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Decision 95-12-062 December 20, 1995

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Rulemaking on the Commission's Own Motion into Universal Service and to Comply with the Mandates of Assembly Bill 3643	R.95-01-020 (Filed January 24, 1995)
Investigation on the Commission's Own Motion into Universal Service and to Comply with the Mandates of Assembly Bill 3643	I.95-01-021 (Filed January 24, 1995)

ORIGINAL

ORDER DENYING REHEARING OF DECISION 95-07-050

I. SUMMARY

This decision denies the applications of Pacific Bell (PacBell), GTE California Inc. (GTEC), Contel of California, Inc. (Contel), Roseville Telephone Company (Roseville), and Calaveras Telephone Company and other smaller independent LECs (Applicant Small LECs)[1], for rehearing of the Interim Opinion in this proceeding to develop rules for universal telephone service in a competitive telephone environment, D.95-07-050 (Interim Opinion).

Applicants for rehearing had challenged the portion of the Interim Opinion which concludes that the "LECs should not be granted any additional recovery for stranded investments" as a

1. The Small LEC's application for rehearing was jointly filed by Calaveras Telephone Company, California-Oregon Telephone Co., Ducor Telephone Company, Foresthill Telephone Co., Happy Valley Telephone Company, Hornitos Telephone Company, The Ponderosa Telephone Co., Sierra Telephone Company, Inc., and Winterhaven Telephone Company.

taking of utility property without just compensation.[2] That conclusion of law shall be stricken and shall be replaced with the following: "An LEC may obtain regulatory relief if the inability to recover the cost of embedded plant, when weighed together with the total revenues to the LEC, threatens the financial integrity of the LEC and denies shareholders the opportunity for earnings appropriate to the risk of the restructured telephone industry."

The availability of mechanisms ordered in D.95-07-050 to promote universal service will not be delayed pending the availability of interLATA relief for Pacific Bell because no purpose would be served by conditioning the implementation of the universal service provisions upon interLATA relief. The term "inter-LATA relief" will be deleted from the first full paragraph on page 47 of the Interim Opinion.

Rehearing is denied because D.95-07-050 was an interim order which merely proposed rules for the provision of universal telephone service.[3] Parties may present testimony addressing the impact of local competition upon the ability of an LEC to recover the cost of investment in rates, and consequent effect upon LEC earnings, in evidentiary hearings scheduled to begin January 3, 1996, in the Local Competition rulemaking and investigation, (R.95-04-043/I.95-04-044.)

II. BACKGROUND

A. Procedural History

The Universal Service proceeding was initiated by the Commission to develop rules to pursue universal service goals in

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2. D.95-07-050, conclusion of law 40, at mimeo p. 88.

3. A final order implementing universal service rules will be issued around June of 1996. See, D.95-07-050, mimeo pp. 77 and 78 for procedural process.

a competitive telecommunications environment. Specifically, the Commission intends to determine what, if any, funding mechanisms will be needed to promote universal telephone service in a competitive market.

The Interim Decision was issued on July 19, 1995. D.95-07-050 purports to issue "only proposed rules;... a final set of rules will be developed after public hearings are held, comments regarding the proposed rules are filed, and after evidentiary hearings, if needed, are held, or legislative changes are made."

Pacific Bell, GTE California, Inc., Contel of California, Inc., Roseville Telephone Co., and Calaveras Telephone Co., et al., filed applications for rehearing of the Interim Opinion.

Replies to the applications were filed by the California Telecommunications Coalition (Coalition)[4], CP National and other small independent local exchange companies (Respondent Small LECs)[5], the California Department of Consumer Affairs (DCA), and this Commission's Division of Ratepayer Advocates (DRA).

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4. The Coalition, for purposes of the universal service proceeding, consists of AT&T Communications of California, Inc. (AT&T), California Association of Long Distance Telephone Companies (CALTEL), California Cable Television Association (CCTA), ICG Access Services, Inc., MCI Telecommunications Corp. (MCI), MFS Intelnet, Inc, Sprint Communications Co., L.P. (Sprint), Teleport Communications Group, Time Warner AxS of California, L.P., and Toward Utility Rate Normalization (TURN). The views expressed by the Coalition represent a compromise or consensus view of its members and may not represent all of the views held by the members of the Coalition individually.

