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FEB 28 1997

Decision 97-02-049 February 19, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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| In the Matter of the Alternative Regulatory Frameworks for Local Exchange Carriers. | I.87-11-033<br>Filed November 25, 1997 |
| And Related Matters. | Application 85-01-034<br>Application 87-01-002<br>I.85-03-078<br>Case 86-11-028<br>I.87-02-025<br>Case 87-07-024 |

ORIGINAL

**OPINION DENYING PETITION TO MODIFY**

On September 1, 1995, Pacific Bell (Pacific) and GTE California (GTEC) filed their Joint Petition of Pacific Bell (U 1001 C) and GTEC California Incorporated (U 1002 C) for Modification of Decision (D.) 94-09-065 (Petition). Pacific and GTEC allege that in D.94-09-065 (the Implementation Rate Design (IRD) decision), the Commission adopted an estimate of the increase in toll and switched access use to result from lower prices that has proven to be less than actual results, yielding revenue losses for Pacific and GTEC. Pacific and GTEC append several declarations to the Petition in support of their contentions. On January 22, 1996, Pacific filed an amendment to the Petition containing additional data and supporting declarations with information on intraLATA toll and switched access growth for all of 1995. No corresponding amendment was provided by GTEC.[1]

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[1] We make no determination in this decision as to the accuracy or correctness of either of these alleged shortfalls. The actual figures may well be different, perhaps significantly so. All we examine here is whether the opportunity to pursue a request should be permitted. Were that to be allowed, discovery and the

Pacific and GTEC contend that in adopting an elasticity estimate for both utilities in the IRD decision the Commission "Without any record support, used an elasticity of demand for toll services for both Pacific and GTEC of -.5, significantly greater than the estimates determined by the Pacific and GTEC studies." (Petition at 2.) They allege that for Pacific the elasticity estimate used in the IRD decision resulted in the forecast of $234 million more in toll calling revenue for Pacific than has materialized, resulting in $234 million less in price increases that Pacific needed to be revenue-neutral. For GTEC, the overestimation/undercollection is alleged to be $103 million. (Petition at 3.) Seemingly, they contend that to the exact extent the forecasted revenue was not produced, the IRD decision was not revenue neutral, violating one of its basic precepts.

A similar issue is raised with respect to the elasticity estimate used to calculate the volume stimulation due to price reductions for switched access. The petitioners again contend that the elasticity adjustment chosen was without record support. Pacific asserts that the elasticity estimate used to forecast switched access revenue resulted in a shortfall of approximately $53 million. The Petition notes that GTEC did not present a switched access elasticity estimate of their own in the IRD proceeding, but asserts that based on the adopted elasticity, GTEC's shortfall in switched access revenue is $32 million. (Petition at 3.)

To alleviate this shortfall, and maintain Pacific's and GTEC's view of the Commission's commitment in D.94-09-065 to not raise or lower authorized revenue, the utilities request price

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full opportunity for cross-examination of these claims would be required.

increases to recover an additional $214 million for Pacific and $107 for GTEC.[2]

Pacific's and GTEC's bottom line contention is best stated in their own words:

> "By this Petition Pacific and GTEC are not simply saying that our predictions and estimates should have been adopted; rather, the actual results and revenues demonstrate that the IRD-adopted elasticities of demand for toll and switched access must be corrected to correspond with actual experience." (Petition at 3.)

In order to implement their request Pacific and GTEC propose a wide range of service rate modifications. Pacific proposes reducing allowances and increasing prices for Directory Assistance, increasing the initial-minute rate for local calling and reducing the existing permanent surcredit. (Petition at 14-15.) GTEC suggests increasing its foreign exchange business price, increasing its returned check charge, increasing measured local service and ZUM prices by decreasing certain discounts, reducing directory assistance free calling allowances, increasing operator handled and credit card prices, and adjusting the A-38 surcharge mechanism. (Petition at 15.) They contend that none of these changes would require hearings "as all the evidence supporting such increases is in the IRD record." (Id.)

Responses to the Petition to Modify were filed by the California Telecommunications Coalition[3], the California

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2 The adjustments requested vary from the short fall alleged due to the arithmetic of netting the toll and switched access overestimation with somewhat reduced implementation costs. (Petition at 14, footnote 11.)

3 Members of the Coalition joining in the Response were: AT&T Communications of California, Inc., California Association of Long Distance Telephone Companies, California Cable Television

Committee for Large Telecommunications Consumers[4], and the Office of Ratepayer Advocacy (ORA).[5] In summary, all three responses oppose the Petition to Modify and advance similar rationales:

- The Petition simply seeks to true-up one estimate adopted in D.94-09-065 to reflect actual results. The Commission specifically rejected such "truing up" in the Decision.

- The Petition to Modify seeks a substantial rate increase without a hearing. Such an outcome is prohibited by Public Utilities (PU) Code § 454.

- Pacific and GTEC are attempting to augment the record in this case in support of their [then] pending applications for rehearing. Such augmentation is highly improper as the Commission did not have this information before them when issuing the decision.

ORA challenges the Petition on several grounds. ORA contends the Petition was merely a way to endeavor to improperly augment the record in this proceeding in support of the then-pending application for rehearing. (ORA response at 3.) ORA contends the Petition seeks nothing more than a rate increase and that it is improper to use the vehicle of a petition for

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Association, MCI Telecommunications Group, Time Warner AxS of California, L.P., and Toward Utility Rate Normalization.

4 The California Bankers Clearing House Association and the County of Los Angeles are the members of the California Committee for Large Telecommunications Consumers for the purposes of this proceeding.

5 By action of the Executive Director, the Division of Ratepayer Advocates ceased to exist as a staff unit on September 10, 1996. The functions it performed as a participant in this proceeding now reside with the Commission's Office of Ratepayer Advocacy.

modification under Rule 47 of the Commission's Rules of Practice and Procedure (Rules) to do so. Rather, if Pacific and GTEC wish a prospective increase in their rates, ORA contends that they should do so by means of an application pursuant to Rule 23 and PU Code § 454, with the attendant notice requirements. (ORA Response at 4, 6.)

ORA also questions the integrity of Pacific's and GTEC's request. ORA contends that during the course of the IRD proceeding (Phase III of I. 87-11-033), parties other than Pacific and GTEC advocated a "true-up" mechanism to deal with the potential for forecasting errors involving toll-elasticity estimates. ORA contends that Pacific and GTEC both strongly argued against such an approach for several reasons. According to ORA, Pacific, and GTEC were opposed to, true-ups as being inconsistent with the purpose and policy of the New Regulatory Framework (NRF); a form of disguised rate of return regulation, constituting an additional, unnecessary regulatory burden; it being impossible to segregate the toll stimulation effects from other market effects; and an improper modification of the incentive nature of NRF. (ORA Response at 8-10.)

ORA also challenges the petitioners' factual contentions, observing that there are multiple possible causes for the revenue shortfalls reported by Pacific and GTEC. According to ORA these could also include competitive losses and the operation of the economy as a whole. (ORA Response at 13-14.) ORA strongly suggests that Pacific and GTEC are merely using the Petition to endeavor to recover competitive losses, including revenues lost through the voluntary entry into rate discount agreements. (ORA Response at 15.)

ORA also requested permission to file a response to the Petition amendment Pacific filed on January 22, 1996. The assigned administrative law judge (ALJ) authorized ORA to submit the additional response along with a motion to request its filing. That motion is granted and we will consider ORA's February 28, 1996, response denominated "Response of the Division of Ratepayer Advocate to Pacific Bell's Amendment of the Joint Petition of Pacific Bell and GTEC California Incorporated for Modification of D.94-09-65 (ORA's February Response).

