regulate demand.

To me, the majority's entire approach seems simplistic and short-sighted. Although it recognizes that current returns on cellular investment greatly exceed those allowed other utilities, it waxes eloquent about the need to encourage massive investment in this allegedly discretionary utility service and refuses to reduce rates to reasonable levels. Consumers are supposed to take comfort from statements that sometime down the road, if we believe rates have not been reduced to levels necessary to provide full utilization of the cellular system, we will review rates and reduce them if necessary. Under a capacity utilization approach, however, it would seem probable that all cellular carriers would need to do to meet the majority's full utilization criteria would be to offer a series of small rate reductions designed to ferret out the highest level of prices the market would bear and still keep the system full. These rates could still be far in excess of those needed to recover operational costs and a fair return, but they would almost certainly lead the majority to conclude that the rates were still just and reasonable unless, of course, the majority eventually decides that rates should bear some relationship to the costs incurred in providing the utility service.

Even if effective competition is not present at the wholesale level, there is at least the possibility that it might occur at the retail level if the facilities-bases carriers are required to allocate costs between these two activities in a fair and reasonable manner and to set their wholesale prices on the bases of the appropriately allocated costs of wholesale service. This is one of the encouraging signs in the majority opinion. However, this is unlikely to occur absent an explicit regulatory requirement, because the facilities-based carriers have a strong economic incentive to frustrate competition at the retail level as well as the market power to accomplish precisely this result. The majority's approach may help to control this problem; we shall see.

In any event, requiring retail operations to be profitable will not solve the excessive wholesale rate problem.

In my view wholesale and retail cellular prices are excessive and must be reduced. Excessive pricing of this essential telecommunications service discourages beneficial usage and creates deadweight losses in the economy generally. I believe the appropriate regulatory action that will prevent franchised facilities-based wholesale cellular carriers to extract monopoly rents from their control of scarce bottleneck cellular licenses is for wholesale cellular rates to be set on the basis of cost.

Although this is a relatively new industry, it is clearly operating well beyond any "start-up" phase in which the capital costs are so high that current cash flows are necessarily negative. A $500 million a year, 5 years old industry is not a start up operation. The fact that the market for cellular licenses will support prices that are many multiples of the actual cost of cellular plant is, standing alone, a fully sufficient demonstration that no special regulatory considerations with respect to start-up or capital attraction is required. Experience shows capital investment has been no problem. The only reasonable conclusion that is possible is that cost-based prices developed in a manner that is consistent with traditional Commission practice are essential to assure that this important and essential service is offered on a fair, just, reasonable and non-discriminatory basis. My alternate proposed to regulate profits so as to achieve that positive result.

The opinions I have expressed here have adopted to a great extent material submitted in this case by the County of Los Angeles. Their comments brought clarity, insight and perception to the issues. In particular, I concur with the L.A. County analysis of the cellular industry origins, growth, and development leading to the opportunities and problems of today. I deeply regret that rate reductions that the people of California are entitled to are not being ordered at this time.

The people of the State of California as U.S. citizens are the owners of the cellular airways, the radio spectrum. It is for their benefit that licenses to use that radio spectrum are given. Spectrum use must never be managed in any way that deprives the people of what is rightfully theirs. Cellular utilities should be required to expand their facilities and use the most modern technology in order to make this incomparable service available to the greatest number of Californians possible.

It is this Commission's fundamental duty to make sure Californians receive the best service at the least cost. This duty is owed to all Californians, not just the wealthy ones. Excessive rates for cellular service deprive many people the use of this valuable service. Many small businesses suffer competitive disadvantages because they can't afford cellular prices at current rates. This is wrong and must be corrected. The denial of rate reductions leaves unjust rates.

Potential future rate reductions are but pie in the sky. I believe that justice delayed is justice denied. The present failure to order the adjustment of rates downward to a just and reasonable level is a grave mistake. This glaring error can be corrected; the sooner the better.

/s/ FREDERICK R. DUDA
Frederick R. Duda, Commissioner

June 6, 1990
San Francisco, California

I.88-11-040 et al.
D.90-06-025

90-06-025
6/6

FREDERICK R. DUDA, Commissioner, dissenting.

Although I agree with the majority's decision to grant downward only pricing flexibility, to reduce tariff change notice requirements, and to make a number of other necessary adjustments to the cellular marketplace, I am filing this dissent because I believe that present cellular rates are excessive and that by allowing these rates to continue into the indefinite future the majority has abdicated its responsibility to enforce the Public Utilities Code § 451 requirement that all utility rates be just and reasonable. I would have preferred a simple mechanism to true-up rates of carriers in the major metropolitan markets to a level commensurate with a fair and reasonable rate of return.