5. The Respondent Small LECs include CP National, Evans Telephone Company, GTE West Coast Incorporated, Kerman Telephone Co., Pinnacles Telephone Company, The Siskiyou Telephone Company, Tuolumne Telephone Company, and The Volcano Telephone Company.

B. Positions of the Parties

1. Applicants for Rehearing

The applicants for rehearing (Applicants) are aggrieved by Conclusion of Law 40, which states, "The LECs should not be granted any additional recovery for stranded investments." That conclusion is legally defective, according to Applicants, because it is unsupported by any evidence, would deny utility investors an opportunity to earn a fair return on investments made to provide universal service, and would result in a taking of property without just compensation. The associated findings of fact, numbered 58 through 61, are also disputed.[6]

Generally, Applicants seek assurance that the Commission will quantify and establish a mechanism for recovery of all past investments, if not immediately, then in some future proceeding. GTEC and Contel request evidentiary hearings to select a mechanism for recovery of investments rendered uneconomic by local competition. The Smaller LECs seek immediate reversal and a conclusion that LECs are entitled to recover their

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6. The challenged findings of fact are as follows:

58. D.89-10-031 sought to disassociate rates from depreciation practices.

59. The excessive amortization period that GTEC and Pacific complain of has been diminishing as the expected life for depreciation purposes has been steadily reduced.

60. Investments made in anticipation of competition should not be regarded as stranded investment.

61. The assets associated with serving high cost areas will not be stranded if the incumbent LEC continues to serve the service area, or if it resells to other providers.

stranded investment. Contel wishes the mechanism to be in place prior to the introduction of local competition.

In addition, PacBell asserts that the proposed postponement of the universal service funding mechanism until intraLATA presubscription and interLATA relief are in place conflicts with the advent of local exchange competition in spring of 1996.[7]

2. Respondents

The Coalition claims the applications lack merit because (1) due process does not guarantee recovery of investment rendered uneconomic as a result of competitive market forces, (2) the New Regulatory Framework (NRF) [8] prohibits the recovery of uneconomic investment, (3) approval of the requested recovery would harm competition and ratepayers, (4) Applicants retain the opportunity to earn a fair return on their investments, which is all the law requires, and (5) evidentiary hearings are not required when the Commission makes policy determinations.

The DRA urges denial of the applications because the challenged decision already provides the LECs an opportunity to earn a fair return on their investment through either the high-cost voucher fund or the carrier of last resort auction; the LECs have not established the existence of stranded investment; the continued viability and operation of the LECs has not been threatened so there is no taking; and small LECs are not at risk

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7. At page 47 of the Interim Opinion, the Commission stated, "We agree...that any new explicit subsidy for large LECs should only be implemented when (1)...a subsidy is necessary and (2) the minimum conditions for competition, such as unbundled network components, interconnection arrangements, intraLATA presubscription and interLATA relief, are in place.

8. The NRF was established in Re Alternative Regulatory Frameworks for Local Exchange Carriers, 33 CPUC 2d 43; D.89-10-031.

for stranded investment because they have been subject to depreciation reviews as a part of cost of service regulation. DRA also concurs in the arguments of the Coalition.

The Respondent Small LECs assert that if the Commission intended to hold that there is stranded investment but that recovery will not be allowed, then the decision violates applicable constitutional limitations. On the other hand, they claim, if the Commission intended to find that "the regulatory policies that have been adopted to date have not caused LEC investments to become stranded, that is an issue that already is scheduled to be addressed in the local competition proceedings, where appropriate evidence will be developed on the subject."

The DCA generally supports the arguments of PacBell and GTEC. However, DCA's response in support of rehearing strays from the requirement that "(t)he application for a rehearing shall set forth specifically the ground or grounds on which the applicant considers the decision or order to be unlawful." (Public Utilities Code section 1732.) [9] The comments summarized in the preceeding footnote do not assert legal error on the part of the Commission, are not responsive to the issues raised in the applications for rehearing. DCA is advised to conform its subsequent pleadings to the standards for rehearing set forth in statute and relevant case law.