In its February Response ORA raises the concern that Pacific only provides data on the growth (or lack thereof) of intraLATA toll volumes. ORA argues that it is necessary to examine all the factors which make up Pacific's and GTEC's revenue stream. (ORA's February Response at 4.) For example, ORA notes correctly that during the IRD proceeding Pacific and GTEC utilized 1990 and 1989 access line volume data, respectively, for use in calculating the IRD revenue requirement and corresponding rate design. (Id.) ORA states: "It is impossible to imagine that Pacific's and GTEC's access line volumes have not increased in the approximate six years since the 1989-to-1990 time period on which their IRD showings were based." ORA notes the growth of fax machines, and other communications devices, and the strain this growth has placed on California's numbering resources. (Id.)

ORA concludes by suggesting that while its recommendation is to deny the Petition, the alternative, if we are persuaded that the Petition, as amended, has merit, is to necessarily consider all of the factors that bear on the Petition, including the status of other revenue factors. ORA offers its insight on the effort likely to be involved in such an examination, particularly in the context of our current telecommunications workload. (Id. at 6.)

The California Telecommunications Coalition provides a similar analysis. It contends that revenue neutral rate design was a goal and not a commitment of the IRD process. The

Coalition also observes that this Commission is not unfamiliar with the concept of allowing for a true-up or establishing a balancing account if that is what is intended. It recounts the request of two parties - TURN and the California Bankers Clearing House Association that suggested that such a balancing account be established to prevent unreasonably large recoveries by Pacific and GTEC, and the opposition of Pacific and GTEC to such treatment. The Coalition observes that Pacific and GTEC had the opportunity during the IRD proceeding to make virtually any showing they desired on the topic of elasticities. The Coalition comments on their perception of the inconsistency between the true-up Pacific and GTEC request and the concept of incentive regulation. Finally, its suggests that for the type of relief, requested the appropriate vehicle should be an application.

The California Committee for Large Telecommunications Consumers (Committee) raised similar concerns and extensively challenged the reliability of the impacts allegedly suffered by Pacific and GTEC. They too comment on the interrelationship of the many rate, volume and elasticity elements evaluated in the IRD proceeding. They state that the specific rate changes that Pacific and GTEC now seek in order to recoup the claimed revenue loss were specifically recommended by Pacific and GTEC in the IRD proceeding, but rejected by the Commission. (Committee Response at 4.)

They argue that even if the Commission were to begin to examine the elasticity issue raised by Pacific and GTEC, that examination must necessarily lead to a reopening of the entire IRD proceeding. They note that the elasticities decided in IRD include more than those identified by Pacific and GTEC. They included elasticity estimates for coin, calling card, WATS and 800 services, among others. (Id. at 5.) They question whether the source of the alleged revenue shortfall may even be related to an elasticity forecast, suggesting it could stem from other sources such as a failure of marketing reduced toll rates. They contend that while an examination of the various factors that might impact revenues would be reasonable in a general rate case for a utility subject to comprehensive rate regulation, it is at odds with the concept of price cap regulation. (Id. at 6.)

The Committee also comments on the history of true-ups being sought in the IRD proceeding, having sponsored that idea. They note Pacific and GTEC's objection to it and the Commission's rejection of a true-up (Id. at 6-8.) and contend the Pacific and GTEC request is at odds with the NRF regulatory structure. They note the existence of mechanisms already in NRF if earnings decline beyond certain limits. (Id. at 8-9.)

Finally, they request that if they Commission were to determine there was a need to consider the modification request, the matter be assigned for hearing with a significant opportunity being allowed for discovery, by which to analyze the Pacific and GTEC claims, and the presentation of testimony. (Id. at 11.)

A group of small local exchange companies[6] filed a response in support of the Petition to Modify. They argue that since new and changed facts now available show the elasticity estimates adopted to D.94-09-065 were erroneous and that the Rules of Practice and Procedure permit the Commission to modify the decision to reflect the new information, the Commission should correct these erroneous conclusions.

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[6] CP National, Evans Telephone Company, GTE West Coast Incorporated, Kerman Telephone Company, Pinnacles Telephone Company, The Siskiyou Telephone Company, Tuolumne Telephone Company, and The Volcano Telephone Company.

## Discussion

The Petition seeks an update to previously adopted estimates to reflect actual results. While Pacific and GTEC assert that the elasticity estimates in question, were adopted "without any record support," such contention is without merit. GTEC filed an application for rehearing of D.94-09-065 in which GTEC challenged the same elasticity estimates at issue here. In D.96-02-023, we rejected any allegation of error while discussing the record basis for the elasticities adopted. GTEC did not seek further review of that decision and it is, therefore, final. Pacific did not file an application for rehearing, the appropriate remedy if something of such great moment was truly decided "without any record support." Therefore, any residual contention that the adopted elasticity estimates are without record basis must be rejected out of hand.

Thus, what Pacific and GTEC are really seeking is a "true up." They seek to have revenues adjusted for specific accounts premised on actual recorded results.

Two issues must be addressed here. First, what does the term revenue neutrality mean in terms of what explicitly was done by us in adopting D.94-09-065, and what are the reasonable expectations of the local exchange carriers and the other affected parties who must operate under it?

Pacific and GTEC urge that a deviation of actual recorded revenues during the first year following implementation of the IRD decision from those utilized in the development of the rate design adopted by that decision violates the concept of revenue neutrality. As explained by the Commission:

> "...every rate change ordered by this decision which results in a revenue increase or decrease is offset by countervailing rate changes or revenue adjustments so that the cumulative effect of all revenue changes for each NRF company is zero (revenue neutrality)." (D.94-09-065 at 3 (mimeo.).)

What the Commission declined to do, however, was to provide protection for Pacific and GTEC from revenue impacts that might result once the revenues and rates were rebalanced and adopted for prospective application. We noted in discussing the related topic of lost revenues due to the introduction of competition:

> "Compensating for competitive loss would force the LECs' customers to shelter those percentages of toll revenue from competitive risk even after rates are rebalanced, effectively granting the LECs rate cap returns on those revenues. This would be inconsistent with the ratepayer safeguards and LEC incentives established in NRF. Moreover, Pacific's and GTEC's competitors have no captive markets to provide them with a steady revenue stream if they are inefficient. The effect of Pacific's and GTEC's request would be to increase the rates of all of their ratepayers because of the prospect that some ratepayers might choose another toll carrier. This would shift the risk of competition from the LECs to their ratepayers - not a result we expect from NRF. Therefore, Pacific's and GTEC's

> requests for compensation for competitive losses are denied." (D.94-09-065 at 164-165.)

GTEC filed an application for rehearing of D.94-09-065, challenging, among other things, the specific issues raised in this Petition, i.e., "the validity of the elasticity estimates, the analyses, the findings, conclusions and the application of those estimates in the IRD rate design." (D.96-02-023 at 2.) GTEC contended in its application for rehearing that:

> "In the area of elasticity, the Decision [94-09-065] erred as a matter of law in several areas: (1) adopting unsupported elasticity estimates for toll and switched access; (2) misapplying these estimates; and (3) arbitrarily refusing to acknowledge the effects of price increases or repression for other services in the rate design process." (GTEC Application for Rehearing at 2.)

In considering that application for rehearing, we determined that the record with respect to the adopted elasticity estimates was sound and noted the specific defects in the elasticity estimates advocated by Pacific and GTEC that prohibited their consideration. (Id. at 7-9.) We noted again the finding we made in D.94-09-065 that the adopted elasticity estimate of -0.5 reflected careful consideration of the evidence presented and drew its weight from the fact that the estimates of several studies clustered around it. (Id. at 8.)