In 1989, CACD analyzed cellular rates of return on investment and found that, by their own calculations, 5 carriers in the 3 major markets earned returns on investment ranging from over 20 to more than 50% percent. The California Reseller's Association analysis of the Los Angeles, San Diego, and San Francisco/San Jose market operations in 1988 show that wholesalers' investment returns in these markets ranged from 25.3 percent to 123.1 percent. CRA's comments showed that the weighted average rate of return on net book plant of the duopoly cellular carriers operating for at least 3 years exceeded 45 percent.

When compared to the returns authorized for other utility sectors, which hover around 10 to 11%, rising to a ceiling level of 16.5% for General Telephone and Pacific Bell, cellular returns in excess of 50% are excessive.

I cannot agree with the majority's rationalization for these excessive rates.

I believe that cellular radiotelephone service is an essential public utility service that is furnished on a non-competitive basis by franchised carriers who, absent some regulatory constraints, have the ability to and in fact do exert significant market power in the setting of rates. The DRA, in its Phase I Comment, notes: "It appears that market-driven forces rather than the cost of providing service determines the actual prices charged and that there is collusion between the carriers who offer cellular services." Indeed, even in the absence of explicit collusion, the non-competitive character of the cellular market noted by the DRA is entirely consistent with the duopoly market structure adopted by the Federal Communications Commission (FCC) and under which this industry operates. Unfortunately, the majority decision, while generally dismissing the possibility of outright collusion, fails to appreciate the full impact of the FCC-mandated market structure and, as a consequence, has made erroneous findings as to the nature and extent of actual, effective, competition among the wholesale facilities-based carriers.

I will now address the fundamental misunderstandings as to the structure and competitiveness of the cellular market that, in my view, have misdirected the majority to erroneous policy conclusions.

Cellular service is not discretionary for many users. I agree with the County of Los Angeles that the perception of cellular service as discretionary is basic to the majority's proposal for reduced regulation of cellular carriers and is also fundamentally incorrect. For example, the use of cellular communications by agencies of the County of Los Angeles is for essential public safety and other public services the efficiency and effectiveness of which are facilitated by the availability of high quality mobile telephone communications. Cellular telephone service is a natural extension of and enhancement to the wireline telephone network, and is fast becoming no more discretionary to the efficient functioning of a government or business organization than any of a large number of "business telephone services," such as private lines, digital data services, and local and long distance calling. These facts rebut the majority's discretionary service concept.

In Fiscal Year 1990 the County of Los Angeles will spend some $325,000 on cellular services furnished by PacTel Cellular. Moveover, this expenditure is expected to increase to about $375,000 to $400,000 in FY 1991. Cellular communications is utilized to support and facilitate a variety of public safety and other essential public services, among which are:

- o Maintenance of essential contact among Department heads and key management personnel when in transit between county facilities and/or their residences.
- o Coordination of various County field services with local municipalities and communities.
- o Field use by Department of Children's Services in connection with reported cases of child abuse.
- o Coordination of agencies involved in clean-up of hazardous waste spills.
- o Hostage negotiation.
- o Undercover narcotics investigations.
- o Coordination of security and other protocol arrangements incident to visits by various dignitaries.

I am convinced these are highly sensitive important governmental uses of cellular telephone service and are in no way discretionary. I believe it is both unfair and patently incorrect to suggest that cellular is some sort of a "luxury" that deserves less regulatory protection from excessive prices than other essential telecommunications services that, like cellular, are furnished on a monopolistic basis.

Further, cellular service will continue to become more of a basic service into the future _if_ rates are reduced. As rates go down, more business and residential users will enter the market. This will spur the need for more capacity, which (after capital costs are sunk for digitalization) will likely lower the per-unit costs even further. Thus, rates should decrease even further. As cellular rates decrease, cellular service will become more competitive with landline service, especially if landline rates increase. As we are consistently told by the landline firms, basic landline rates are far below cost. Thus I envision the day soon when the costs and rates for cellular and landline telephony are not far apart. Of course, this is wholly dependent upon affirmative actions by this Commission to reduce cellular rates.

The majority concludes that the duopoly provides for a sufficient level of competition between the two suppliers. They conclude that only through collusive behavior could the two incumbents jointly monopolize the market, and that such behavior would be illegal. However, the duopoly market structure adopted by the FCC is incapable of assuring adequate price competition between the franchised facilities-based carriers. The majority appears to accept the arguments of the facilities-based carriers that the duopoly market structure provides a workably, if not perfectly, competitive market if only minor changes to tariff arrangements are made. I disagree. The duopoly market structure permits the two carriers serving each market to behave duopolistically with respect to their joint pricing policies.