III. DISCUSSION

A. There is no evidentiary basis to conclude that the financial integrity of the LECs will remain intact despite the denial of any additional recovery for stranded investments.

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9. DCA suggests criteria for determining whether investment is stranded and whether recovery should be allowed, and reiterates its comments concerning criteria for making the high-cost voucher fund available. It also attaches news articles to illustrate the presence of facilities-based competition and to urge the expedited implementation of intraLATA presubscription.

1. The Commission's Proposal

In the Interim Opinion, the Commission has proposed affordable basic exchange service to low income residential ratepayers and to residential ratepayers residing in high cost areas as the two pillars of its universal service program. Local exchange competition may result in rates that no longer provide the subsidy needed to maintain affordable rates for these customers.

The Commission has identified facilities needed to serve high cost areas and the local loop and central office facilities used to serve low income residential customers as the investment needed to protect universal service. The Interim Opinion provides mechanisms to ensure the continuation of this service. To accommodate the possibility that basic rates do not recover their full cost, the Interim Decision proposed that the existence and amount of subsidies used to support rates for basic services be examined in the Open Architecture Network and Design (OANAD) proceeding, (R.94-04-003/I.94-04-002). The Commission anticipated that upon the completion of the cost studies relating to high cost areas in the OANAD proceeding, the total subsidy for high cost areas could then be derived and used in this proceeding to put the high cost voucher fund into effect. Consequently, the Commission concluded, "The LECs should not be granted any additional recovery for stranded investments."

The announced principle is consistent with the Commission's definition of its universal service goals. However, the Commission cannot know, on the basis of the comments filed in this proceeding, whether its proposed policy will jeopardize the financial health of the LECs, particularly the large LECs who have substantial high cost areas. The Interim Opinion proposed rules for public comment. After consideration of these comments, evidentiary hearings, and any legislative changes, final rules would be issued. It was against this procedural backdrop that the Commission made its proposal.

B. Applicants are Not Entitled to the Protections of Full Cost of Service Ratemaking Under the New Regulatory Framework.

GTEC and Roseville ask the Commission to find that the LECs will be provided a means of obtaining full recovery of its past investments. Ironically, as the telecommunications industry is poised for more competition, GTEC and Roseville seek a shareholder guarantee that never existed under the most traditional form of economic regulation. Shareholders are only afforded an opportunity to recover their investment and to earn a return on capital investment; there is no guarantee of a return. The request of GTEC and Roseville for guaranteed recovery must be denied.

C. Substantive Due Process Concerns will be Addressed by the Adoption of Ratemaking Mechanisms to Preserve the Financial Integrity of the LECs

One of the Commission's abiding goals is lower rates. The Commission can achieve lower rates by limiting the recovery of above-market rate costs. However, it must also avoid a regulatory "taking", as cautioned by the applicants for rehearing.

In 1988, the teachings of Hope Natural Gas were reaffirmed by the Supreme Court in Duquesne Light co. v. Barasch, 488 U.S. 299. "'(I)t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry ... is at an end.'...(W)hether a particular rate is 'unjust' or 'unreasonable' will depend to some extent on what is a fair rate of return given the risks under a particular ratesetting system, and on the amount of capital upon which the investors are entitled to earn that return." (Duquesne, supra, at 310.)

Under the prudent investment rule cited favorably in Duquesne Light Co. V. Barasch, "what was 'taken' by public utility regulation is not specific physical assets that are to be

individually valued, but the capital prudently devoted to the public utility enterprise by the utilities' owners." (Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n, 262 U.S. 276, 291 (1923 (dissenting opinion of Justice Brandeis.)[10] Denial of the recovery of stranded investment does not result in a taking so long as the Hope test has been met.