Finally GTEC challenged D.94-09-065 as being arbitrary and unfair because the decision failed to compensate the local exchange carriers for intraLATA toll revenue loss. As we stated in the rehearing decision:

> "intraLATA toll revenue loss, if any occurs, is a competitive loss. We should not protect LECs from a failure to adequately compete. To extend to LECs protection against

> competitive losses would be to turn our back on ratepayers and to undermine the LEC incentives and the ratepayer safeguards established in the New Regulatory Framework" (D.96-02-023 at 12.)

We have previously had the opportunity to review the meaning of a revenue-neutral rate design and whether that has the impact of requiring truing-up to ensure an exact recovery of the revenue forecast in the IRD decision. In a petition for modification of the IRD decision filed by the California Association of Long Distance Telephone Companies, we examined the impact of the calculation and collection of certain surcharges and surcredits. We were asked to evaluate the request in the context of the "overarching policy of revenue neutrality of the IRD decision" and remedy a particular "unexpected consequence" of that decision. (D.96-03-021.) We noted the language in D.94-09-065 setting forth the intent and mechanics of developing a revenue-neutral rate design, and the problems entailed in doing that while implementing desired rate design and pricing policies. In discussing revenue rebalancing and whether the IRD decision requires a "true-up," We stated:

> "We are not persuaded that revenue neutrality was quite the 'overarching policy' in the IRD Decision as CALTEL urges to justify its request for relief. CALTEL's focus on access customers as a separate class is inconsistent with how we used revenue neutrality in the IRD Decision, which was as an estimating tool. Although the effect of which CALTEL complains may have been unintended, since neither the parties nor we expressly addressed it in the proceeding or the IRD Decision, it was not unanticipated." (D.96-03-021 at 8.)

While the specific rate element was different, the analysis is the same. Revenue neutrality was intended as a test for whether the myriad of rate elements and forecasts examined in the IRD proceeding were packaged to reflect to the greatest extent feasible our intended pricing policies, while providing Pacific and GTEC with neither a windfall nor a loss of opportunity to realize their authorized returns.

The mechanics of revenue neutrality are illustrated by Appendix C, p. C-1 and Appendix D, p. D-1 of D. 94-09-065 (as modified by D.96-02-023 and D.96-06-023). These pages show the specific changes to each element of Pacific's and GTEC's rate structure necessary to implement needed modifications without resulting in a net loss or gain for the utility. To maintain the goal of revenue neutrality, if it wished to grant the Petition to Modify, the Commission would need to similarly update each and every rate element. This would require an extraordinary commitment of resources from all parties. The Commission has no intention of taking such action.

The question of whether there was some reasonable expectation a true-up would be available has been dealt with explicitly. In the IRD proceeding several parties were concerned that the adoption of the elasticity rates advocated by Pacific and GTEC would have the same effect as now complained of by Pacific and GTEC, but in the opposite direction, i.e., that use of their elasticity forecasts would underestimate toll demand and revenues. To protect against the risk of a windfall to Pacific and GTEC, these parties urged adoption of a balancing account. The Commission specifically rejected such proposals, stating:

> "We reject this proposal for two reasons. First, we have not adopted the LEC's proposed elasticity estimates, and we have thus reduced the risk that is cited as the justification for the balancing accounts....
>
> Second, imposition of a balancing account would blunt the competitive incentives that we are trying to foster. If increased toll

> revenues are subject to a balancing account, the LEC's motivation after IRD to increase net toll revenues becomes clouded. We prefer to leave the LECs' competitive incentives as undiluted as possible. (D.94-09-065 at 155 (mimeo.)).

Pacific and GTEC contend the alleged discrepancy between forecasted and actual results in toll and switched-access revenues are the cause for, as Pacific puts it, a "dramatic deterioration" in their financial condition in the months following the IRD decision. (Petition at 4.) However, it is unreasonable to consider the results of their complained sales and revenue losses in isolation, as Pacific and GTEC suggest. First, as ORA noted in their response, there are many factors that may have caused the impacts. The period from which the Pacific and GTEC data is drawn relates only to the first year immediately following the issuance of D.94-09-065. There are many matters that could have affected their toll volumes and revenues during that period. To the extent the state of the economy as a whole was a factor, we would be asked to compensate for general economic conditions and we will not do that. To the extent Pacific and GTEC lost traffic to competitors, even in the absence of intraLATA presubscription, we would be asked to compensate for competitive losses, and we have clearly articulated that we will not do that either.

Most importantly, Pacific and GTEC only raise the area in which they claim to have suffered volumes and revenues less than forecasted in the IRD decision. To reconsider the elasticity adopted and the resulting forecasted volumes and revenues would necessitate reexamining all of the myriad of rate components and forecasted revenues which comprised the revenue neutral rate design. The alternative would be to review the decision's impacts on a "heads we lost, but don't consider the tails we won" basis. We have good reason to believe that in at least some significant areas the deviation between IRD-forecasted revenues and those actually realized will have been to Pacific's and GTEC's benefit. One example will suffice.

In the IRD record the estimate used for access lines for Pacific and GTEC was based on 1990 and 1989 data, respectively. We noted in the IRD decision that the rates established were intended to yield the NRF start-up revenue requirement for 1990, adjusted to reflect certain Commission actions. In response to Pacific's request at that time for compensation for competitive losses, we observed that such a request:

> "should be contrasted with its [Pacific's] failure to request adjustment of the target revenue level to reflect the growth in volumes that has occurred since the start-up date, January 1, 1990... The resulting rates will be applied to actual post-IRD sales, however. Because the number of access lines and minutes of use is greater now than it was in 1990, [footnote omitted], the revenue collected through post-IRD rates will predictably exceed the LECs' start-up revenue requirements.
>
> Because the productivity factor assumed that management would achieve a minimum level of productivity under those conditions, compensating for the effects of either competition or growth in volumes would undermine the operation of the price cap mechanism. Since the rates adopted here are intended to implement NRF and not to redesign the price cap mechanism, loss in revenues due to intraLATA competition should not be recognized." (D. 94-09-065 at 162-163, mimeo.)

We can well take official notice of our own active proceedings and decisions which discuss the virtual explosion in access lines which has occurred not just since 1989 or 1990 but since the issuance of the IRD decision barely two years ago. In our local competition proceedings (I.95-04-044/R.95-04-043) we have issued numerous decisions addressing the problems of number availability and number exhaustion. Through various complaint proceedings, we have been called upon to determine the manner in which to relieve several area codes approaching number exhaustion. These are all reflective of the tremendous growth not only in telephones, but computers, facsimile machines, and other communication devices. These reflect growth in access lines.[7] We take note of the fact that no request has been made by Pacific or GTEC to rebalance revenues to account for this seeming deviation of actual volumes and revenues from those forecasted in IRD.

And there is good reason to not have such a request. The IRD decision was a package, not an assurance of explicit outcomes on individual elements. To the extent that package has resulted in neither a windfall nor the loss of an opportunity for Pacific and GTEC to achieve their authorized returns, it was a success. There has been no allegation that the package has failed in that respect. It would be fundamentally unfair for us to examine one element of that package, even a significant one in terms of revenues, in isolation.

**Related Matters-Motions for Establishment of Memorandum Accounts**

In addition to the Petition (and its amendment), on April 5, 1996, Pacific and GTEC filed a Joint Motion of GTE California Incorporated and Pacific Bell for Establishment of Memorandum Account Relating to the Implementation Rate Design

[7] We also observe but, of course, cannot officially notice, recent press coverage in which Pacific in particular touts its recently improved financial situation resulting from a better than expected increase in access lines.

Decision (Joint Motion). The purpose of this request was to provide a procedural accounting vehicle, in the event their Petition was granted, to allow recovery of revenues allegedly lost without incurring the prohibition on retroactive ratemaking. Since we find that the Petition should be denied, no further consideration need be given to establishment of the memorandum account and the Joint Motion is denied.