Duopoly theory tells us that both firms will tend to keep prices above the competitive level and compete on service rather than price. Even without explicit collusion, both firms realize that reducing prices will result in lower profits since the other firm can match the reduction; both firms know it is better to limit demand but increase profits by independently avoiding any rate decreases not mandated by regulators. This is exactly what we have seen in California. In D.84-04-014, this Commission set rates in order to provide an adequate return for carriers, as well as a sufficient margin to create a viable business opportunity for potential resellers. Despite customer growth far beyond expectations, which should have reduced the per unit cost of cellular service, there have been almost no basic service price changes by either carrier in any market since rates were set over five years ago. Instead, cellular returns on investment have skyrocketed.

Wholesale cellular prices should be set on the basis of cost, excluding any economic premiums paid by the facilities based carriers for their acquisition of their cellular franchise on the open market. While cellular radiotelephone systems do in fact exhibit high fixed costs, these are often dwarfed by the substantial market-driven prices that have been paid by their owners to acquire the franchise from a previous holder. These acquisition premiums are not costs in the regulatory sense; they are nothing more than the present discounted value of the monopoly rents that the buyers of these franchises believed were available as a direct consequence of the facilities-based carriers' ability to set prices at monopolistic levels. In other words, these high acquisition costs are based on the assumption that no outside force -- either the market or the regulators -- will prevent the continuation of duopoly profits. The Commission should not permit these discounted excess profits to be transformed into "costs" that are in turn utilized as a basis for setting prices.[1]

History provides a key to understanding the cellular industry today. When the Federal Communications Commission (FCC) in 1979 initiated its efforts to create a regulatory framework for the yet to be established cellular radio service industry, it

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1 The Commission presently excludes acquisition premiums from rate base in order to ensure that utilities earn a return only on plant used to provide utility service and not on unproductive profit motivated acquisition payments. If acquistion premiums were rate based, utilities would have an incentive to increase their rate base through frequent nominal ownership changes and sizable acquisition adjustments; this would exert substantial upward pressure on utility earnings and rates without any accompanying consumer benefits.

confronted the conflicting goals of creating a competitive industry structure while at the same time assuring rapid development and deployment of the new technology to the public. The FCC's response to this dilemma was to allocate half of the available frequency spectrum earmarked for cellular to an indigenous wireline telephone utility while reserving the other half for non-wireline applicants. The FCC thought that although the wireline carrier would be able to initiate service sooner than the non-wireline carrier the non-wireline carrier would eventually provide effective wholesale price competition which could help it overcome the wireline carrier's head start advantage. Unfortunately, the FCC's duopoly market structure creates a bottleneck, allowing suppliers to charge prices well in excess of actual cost.

The scarcity of cellular licenses, coupled with the absence of effective state regulation of cellular rates, made the licenses so valuable that they are now traded at figures many times greater than their original cost.[2]

In other utility sectors, monopoly franchises are granted because we believe that the development of duplicative utility infrastructure would be economically and socially wasteful. Public rights of way would be constantly torn up as redundant pipelines and wires were installed and repaired, and the utilities could not benefit from the full economies of scale associated with their massive investment if their facilities were underutilized because

2 Wireline carriers in particular have realized an enormous economic windfall from the appreciation in the market value of the wireline cellular licenses which they received at no cost from the FCC. Bacause all of the RBOCs have since transferred these gifted assets to their non-price regulated cellular affiliates, all of the economic benefits associated with the windfall gains and profit opportunities that now exist within the cellular market because of the non-wireline price umbrella accrue in their entirety to stockholders of Pacific Telesis and GTE. There is no cellular cash flow to support basic services.

the demand was too thinly spread over competing systems. Because utility franchises granted for society's benefit could unjustly enrich their owners by giving them monopoly market power, however, the grant of such franchises is accompanied by the placing of limits on the rates those governmentally created monopolists can charge.

Today's decision, unfortunately, gives cellular carriers the opportunity to take advantage of their duopolistic market status with no effective price constraints. We have created an unregulated duopoly.

The magnitude of the monopoly rent, or excess profit, at issue is the discounted present value of future excess profits which is revenues less direct service-related costs, including return on the physical plant actually deployed in providing the service. In my opinion this is the basis for the market values of cellular franchises that have changed hands in California. The excess payment is instead a direct and inescapable consequence of the FCC's duopoly policy and the willingness of regulators such as ourselves to permit cellular carriers to impose prices for their services that include such economic rents. This is a fundamental mistake that must be corrected now.