Shareholder risk changed substantially with NRF and is still being reshaped in the local competition proceeding. The return on investment cannot be based upon the risks of a former period, when traditional economic regulation established a different set of investor risks. PacBell's contention that NRF is irrelevant to the LECs' right to recover capital investments made before NRF was adopted is wrong. Even though those investments were made under a regulatory regime based upon recovery of capital from ratepayers, it is the present financial integrity of the company, and the risk to shareholders posed by the current regulatory scheme, that is relevant to establishing the revenue needed to avoid a "taking".

In the instant proceeding, the Commission has proposed that LECs receive no additional recovery for stranded investments. According to the strategy mapped out in the proceeding to examine competition for local exchange service (R.95-04-043/I.95-04-044, "Local Competition OIR/OII") , the Commission would first examine whether the inability to recover the cost of embedded investments in post-competitive rates would no longer afford the LECs "an opportunity to earn a fair return on invested capital." The next step would be to quantify the

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10. In Duquesne, the Supreme Court upheld an order of the Pennsylvania Public Utilities Commission which denied a utility a return on capital spent on nuclear generating units that were cancelled. Rate relief was denied because the plants were not "used and useful". The concept of "used and useful" refers to the physical provision of service; a plant may not be used or useful (i.e., it is "stranded") because its cost of operation exceeds the market value of its output.

amount of relief necessary to supplement LEC earnings in a competitive environment. Only then would an appropriate rate mechanism be authorized to protect the financial integrity of the LEC.

Conclusion of Law 40 is inconsistent with the approach adopted in the Local Competition proceeding. LEC relief from the impact of local competition must be based upon the net effect of competition upon the costs and revenues which contribute to a utility's earnings. The cause of a revenue shortfall is irrelevant, unless it is a cause which the Commission singles out for policy reasons. Thus, although the failure to recover costs assigned to specific plant results in stranded investment, it is the net effect of local competition on earnings, rather than the loss of any specific revenue stream, that will entitle the utility to relief.

Hearings have been scheduled in the the Local Competition proceeding to consider what measures should be taken to ensure the fairness of the Commission's decision to permit competition to provide local exchange service.[11] Evidentiary hearings beginning in January will permit parties to identify and quantify any need for LEC relief. A subsequent phase of that proceeding will also provide a forum for fashioning any necessary remedy.

Conclusion of Law 40 should be stricken because the discrimination against stranded investment is irrelevant to the

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11. In the Local Competition proceeding , the Commission will examine whether the rules proposed to "permit local exchange competition alter our regulatory program so that it no longer affords Pacific and GTEC an opportunity to earn a fair return on invested capital. If we find that there is not such an opportunity to earn a fair return, then we shall consider what measures, if any, are appropriate to ensure the fairness of our regulatory policies....We shall also coordinate this hearing,... with the ... universal service docket(s)." (__ CPUC 2d ___, D.95-07-054, mimeo, p.33, emphasis added.)

true inquiry before the Commission. A new conclusion should be adopted to provide that an LEC may obtain regulatory relief if the inability to recover the cost of embedded plant, when weighed together with the LEC's total revenues, threatens the financial integrity of the LEC and denies shareholders the opportunity for earnings appropriate to the risk of the restructured telephone industry.

D. Procedural Due Process will be Afforded Through Evidentiary Hearing on the Potential Impact of Local Competition Upon the Financial Integrity of the LECs

As a preliminary matter, various definitions of the term "stranded investment" have been tendered and must be resolved. It appears that most broadly, stranded investment consists of capital investment that can no longer be recovered by the LEC under the restated regulatory scheme because the method of recovery is no longer economically competitive. This perspective on stranded investment differs from the approach taken by some of the parties, which emphasizes the purpose for which plant was deployed, the geographic location of facilities obtained with that investment, and the regulatory framework in existence at the time it was placed in service. Factual controversy may be minimized by avoiding debate over whether the facilities were intended to provide universal service by the carrier of last resort. That debate may not be fruitful, since even now, each LEC is the carrier of last resort within its service territory.[12]

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12. Several of the applicants for rehearing have asserted that unless they are guaranteed compensation for facilities used to serve specific geographic areas, a "taking" of their property without just compensation will have occurred. Admittedly, in

(Footnote continues on next page)

1. Whether the investment associated with service to high cost areas will be stranded should be determined in evidentiary hearing.