Finally, we need to address the "Motion of Roseville Telephone Company To Establish Memorandum Account Relating to the Implementation Rate Design Decision", filed April 29, 1996 (Roseville Motion). Roseville states that it filed this motion to track revenues Roseville contends it might have lost based on the allegations about elasticity forecast errors in the Petition. Again, because we deny the Petition, there is no basis to give any further consideration to the Roseville Motion.

**Findings of Fact**

1. Pacific Bell and GTEC request modification of the elasticity factors adopted in D.94-09-065 to calculate changes in intraLATA toll and switched-access volumes.

2. Pacific and GTEC allege that they have suffered substantially lower intraLATA toll and switched access revenues than were forecasted in the process of calculating the rate design adopted in D.94-09-065.

3. The figures of claimed revenue shortfall alleged by Pacific and GTEC have not been determined to be accurate or correct.

4. GTEC filed a timely application for rehearing of D.94-09-065 which, among other things, challenged the reasonableness of the adopted elasticity factors.

5. GTEC's application for rehearing with respect to the issues related to the petition for modification was denied.

6. Pacific did not file a timely application for rehearing with respect to the reasonableness of the elasticity factors adopted in D.94-09-065.

7. The Commission's ORA, The California Telecommunications Coalition and the California Committee for Large Telecommunications Consumers filed responses in opposition to the petition for modification.

8. Several small local exchange companies filed a joint response in support of the petition for modification.

9. The modification request is to "true-up" the revenues of each petitioner for the alleged revenue discrepancy by adjusting other cost components to recover the revenue allegedly lost.

10. Pacific and GTEC offer no other explanations for the lower than forecasted revenues other than alleged error in the elasticity factors adopted.

11. Pacific and GTEC do not propose examination of any other revenue components to ascertain whether they are producing less or more revenue than was forecasated in the adoption of D.94-09-065.

12. The number of access lines has grown considerably both from the time of the data used to calculate the rate design adopted in D.94-09-065 to the date of that decision and from the date of that decision to the present.

**Conclusions of Law**

1. Revenue neutrality was not intended in the IRD decision to apply on a service-by-service basis.

2. Revenue neutrality was premised on a rate design in which every rate change ordered in D.94-09-065 that resulted in a revenue increase or decrease was offset by countervailing rate changes or revenue adjustments so that the cumulative effect of all revenue changes for each company was zero.

3. The Commission explicitly rejected the concept of revisiting revenues levels adopted in D.94-09-065 to true them up where they might vary from recorded figures.

4. The elasticity factors adopted in D.94-09-065 were supported by the record as confirmed in D.96-02-023.

5. Factors other than errors in the manner in which elasticity factors were calculated may explain all or any part of the variation between forecasted and actual intraLATA toll and switched-access revenues.

6. Revenue neutrality as adopted in D.94-09-065 was premised on a rate design for each petitioner which as an aggregate of all its components had a reasonable expectation of neither creating a windfall for either Pacific or GTEC nor jeopardizing their having a reasonable opportunity to realize their authorized rates of return.

7. There is no reasonable basis to do a true-up of actual-to-forecasted revenues associated with any one component of the overall rate design adopted in D.94-09-065 without the opportunity for a reexamination of all of the components.

## ORDER

**IT IS ORDERED** that:

1. For the above stated reasons, the Joint Petition of Pacific Bell and GTE California Incorporated for modification of Decision 94-09-065 is denied.

2. The motions of Pacific Bell and GTE California, filed April 5, 1996, and Roseville Telephone Company, filed April 29, 1996, for the establishment of memorandum accounts relating to the Implementation Rate Design proceeding are denied as moot.

This order is effective today.

Dated February 19, 1997, at San Francisco, California.

P. GREGORY CONLON
President
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
RICHARD A. BILAS
Commissioners

I will file a concurring opinion.

/s/ JESSIE J. KNIGHT, JR.
Commissioner

I will file a written dissent.

/s/ JOSIAH L. NEEPER
Commissioner

A. 87-11-033
D. 97-02-049

**COMMISSIONER JESSIE J. KNIGHT, JR., CONCURRING:**

I concur in this decision which denies the request by Pacific Bell (Pacific) and GTE California (GTEC) to modify D. 94-09-065, the Implementation Rate Design (IRD) Decision.

In their petitions, Pacific and GTEC allege that our IRD decision adopted a forecasted estimate for increased toll and switched access usage that has proven to be far less than actual market results. The petitioners request an increase in prices to recover millions in alleged lost revenue. This decision denies Pacific and GTEC's request for numerous reasons which I fully endorse.

First, if the Commission were to grant the petitioners' request, this could allow a rate increase on the most inelastic services not currently subject to competition. As the Office of Ratepayer Advocates has noted, it is improper to use a petition to modify as the vehicle for a rate increase. Rather, if Pacific and GTEC wish to pursue a prospective increase on rates, they should do so by means of an application pursuant to Commission rules, with the attendant notice requirements. This would allow balanced examination of the parties' alleged losses.

Second, the Commission has already rejected allegations of procedural error and lack of evidence in adopting toll elasticity estimates. In D.96-02-023, we denied GTEC's application for rehearing of IRD and we explicitly discussed how the record supported the elasticity estimates we adopted.

Third and most significantly, I do not support reopening the IRD case to examine potential error in an elasticity estimate because when the Commission adopted the estimate and corresponding formula in IRD, we knew a priori that the forecast was bound to deviate from actual results. The IRD decision specifically rejected any future "true-up" of the revenues resulting from IRD because the Commission explicitly feared that a true-up would blunt competitive incentives. The Commission strongly stated that it should not protect incumbent monopolies with future true-ups if they failed to adequately compete in the new market structure. In fact, the petitioners argued against a true-up in their testimony on the original case. They now attempt to recraft their point of view when the results work against their present circumstances.

The Commission's IRD decision did not <u>promise</u> or guarantee revenue neutrality, but gave the companies the <u>opportunity</u> to increase revenues and improve earnings. IRD was a carefully crafted policy package, not an assurance of explicit outcomes on individual rate elements. As companies in our New Regulatory Framework (NRF), both Pacific and GTEC have pricing flexibility, the ability to enter contracts, and the advantage of carrying all default traffic. In a petition to modify IRD, Pacific and GTEC bear the burden of demonstrating that their respective overall rate designs have failed to achieve revenue neutrality. It is not an inconsequential observation that neither company has even alleged that the IRD package has failed. In my judgment, the petitioners have been unpersuasive in their quest to deviate from these prior decisions.

Furthermore, it would be improper in hindsight to establish criteria for a "reasonable" deviation from earlier estimates when the Commission rejected this notion earlier. If the Commission were to reopen its IRD proceeding as the petitioners suggest to determine whether revenues were beyond a "foreseeable" margin of error, an endless cycle of hindsight analysis of decisions which all participants had relied upon as final would be unnecessarily created. Nothing extraordinary or unforeseeable has occurred that warrants a reopening. <u>This is not in the public interest and certainly provides an unnecessary protection for the incumbent local exchange carriers and would serve to raise the level of risk for new entrants</u>. The Commission's new regulatory framework has established a process whereby Pacific and GTEC may seek a rate increase if their rate of return falls below an established trigger level. This is the proper means to handle their current request.