The monopoly rent that we allow the wholesale carriers to extract from their subscribers is a windfall gain over and above any normal or "fair" return on the investment made in actual cellular plant in service. The earned rate of return on actual investment in cellular plant in service by the Los Angeles wireline cellular carrier, LA SMSA Partnership, was an incredible 41.56% for 1987. The fact that the market value of a cellular utility exceeds the cost of the physical equipment (towers, transmitters, etc.) is further evidence of the presence of a monopoly rent on the cellular capacity. In my view, the presence of these windfall gains is clear evidence of a fundamental failure of regulation of this service, and one that should be remedied now, before conditions become even more untenable.

I have urged my fellow Commissioners to regulate in a simple and straightforward manner to ensure fair rates for consumers and only reasonable returns to investors. I believe we must do this now. In particular, the regulated wireline telephone utilities who received "wireline set-aside" cellular licenses from the FCC have no more entitlement to benefit from the windfall gains associated with this franchise award in setting service prices than would any other public utility.

Utilities are not entitled to monopoly rents. Economic regulation is intended precisely to prevent utilities from earning such rents. Prices for bottleneck services furnished by franchised, facilities-based cellular wholesale carriers should be set on the basis of cost, defined for this purpose in the same fundamental way as it would be for any other telephone utility under the Commission's administrative jurisdiction. This imperative is the fundamental building block of a growing healthy, stable, universal cellular telephone infrastructure for California. There are alternate ways and means to accomplish this result. I have suggested the simple mechanism of a "true-up" of carrier's rates to a fair rate of return level (perhaps at the high end of that allowed in the Pacific Bell and GTEC sharing formula).

The current high rates cannot be justified by the need to encourage further utility investment. The use of high rates to stimulate investment is contrary to longstanding regulatory law and policy. In the past, telecommunications utility rates were designed to allow a utility to recover the costs of providing the utility service plus a fair return on its rate base investment. Rates of return were set at levels comparable to those earned by businesses facing similar risks; and were designed to maintain the financial integrity of the utility and allow it to continue to attract capital. These returns themselves provide the incentive for new investment in other utility sectors, which have had no trouble attracting adequate investment capital. None of these basic principles have changed under the new LEC regulatory framework; the added flexibility is intended to increase the LEC's incentive to operate efficiently while still providing service at reasonable rates. There is no reason to create an additional unique windfall incentive for cellular investment by allowing clearly excessive returns now and into the future.[3]

I find complaints about the difficulty of applying rate of return regulation to the cellular industry an unconvincing reason to adopt the pretense of a market based regulatory structure. I also note that my alternate did not advocate traditional rate of return regulation, but merely a simple true-up mechanism similar to that recently adopted in D.89-10-031.

I recognize that, as the majority points out, different carriers have different cost structures. The cost variations may result from the timing of entry into the market place, with variations in the technology utilized, with the acquisition price paid for the cellular franchise, and so on.[4] I note that the impact of these cost differences may be overwhelmed by other factors and that our review of the relationship between the wireline and nonwireline carriers ultimately concluded that neither

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3 Especially since the majority considers cellular service discretionary.

4 Unfortunately, since the wireline licenses were awarded at no cost, while the non-wireline licenses were awarded through a lottery approach that inspired those who were not awarded licenses to bid for licenses from those who originally received them, non-wireline carriers generally paid more for their franchise license than wireline carriers. If all other costs were equal, non-wireline carriers would have to charge more than wireline carriers to recover their investment. Faced with a competitor with an incentive to charge higher rates, the wireline carrier in a market need only charge slightly less in order to compete succesfully. This creates a "price umbrella" for wireline carriers.

had a clear competitive advantage over the other. This conclusion is further supported by evidence that nonwireline carriers often earn a much greater return on their cellular investment than do their wireline competitors.

In any event, I believe that the cellular provider who can provide quality service at the most reasonable price should be allowed to benefit from its economic efficiencies. After all, we are not in the business of offering a safe economic haven for noncompetitive competitors. If we keep rates high simply so the higher-priced provider did not need to take the steps necessary to bring its costs down to a truly competitive level, we are not meeting our obligation to California's cellular consumers. Further, the majority opinion allows downward only pricing flexibility; I support this provision. With this flexibility, the carrier with the higher rates resulting from basing rates more on costs could lower its rates to the levels of the more efficient carrier. This has the additional benefit of giving a strong incentive to the higher cost carrier to become more efficient.