The Commission stated generally, at finding of fact 61 in the Interim Opinion, that the assets associated with service high cost areas will not be stranded if the incumbent LEC continues to serve the service area, or if it resells to other providers. This finding is premised on the assumption that no facilities other than the incumbent LEC's would be used to provide service. Hearings would help to determine the likelihood of alternative providers, potential harm to the LECs, and the appropriate regulatory response.

Clearly, whether investment is uneconomic or not depends on the means undertaken to recover the investment. Hearings are scheduled in the Local Exchange Competition proceeding (R.95-04-043/I.95-04-044) to consider whether flexible pricing, the bundling or unbundling of retail services, and the geographic deaveraging of rates may enable LECs to recover their investment. What may be "stranded" in one market may be recoverable when the facilities are redeployed in a redefined market. The use of telecommunications facilities may be altered to serve new demand. Plant may not be entirely uneconomic if its costs can be recovered through resale rates, the virtual voucher system, or other offsets. These possibilities will be considered

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(Footnote continued from previous page)

remote locations in the state, the LEC may remain the only carrier, the monopolist, the carrier of last resort. However, ratepayers would be prejudiced by a hasty conclusion that an LEC is guaranteed recovery of the cost of those specific facilities.

in the evidentiary hearing scheduled in the Local Exchange Competition docket.

2. Investments Made in Anticipation of Competition Should Not be Regarded as Stranded Investment.

At finding of fact 60 of the Interim Opinion, the Commission stated, "Investments made in anticipation of competition should not be regarded as stranded investment." By definition, the utility monopoly faced no competition, therefore, commitment of capital to services or facilities in anticipation of competition was not made in furtherance of the utility's obligation to provide universal service. It was a voluntary commitment of capital to a riskier venture. Shareholders are entitled to less regulatory protection for such investments. Thus, the Commission may exclude investments made in anticipation of competition from its consideration of the utility's financial needs in the Local Competition Proceeding. Finding of fact 60 was not in error.

3. Differences Between the Telephone and Electric Industry May Have Created Different Shareholder Risks, which Call For Different Regulatory Treatment of Uneconomic Costs.

The Interim Opinion found that differences between the size of capital investments undertaken by the electric and telephone industries justified differing treatment of stranded investment. While there are many differences between the two industries with respect to investment patterns and regulatory requirements, the overriding test of whether allowances must be made for uneconomic investment is the financial integrity of the utility.

The Commission has apparently determined that certain factors inherent in the electric generating business have created shareholder risk which must be safeguarded by a transition mechanism. Factors affecting the riskiness of shareholder

investment may be examined during the course of evidentiary hearing to determine the appropriate treatment of telephone utility plant investment used for local exchange service. If there are differences between the electric and telephone industries that justify different ratemaking treatment, no violation of the Equal Protection Clause will occur.[13]

As noted by finding of fact 59 of the Interim Opinion, the expected life for depreciation purposes has steadily declined for LECs. (See, e.g., D.93-12-042, D.94-10-033, D.94-12-003.) Finding of fact 59 was not in error.

4. The Commission Signalled Increased Investor Risk for Recovery of Investment in its New Regulatory Framework Decision.

In the New Regulatory Framework (NRF) decision, the Commission entertained PacBell's request for authorization to change depreciation rates. The Commission found, "utility investments and plant lives are to large extent within management's control, we believe that most, if not all, depreciation changes are not exogenous factors and thus should not be reflected in rates through the Z factor." (Re Alternative Regulatory Frameworks for Local Exchange Carriers (NRF Decision) 33 CPUC 2d 43, 138; D.89-10-031.) We find that by expressly excluding changes in depreciation rates from the price cap formula, the Commission has severed the link between rates and investment/depreciation practices for NRF companies. Finding of Fact 58 of the Interim Opinion was not in error.

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13. "In the area of economic regulation, the high court has exercised restraint, ... requiring merely that distinctions drawn by a challenged statute bear some rational relationship to a conceivable legitimate state purpose." (Toward Utility Rate Normalization v. Public Util. Com. 22 Cal.3d 529, 543 and 544, cit.om.)