Fourth, I am not convinced that it would ever be possible to distinguish the source of the revenue losses Pacific and GTEC claim. Alleged losses can be attributed to a variety of factors, including a negative variance in forecasting error in the IRD formula, general economic conditions, and the inability of the companies to preserve the same universe of customers in a newly competitive environment. In fact, in order to determine the merits of their claim, the Commission would have to examine the entire post-IRD intraLATA toll market, including all carriers providing intraLATA toll -- not just the results of Pacific and GTEC. This would be a monumental undertaking. Absent this level of scrutiny, the Commission could never know with certainty that other toll carriers had not merely outstripped the performance of Pacific and GTEC.

In contrast, if the Commission reopened the IRD case for the narrow purpose of examining toll elasticity, this would completely ignore the other areas where these companies may have surpassed our earlier estimates. For example, Pacific has recently reported revenues of $639 million in intrastate toll revenues for the first six months of 1996 (a 3.9% increase over the first six months of 1995). In the second quarter of 1996, Pacific's intraLATA toll revenues increased by 7.7% over the same period in 1995. These numbers appear to indicate that growth in toll markets is outstripping any losses to competition that Pacific has faced, even with a 6% loss of market share. Indeed, recent published reports highlight how increasing demand for services such as Internet access and caller ID have boosted incumbent local exchange company profits. Pacific Telesis in particular has benefited from this surge in demand for internet service, with year-end net income up 22% percent over 1995. It is certainly possible that this increased demand alleviates some of the alleged shortfall Pacific and GTEC claim in their petition.

Finally, I note that my concurrence on this decision is consistent with my recent dissent on the Franchise Impact case ,D. 96-09-089 (see attached). While I still maintain my original position regarding franchise impacts, I note that the majority of this Commission voted in that decision to allow a further look at the claims of monetary impacts to the monopoly franchise. Therefore, I would concede that procedurally, the request denied herein is more appropriately considered in that venue. It is far more rational to employ a holistic approach to the issue of monetary impacts and avoid fragmenting any alleged impacts into a forest of smaller proceedings.

I have carefully considered the companies' requests. In the interest of preserving the integrity of the IRD decision, and our process in arriving at it, I reject reopening the case in the manner suggested. Therefore, I concur in the decision of my colleagues.

Dated February 19, 1997 in San Francisco, California.

/s/ Jessie J. Knight, Jr.
Jessie J. Knight, Jr.
Commissioner

## COMMISSIONER JESSIE J. KNIGHT, JR., DISSENTING:

In my three years of experience as a Commissioner, never has a decision been so widely debated and analyzed within the California Public Utilities Commission. The issue before us regarding competitive franchise impacts on the incumbent telephone utilities, generated five proposed decisions, as many decisions as there are sitting Commissioners. With such focused, though varied positions, one would have hoped that this collegial body ultimately would be decisive and reach a sage result. Regrettably, this did not happen. In the end, compromise produced a decision which is neither decisive, nor wise in my opinion. Thus, I must strongly dissent from the vote of the majority.

After having dedicated nearly a year of this Commission's limited resources to the franchise impact issue, the decision resolves very little. The majority concludes that this phase of the Local Competition proceeding was premature and that sometime after January 1, 1997, at the behest of Pacific Bell (Pacific) or GTE California, Inc. (GTEC), the interested parties can re-visit the subject again. Additionally, the majority redefines the inquiry and greatly broadens the scope of the postponed Franchise Impact case unnecessarily.

Aside from being a waste of administrative resources, some might view the majority's decision as innocuous, or at least embrace the unfortunate belief that the decision does not deal a detrimental blow to this Commission's long term commitment to the promotion of competition in the telephone industry. I wish this decision truly promulgated so benign a circumstance. I believe that a close reading of the majority opinion will clearly reveal unforeseen and unintentional protection of the incumbent monopolies. The protection that the majority decision affords Pacific and GTEC is unwarranted, unnecessary and potentially destructive to our quest for full competition.

As a result of the majority's decision, Pacific and GTEC emerge as big winners, and perhaps the only winners. Since the utilities could not persuade the Commission to compensate them in any amount, let alone the several billion dollars requested, then the next best outcome for these entities would be an expressly sanctioned opportunity to try again. The majority has provided that opportunity.

Virtually every theory raised in support of the utilities' compensation request is preserved or expanded by the majority decision. Moreover, potential competitors in the local exchange market will find no comfort in the majority's positions. At best, the decision creates a discouraging atmosphere of uncertainty for new entrants into the market. At worst, the decision can be read as a foreboding message that higher economic risk is created because of an enhanced possibility of investment loss for new entrants into the local exchange market in California, as the incumbent monopolies seek to establish a treasure chest of future funds to bolster their economic standing in the emerging competitive world.

## The Franchise Impact Claim

The issue before us was prescribed in D.95-07-054 as the examination of whether the rules which

> "'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).'" (D.95-12-062, slip op. p.10, fn. 11 quoting from D.95-07-054, slip op. p. 33.)

In response to the franchise impacts inquiry, Pacific and GTEC claim that they have a constitutional right to be compensated for the adverse effects of local competition because such competition, developed pursuant to this Commission's rules, constitutes a taking under the Fifth Amendment (Takings Clause) and the Fourteenth Amendment (Due Process Clause) of the United States Constitution. The taking argument is framed as the confiscation of shareholder property, either because Pacific and GTEC will be unable to recover past capital investments, or because shareholders will be denied the opportunity to earn a fair return on those investments.

In the case of a claim of taking or confiscation of property, it is axiomatic that the party responsible for the alleged taking be the party to which the claim is directed. In this case, the utilities' claim that this Commission is the entity responsible for local exchange competition and therefore, the Commission is liable for the alleged taking of Pacific and GTEC's right to earn a fair return on invested capital. Prior to February 8, 1996, such a claim might have been credible, because the applicable law (The Telecommunications Act of 1934) gave the states primary jurisdiction over intrastate communication services (See Louisiana Public Service Commission v. F.C.C.) . However, on that date, the United States Congress passed the Telecommunications Act of 1996 (The Act), a statute which reasonably can be understood as effectively extinguishing the utilities' claims of this Commission's culpability in requiring local competition. The Act provides in relevant part:

> "No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service." (emphasis added, Public Law 104-104, Section 253 (a).)

> "Nothing in this section shall affect the ability of a State to impose, on a competitively neutral basis and consistent with section 254, requirements

necessary to preserve and advance universal service, protect the public safety and welfare, ensure the continued quality of telecommunications services, and safeguard the rights of consumers." (Id. Section 253 (b).)

"If, after notice and an opportunity for public comment, the Commission determines that a State or local government has permitted or imposed any state, regulation, or legal requirement that violates subsection (a) or (b), the Commission shall preempt the enforcement of such statute, regulation, or legal requirement to the extent necessary to correct such violation or inconsistency." (Id. Section 253 (d).)

During this proceeding, several parties commented on the effect of the Act on the instant franchise impact inquiry. (See discussion of comments in the majority decision, D.96-09-089, slip op. pp. 9-12.). The Coalition and DRA assert that as a result of passage of the Act, the utilities' claims should be dismissed. DRA claims that pursuant to Article VI, clause 2 (the Supremacy Clause), of the United States Constitution, the Act preempts the Commission's regulation of local competition.

"The supremacy clause invalidates all state laws that conflict or interfere with an act of Congress.... DRA points out that both Pacific and GTEC have argued that even with the most favorable local competition rules, they will not have an opportunity to earn a fair return. Therefore, DRA concludes that it is the fact of local competition, and not specific rules, that GTEC and Pacific contend prevents them from earning a fair return. Since the Act preempts the Commission's regulation, DRA asserts that the carriers' claims before this Commission are moot and should be dismissed." (Id., p.10.)

The Coalition argues the principles of traditional fault doctrine, pointing out that "any franchise impacts complained of are caused by the Act and would occur if this Commission were to take no action. Therefore, the carriers have no claim against this Commission." (Id., p. 11.)