The majority's belief that the current high rates serve the useful purpose of discouraging new demand which might overwhelm the capacity of cellular systems is not supported by the record and leads to an elitist distinction between rich and poor consumers. All parties to this proceeding agreed there were no present constraints on cellular capacity. At worst, there are a few locations in Los Angeles where a temporary bottleneck exists because cell site development lags demand during peak traffic hours. Even if there was a real reason to fear future capacity constraints, a "first come, first served" rationing plan would make more economic and social sense than one which uses price to indirectly regulate demand.

To me, the majority's entire approach seems simplistic and short-sighted. Although it recognizes that current returns on cellular investment greatly exceed those allowed other utilities, it waxes eloquent about the need to encourage massive investment in this allegedly discretionary utility service and refuses to reduce rates to reasonable levels. Consumers are supposed to take comfort from statements that sometime down the road, if we believe rates have not been reduced to levels necessary to provide full utilization of the cellular system, we will review rates and reduce them if necessary. Under a capacity utilization approach, however, it would seem probable that all cellular carriers would need to do to meet the majority's full utilization criteria would be to offer a series of small rate reductions designed to ferret out the highest level of prices the market would bear and still keep the system full. These rates could still be far in excess of those needed to recover operational costs and a fair return, but they would almost certainly lead the majority to conclude that the rates were still just and reasonable unless, of course, the majority eventually decides that rates should bear some relationship to the costs incurred in providing the utility service.

Even if effective competition is not present at the wholesale level, there is at least the possibility that it might occur at the retail level if the facilities-bases carriers are required to allocate costs between these two activities in a fair and reasonable manner and to set their wholesale prices on the bases of the appropriately allocated costs of wholesale service. This is one of the encouraging signs in the majority opinion. However, this is unlikely to occur absent an explicit regulatory requirement, because the facilities-based carriers have a strong economic incentive to frustrate competition at the retail level as well as the market power to accomplish precisely this result. The majority's approach may help to control this problem; we shall see.

In any event, requiring retail operations to be profitable will not solve the excessive wholesale rate problem.

In my view wholesale and retail cellular prices are excessive and must be reduced. Excessive pricing of this essential telecommunications service discourages beneficial usage and creates deadweight losses in the economy generally. I believe the appropriate regulatory action that will prevent franchised facilities-based wholesale cellular carriers to extract monopoly rents from their control of scarce bottleneck cellular licenses is for wholesale cellular rates to be set on the basis of cost.

Although this is a relatively new industry, it is clearly operating well beyond any "start-up" phase in which the capital costs are so high that current cash flows are necessarily negative. A $500 million a year, 5 years old industry is not a start up operation. The fact that the market for cellular licenses will support prices that are many multiples of the actual cost of cellular plant is, standing alone, a fully sufficient demonstration that no special regulatory considerations with respect to start-up or capital attraction is required. Experience shows capital investment has been no problem. The only reasonable conclusion that is possible is that cost-based prices developed in a manner that is consistent with traditional Commission practice are essential to assure that this important and essential service is offered on a fair, just, reasonable and non-discriminatory basis. My alternate proposed to regulate profits so as to achieve that positive result.

The opinions I have expressed here have adopted to a great extent material submitted in this case by the County of Los Angeles. Their comments brought clarity, insight and perception to the issues. In particular, I concur with the L.A. County analysis of the cellular industry origins, growth, and development leading to the opportunities and problems of today. I deeply regret that rate reductions that the people of California are entitled to are not being ordered at this time.

The people of the State of California as U.S. citizens are the owners of the cellular airways, the radio spectrum. It is for their benefit that licenses to use that radio spectrum are given. Spectrum use must never be managed in any way that deprives the people of what is rightfully theirs. Cellular utilities should be required to expand their facilities and use the most modern technology in order to make this incomparable service available to the greatest number of Californians possible.

It is this Commission's fundamental duty to make sure Californians receive the best service at the least cost. This duty is owed to all Californians, not just the wealthy ones. Excessive rates for cellular service deprive many people the use of this valuable service. Many small businesses suffer competitive disadvantages because they can't afford cellular prices at current rates. This is wrong and must be corrected. The denial of rate reductions leaves unjust rates.

Potential future rate reductions are but pie in the sky. I believe that justice delayed is justice denied. The present failure to order the adjustment of rates downward to a just and reasonable level is a grave mistake. This glaring error can be corrected; the sooner the better.

Frederick R. Duda

Frederick R. Duda, Commissioner

June 6, 1990
San Francisco, California