B. Implementation of Universal Service Funding Mechanism should be Coordinated with Introduction of Local Exchange Competition.

The Commission has authorized competition to provide local exchange service beginning on January 1, 1996.[14] The Interim Opinion proposes to postpone implementation of the universal service funding mechanism until "(1)...a subsidy is necessary and (2) the minimum conditions for (local exchange) competition, such as unbundled network components, interconnection arrangements, intraLATA presubscription and interLATA relief, are in place." (D.95-07-050, mimeo, p.47.) InterLATA relief refers to a change in federal laws to permit Regional Bell Operating Companies, of which PacBell is one, to provide interLATA service. When such a change will occur is extremely hard to predict.

PacBell believes that the universal funding mechanism should be implemented concurrent with any resale of local exchange services to be authorized as a result of the Competition OII. Otherwise, PacBell will be required to continue to shoulder the universal service burden alone, after competition erodes the previous source for maintaining universal service.

The purpose of the universal service funding mechanism is to support local exchange service at affordable rates. The attainment of this goal should not be contingent upon interLATA relief for PacBell. Indeed, the only connection between the two is the fact that a universal service funding mechanism will be needed when competition occurs, and a "level playing field" for competition would be more likely if interLATA relief and intraLATA presubscription occurred simultaneously. However, the denial of the universal service funding mechanism until interLATA

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14. D.95-07-054 in the Competition OII (R.95-04-043/I.95-04-044) authorized entry by facilities-based local exchange carriers on January 1, 1996 and by resellers on March 1, 1996.

relief occurs will not promote a level playing field. Thus, the implementation of the universal service funding mechanism should not be delayed until interLATA relief occurs. The term "interLATA relief" shall be deleted from the cited passage.

IV. CONCLUSION

Specific mechanisms for the protection of universal service were adopted in the Interim Opinion. It is possible that the costs incurred by LECs to serve high cost areas may not be recovered by the high cost virtual voucher system and resale rates. The adequacy of the high cost mechanisms must be tested over a period of time, and the effect of local competition upon LEC earnings must take into account all relevant factors, not just the inability to collect allocated costs through preexisting patterns of plant usage.

The evidentiary hearing scheduled to begin on January 3, 1996 in the Local Competition proceeding will allow the parties to quantify the shortfall in LEC revenues projected to occur under the currently proposed rules for local competition, and to quantify the potential effect upon the LEC's financial integrity. Parties should note that the purpose of such evidence is not to establish a right to recover a specified dollar amount, but to evaluate whether stranded costs have "alter(ed) our regulatory program so that it no longer affords (the LECs) an opportunity to earn a fair return on invested capital". (D.95-07-054, mimeo, p. 33.) The appropriate remedy will be devised in a subsequent phase of the Local Competition proceeding.

THEREFORE, IT IS ORDERED THAT:

1. Conclusion of law 40 shall be stricken and shall be replaced with the following: "An LEC may obtain regulatory relief if the inability to recover the cost of embedded plant, when weighed together with the LEC's total revenues, threatens the financial integrity of the LEC and denies shareholders the

opportunity for earnings appropriate to the risk of the restructured telephone industry."

2. Parties are directed to participate in the Local Competition proceeding, R. 95-04-043/I.95-04-044, to the extent their concerns are still relevant in light of the discussion herein.

3. The words "inter-LATA relief" shall be stricken from the first full paragraph which appears on mimeo page 47 of the Interim Opinion. The resultant paragraph shall state:

> "We agree with DRA's general premise that any new explicit subsidy for large LECs should only be implemented when (1) there is reliable evidence based on sound cost studies that a subsidy is necessary and (2) the minimum conditions for competition, such as unbundled network components, interconnection arrangements, and intraLATA presubscription are in place. However, we feel it is important to have a mechanism ready to put in place when full competition occurs."

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In all other respects, the applications for rehearing are denied.

This order is effective today.

Dated December 20, 1995, at San Francisco, California.

DANIEL Wm. FESSLER
President
P. GREGORY CONLON
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
Commissioners