Commissioner Daniel Fessler and I reviewed the comments of DRA and the Coalition and found them impressive. We jointly authored an alternate decision in which we concluded the following:

"The Act mandates local exchange competition. The carriers' witnesses have testified that even under local competition rules that are viewed favorably by the carriers, they will experience a taking. In so stating, the local competition rules themselves are removed from the possible causes of the alleged taking. With passage of the Act, we no longer have the authority to 'remedy' takings by not allowing local competition. Therefore,

> we can not be the cause of claims that we have taken from Pacific and GTEC the opportunity to earn a fair return by authorizing local competition consistent with the Act. With the passage of the Act, the taking claims asserted by Pacific and GTEC are moot and should therefore be dismissed."
>
> "Having arrived at this conclusion, this decision need not address further the evidence presented in support of the takings claims or the arguments on any legal obligations this Commission holds to compensate the carriers." (Knight/Fessler Alternate, R.95-04-043, Local Exchange Franchise Impacts, Item H-3c 6/19/96 Agenda, pp.11-12)

I continue to believe that the Knight/Fessler conclusion is legally correct, pragmatically sound and that its adoption by this Commission would have served the best interests of Californians. It would have provided the kind of expeditious, final result that affirmatively facilitates progress toward the types of competition evidenced in non-regulated industries. It would have been a decisive result that could only serve to promote the accomplishment of our competition goals. It would have been an economical preservation of our scarce resources. It would have provided an invaluable measure of certainty for potential entrants to the local exchange market. This inquiry would have ended without financial or competitive harm to Pacific and GTEC, since the utilities could still have obtained remedy from the federal government, upon proof that the local competition mandate contained in the Act would deprive them of the right to earn a reasonable return on capital investment and that such deprivation was a compensable taking. And last but far from being least, it would have obliterated a future round of government scrutiny from the eventual court disputes over this issue which surely will be forthcoming.

Regrettably, the Commission did not adopt the Knight/Fessler position. The majority does not explain why they did not find the arguments of DRA and the Coalition more compelling, especially since they "agree with the Coalition and DRA that were we to take no action, the takings claim asserted by Pacific and GTEC would still occur." (D.96-09-089, slip op. p.12.)

It is appropriate for us to consider how the majority dismisses the applicability of the Act to the franchise impact inquiry: "whether our local exchange competition rules alters our regulatory program so that Pacific and GTEC are not afforded an opportunity to earn a fair return on invested capital. The majority dismisses, without explanation, the applicability of the Act to the instant franchise impact inquiry and states:

> "In comments on the proposed decision, the carriers argue that the Commission must take the effect of the Act into account. The act mandates local exchange competition. The carriers' witnesses have

> testified that even under local competition rules that are viewed favorably by the carriers, they will experience a taking. As discussed in Section 4.1.1., the impact of competition cannot constitute a taking. Therefore, we will consider the evidence and arguments to determine the impact of our local competition rules together with our depreciation policy on GTEC's and Pacific's opportunity to earn a fair return on their respective investments, including their opportunity to recover the depreciation expense in the emerging competitive telecommunications market." (D.96-09-089, p.13.)

It is my firm conclusion that the recently enacted (February 8,1996) Telecommunications Act of 1996 (the Act) prohibits states from constraining local competition. The taking claims asserted by the utilities now must derive from the Act and not from any local competition rules which this Commission is obliged to develop consistent with the Act. The test for this is simple. May the commission rescind its decision to open the local market to competition? The answer is no. Therefore, local competition is not the result of this Commission's actions.

The taking assertion is further augmented by the claims that by introducing local competition, the Commission abrogates the utilities' "exclusive franchise" and/or the Commission breaches the "regulatory compact" which protects the utilities from competition. Finally, cloaking themselves in the Constitution's Equal Protection Clause, utilities claims that the Commission must provide phone companies with transition cost relief analogous to the non-bypassable Competitive Transition Charge (CTC) provided in our Electric Services Restructuring Decision (D.95-12-063, as modified by D.96-01-009). Pivotal to the utilities' quantification of the taking claims is the accounting mechanism which identifies the companies' impaired assets, described by Pacific as depreciation reserve deficiency or as uneconomic assets by GTEC.

A taking argument is difficult to prove and the courts would tend to give deference to the government agency charged with acting in the public interest. The majority decision provides an apt picture of the taking law, but does not emphasize how difficult a burden the proponent has in such a case. Constitutional taking is not easy to prove, as the following summary of "taking" law suggests. Generally, an unlawful taking or confiscation does not occur unless a regulation or rate is unjust and unreasonable (Duquesne Light Co. v. Barash (1988) 488 U.S. 299, 307; 20th Century Ins. Co. v. Garamendi (1994) 8 Cal.4th 216, 292.) Whether a regulation or rate is just and reasonable depends on the balancing of the interests of the regulated entity providing the services and the interests of the consumers of such services. (Federal Power Com. v. Hope Nat. Gas Co. (1943) 320 U.S. 591, 603; see also, 20th Century Ins. Co. v. Garamendi, supra, 8 Cal.4th at p. 293.) " 'The just and reasonable" principle does not require "that the cost of each company be ascertained and its rates fixed with respect to its own costs." ' " (Id. citing Giles Lowery Stockyards v. Dept. of Agriculture (5th Cir. 1977) 565 F.2d 321, 327.) "[A] regulated industry is not entitled, as a matter of right, to realize a particular rate of return, and the interests of the consuming public are also to be considered in establishing rates." (Id. at p. 324.) "That a particular rate may not cover the cost of a particular good or service does not work confiscation in and of itself." (20th Century Ins. Co. v. Garamendi, supra, 8 Cal.4th at p. 293.) Further, a regulated entity neither has a constitutional right to a profit nor a constitutional right against a loss. (Id. at p. 294) "The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid." (Federal Power Com. v. Hope Nat. Gas Co., supra, 320 U.S.at p. 601). Competition alone cannot constitute adequate grounds for an unconstitutional taking, because the Constitution does not shield a utility from such business hazards (Public Service Commission of Montana v. Great Northern Utilities Co., (1933) 289 U.S. 130, 135 ). Finally, it appears that an unconstitutional taking will not lie if there is an adequate method for obtaining individualized relief. "Recognizing that virtually any law which sets prices may prove confiscatory in practice, courts have carefully scrutinized such provisions to ensure that the sellers will have an adequate remedy for relief from confiscatory rates." (Calfarm Ins. Co. v. Deukmejian (1989) 48 Cal. 3d 805, 817.)

The majority decision correctly orders denial of the utilities taking claims related to the introduction of competition in their local exchange markets (D.96-09-089, Ordering Paragraph 3). Because the recently enacted (February 8,1996) Telecommunications Act of 1996 (the Act) prohibits states from constraining local competition, the taking claims asserted by the utilities now must derive from the Act and not from any local competition rules-which this Commission is obliged to develop consistent with the Act. Accordingly, the taking claims related to local competition rules are moot and should be dismissed.

I find the evidence clear and convincing that a takings has not occurred, nor does it appear that a taking of utility property is likely to occur. I find nothing in the analysis of stock price data that indicates the opening of the local telecommunications market to competition constitutes a taking. Even if one assumes a reduction in the value of the stock price of a utility, that is not, in and of itself, evidence of a taking. The stock price simply reflects the investors expectations of the value of the company at a point in time. Simply a reduction in these expectations does not constitute a taking. In reviewing the financial projections of the telephone companies, I am not convinced that a takings is ever likely to occur. The Commission is only responsible for the effects of its regulatory actions. The government is not responsible for shortfalls in earnings due to competitive losses, for shortfalls that occur as the result of poor managerial decisions, for shortfalls that result because of economic conditions, nor for shortfalls that result from technological change. Rather, it is the obligation of government as regulator, to allow for utilities to have a fair opportunity to earn a fair return on their investments dedicated to public service. In my mind, Pacific still has this opportunity.

## The Second Bite at the Apple

The majority decision concludes that, based on the evidence presented, Pacific and GTEC failed to persuade this Commission that the implementation of local exchange competition would adversely impact the utilities' opportunity to earn a fair return on capital investment. That decision should have signaled the end of this case. As a matter of law, decisions made by this Commission are limited by and reflective of the underlying record (Camp Meeker Water System, Inc. v. Public Utilities Com. (1990) 51 Cal.3d 845, 864; see also, California Manufacturers Assn. v. Public Utilities Com. (1979) 24 Cal.3d 263, 265; see also Rule 1.2 of the Commission's Rules of Practice and Procedure, Cal. Code of Regs. tit. 20, paragraph 1.2 which states: "the Commission shall render its decision based on the evidence of record."). If the party seeking a remedy does not carry its burden, then the answer to its inquiries is negative! (Aetna Ins. Co. v. Hyde (1928) 275 U.S. 440, 447-448).

In this case, Pacific and GTEC did not carry their burden. In fact, according to the majority, the utilities' quantitative evidence of adverse impact on future earnings is so speculative that "it should be given no weight." (D.96-09-089, slip op. p. 59). Despite this clear rejection of the quantitative evidence, it is curious that the majority excuses the utilities' unpersuasive presentations:

> "This speculation was necessary due to the timing of this proceeding. Testimony was submitted before our local exchange competition rules were adopted." (D.96-09-089, slip op. p. 59.)

Inexplicably, the majority perceives prematureness as a relevant concern, even though the applicant utilities did not. The utilities chose the evidence and made their showing knowing full well that the franchise impact issues would be heard before resolution of the Commission's local competition interim rules. Furthermore, the utilities' testimony apparently anticipates the question of prematureness and deems it irrelevant. Both Pacific and GTEC conclude that their respective positions on the franchise impact issue will be unaffected by the outcome of the Commission's local competition rules.

> "Pacific's witness Darbee testified that Pacific will not have an opportunity to earn a fair return even if all the then-pending local exchange competition rules were resolved in Pacific's favor. GTEC's witness MacAvoy presented testimony which arrived at the same conclusion." (D.96-09-089, Finding of Fact 1, p.67.)

The majority's express invitation to the utilities to renew their request for franchise impact compensation "after January 1, 1997" was neither a legal nor a pragmatic necessity. Pacific and

GTEC management are quite familiar with Commission procedures and are fully cognizant of all the routes to gain Commission reconsideration of any matter they may have concern. Furthermore, the cornerstone of the utilities' compensation request, the constitutional taking argument, always can be renewed, particularly when changed circumstances or new facts form the basis for the renewed request. Therefore, it seems clear that the majority's reapplication invitation was not necessary. Moreover, when one considers the utilities' evidentiary decisions in the instant proceeding, it appears that the invitation also was undeserved. When one considers the utilities' "excused" speculative testimony and the reapplication invitation together, the following statement from the majority decision seems to have special importance:

> "We reemphasize the important distinction we made ... between protecting the carriers from competition -- which the Commission will not do -- and mitigating any deprivation of the carriers' opportunity to earn a fair return on their investment resulting from our (sic) adopted new regulatory program and on-going NRF regulation. The carriers should be careful to reflect this distinction in any presentation of evidence that our regulatory program deprives them of the opportunity to earn a fair return. We note that though the concept of losses due to competition was debated, <u>the parties did not debate the local competition assumptions Pacific applied in the scenarios it presented. These scenarios, although speculative, provide us with a sense of the possible impact of regulatory and market outcomes which we would like to further consider once our new regulatory programs have been completed.</u>" (D.96-09-089, p. 61.)

It is unclear whether the majority was positively impressed by the speculative quantitative evidence or simply wanted to see if the speculation became fact once the "new regulatory programs" become effective. It is unclear whether the majority felt that only the "debate" on Pacific's local competition assumptions were missing. As intimated by the above citation, it appears that the utility scenarios serve as the basis for the revised franchise impact inquiry which the majority adopts. A more troubling reading is whether the utility "scenarios" have become the blue print for the majority's revision of the franchise impact inquiry. Knowing and respecting the view of each of my colleagues in the majority regarding to their individual beliefs on competition, I am not persuaded that the latter is true. Each Commissioner is thoroughly dedicated to the rapid evolution of competition. I only highlight the possible misinterpretation by less informed parties who may become involved in some future inquiry of the Commission.

## The New Franchise Impact Issue - A Big Target

Certainly the majority's reapplication invitation says more than "come back". Instead of considering the utilities' opportunities to earn a fair return in the context of local exchange competition rules, the inquiry we enunciated in D.95-07-054, the majority redefines and broadens the franchise impact issue. The new franchise impact inquiry as embodied in the Order is as follows:

> "whether our adopted new regulatory program embodied in the roadmap proceedings combined with the NRF-established depreciation methods will deprive them of the opportunity to earn a fair return on their 'regulated assets'." (d.96-09-089, Ordering Paragraph 7, p. 72.)

Before concluding the Order, the majority adds this guidance:

> "The carriers may concurrently recommend recovery mechanisms to mitigate any adverse effects of our regulatory policies. The carriers should specify who will be charged for the recovery. In their applications, the carriers should also specify what portion of their 'regulated assets' subject to our revised regulatory program should be considered in determining the impact of our policies." (D.96-09-089, Ordering Paragraph 7, p. 73.)

By adopting an expansive approach to the franchise impact inquiry, the majority introduces the high risk of creating a real, though unintended, barrier to the advent of full competition. The majority invites the proliferation of proceedings and extensive reargument of well-settled Commission positions, decided as long as seven years ago when the Commission adopted the New Regulatory Framework (NRF) (D89-10-031, 33 CPUC 2nd 43)

While the majority decision apparently provides the express opportunity for Pacific and GTEC to re-argue issues that were decided in 1995 and 1996, out of economic self interest and with nothing to lose, the carriers may attempt to re-argue all issues and decisions in which they did not originally prevail before the Commission. Most likely, they will seek to reverse our determination in D.96-03-020, (i.e. resale decision), that no taking had occurred. Literally, hundreds of calls were made within the 1994 Implementation Rate Design (IRD) decision that will be vulnerable to new claims of franchise loss and assertions of negative impact on the incumbent carriers. Conversely, some interveners might employ this opportunity to re-litigate the Airtouch decision and the 1995 NRF Review decision. The Southwestern Bell Corporation/Pacific Telesis merger application may also be implicated. In essence, the majority's broad reapplication invitation will serve as the unintended excuse for relitigation of ANY issue that has even a modicum of connection to local competition issues. NO issue will be safe or settled. The yoke of regulation will continue to be the albatross around the neck of the industry.

The present franchise impact case has been a time intensive inquiry and has taken nearly a year. It is not a pleasant thought to forecast how long it will take to complete the majority's new mega-proceeding, and how the sheer size and length of such a proceeding might adversely impact the evolution of competition.

This Commission, under Public Utilities Code section 1708, always retains the right to change previous Commission decisions. However, this broad inquiry sets a dangerous precedent that appears to subject all that was established in the march to competition to wholesale reevaluation. Such a belated assessment, or even the appearance thereof, could seriously undermine the entire enterprise to de-regulate, if not by actual changes in policies and rules, at least by the chilling effect such an inquiry will likely have on potential entrants to the newly opened market.

Electric Industry Framework Not Applicable

The majority concludes that ":[t]he fundamental similarity between the electric and telecommunications industries is their transition from monopoly to competitive environments and the role the commission plays in directing that transition. However, this similarity is far outweighed by the looming differences. The majority's decision spends a few scant lines stating that the situation between these industries is comparable. The majority's conclusionary statements are unpersuasive. The majority reaches the conclusion that the showing Pacific and GTEC made are not entirely inconsistent with the criteria the Commission laid out in its electric restructuring decision.[1] They cannot be more incorrect. In the electric restructuring decision, the Commission did allow the electric utilities to recover costs associated with uneconomic assets. However, the Commission refused to do so on the basis of the kind of speculative information offered by the Pacific Bell and GTEC. Rather the Commission simply stated that the utilities would be allowed to recover the difference between the market value of their assets and the book value of those same assets. There are three ways a utility may seek to establish a market value for these assets: 1) sell the asset, 2) spin the asset off to shareholders, or 3) seek a market valuation by an independent valuation expert. Each of these options are based upon the economic value of the asset and compares that to the book value of the asset. In addition, any assets with book values greater than their market value are netted out against those assets with a market value that exceeds the book value. Neither Pacific nor GTEC calculated their "stranded assets" in a similar fashion. Here it is important to note that the electric utilities had a market to book ratio much closer to 1:1 than was the case for either Pacific Bell or GTEC.

A second difference between the situation in the electric industry and the telecommunications

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[1]I note that the language of the decision implies that in the majority's own minds, the showings are not entirely consistent with criteria established in our electric restructuring decision either.

industry is that the Commission has fundamentally altered the pricing of the utilities service offering in the electric industry. The electric utilities are directed to pass along to consumers only the cost of purchasing power in the Power Exchange to consumers. If this price is not sufficient for the utility to recover both its going-forward operating costs and its sunk costs, the electric utility is allowed to recover the difference. However the electric utility may do so only to the extent that rates do not raise above current levels. In the telecommunications industry, Pacific seeks to recover its "compensation" thorough an increase in rates above today's levels or through a surcharge on existing rates. Hence, the electric utilities were seeking only to continue to recover those costs already in rates while Pacific is arguing for recovery of new, higher costs. In essence, the electric utilities seek to unbundle their uneconomic stranded cost recovery from existing rates and seek recovery through a surcharge on those that continue to use its distribution system.

A third difference between the stranded cost issue for electric utilities and the circumstances facing the Commission in the telecommunication industry is that in the electric industry, the utilities are only provided an opportunity to recover these "stranded costs". The utilities are allowed to recover those costs that the market will allow recovery. The electric utilities are allowed to recover stranded investment only until December 31, 2001. There is no guarantee that the utility will fully recover these stranded costs.

In the electric industry, the California Legislature has spelled out very specific guidelines regarding how and when the utilities are allowed to recover uneconomic costs. Rates are frozen at 1996 levels and the utilities are able to forego future rate decreases that would otherwise occur, and use this amount to recover stranded costs. The utility is allowed to forgo these rate reductions and retain the revenues, only until the year 2002 or until the uneconomic costs are fully recovered. In addition, the utility is allowed a reduced rate of return because of the reduced risk of recovery of these uneconomic sunk costs. The utility is not guaranteed a fair rate of return, only a fair opportunity to earn a fair return. Furthermore, the utility explicitly described what costs are recoverable as uneconomic costs. This bears no resemblance to the scheme that the incumbent local telephone companies have in mind.

And finally, the majority overlooks the most fundamental difference between the electric utilities and the incumbent local exchange carriers. The electric companies were regulated under rigorous traditional cost of service regulation and each of the major investments for which the utility would be eligible for recovery were expressly approved by the Commission, which found their construction to be in the public interest. The local telephone companies have been regulated under the New Regulatory Framework (NRF) since 1990 and since then have been at risk for any and all uneconomic investments. In addition, the telecommunications industry was not subject to the same degree of review for the specific investments they now claim are uneconomic. The Commission has allowed the telecommunications business the flexibility to manage their own affairs, while it has retained cost of service regulation and reasonableness reviews for the regulation of the electric utilities. In essence, the electric utilities investment decisions were much more subject to specific commission oversight and hence, the responsibility of the Commission to assure recovery is heightened. This is not, and should not, be the case in telecommunications.

## No Evidence of Impaired Ability to Earn Fair Return

As I reviewed the financial projections of Pacific and GTEC, they appeared to be overly pessimistic and to overstate the impact of regulatory changes on the present and prospective fortunes of the company. In fact, it could be argued that the constant pessimistic outlook that permeated Pacific's projections led the market to under value Pacific Telesis's stock, producing lackluster stock results and resulting in Southwestern Bell Corporation viewing the stock price favorably and hence spurring their proposed acquisition of Pacific Telesis.

Even the majority concludes that Pacific and GTEC did not adequately prove that the Commission's regulatory program would impair the carriers opportunity to earn. The evidence in this caseas put forth by Pacific and GTEC is not only speculative, it is utterly unpersuasive.

As I prepared for the vote on this case, I made a special effort to review Pacific's financial and business conditions. According to publicly available data regarding Pacific's stock price, as of September of 1996, Pacific Bell had outperformed all other companies in its stock price performance since July of 1995. In fact, it outperformed the S&P 500 over that same time period.

Pacific Bell is experiencing tremendous growth in its market. Pacific is coming off a record 2nd quarter, well on its way to a very good year. Pacific Telesis operating income for the first six months of 1996 increased a staggering 18%, $182 million, over the operating income for the first six moths of 1995. This increase in operating income resulted from a surge in revenues of 5.4% combined with a modest increase in expenses, including depreciation, of just 1.7 %. Net income increased by 6.8% reflecting a 5 cent gain, to 66 cents in earnings per share for the 2nd quarter of 1996 over 2nd quarter 1995.

> " Total access lines in service increased by a record 726,000 lines in 1996 or 4.7 percent year over year, as business access lines grew even faster than the record-setting pace of the first quarter, rising to 5.7 percent. Residential lines grew 4.2 percent year over year, up from a 3.1 percent annual growth rate

through the first quarter." [2]

The fact of the matter is that Pacific Bell is selling more access lines now than it did prior to the Commission opening the market. In fact, revenues for local service for the first six months of 1996 is up $99 million dollars over the same six months in 1995 an increase in local service revenues of 5.2%.

> "Toll market share loss of 6 percent was less than we expected, while the overall toll market grew at a strong rate -- 13 percent at year-end." Phil Quigley February 23, 1996 discussing 1995 results of operations. [3]

Pacific Bell reported revenues of $639 million in intrastate Toll revenues for the first six months of 1996. This represents an increase of 3.9% over the revenues for the first six months of 1995. Over the past 12 months Pacific Bell's revenues for intraLATA service has increased even in the face of competition. In fact, for the 2nd quarter of 1996, Pacific's IntraLATA toll revenues increased by 7.7% over the same period in 1995. Clearly, the growth of the toll markets is outstripping the losses to competition Pacific has faced. Despite a market share loss of about 6%, Pacific has seen tremendous growth in its toll revenues. For the first year of competition in the intraLATA toll market the rate of increase in the size of the market more than offset, by a factor of two, the loss of market share by Pacific..

> "Estimated access minutes-of-use for the second quarter continued to be strong, up a substantial 10.0 percent from the same period last year: 8.4 percent interstate; 11.9 percent intrastate." [4]

It is an undisputed fact that the access market is booming in California and Pacific Bell is well positioned in this competitive market. It can be argued that Pacific's low access rates are a competitive advantage because its access rates are the lowest in the country and could serve as a competitive deterrent compared to rates in other parts of the country. [5] Intrastate access revenues are up 6.1% for the first half of this year as compared to the first six months of 1995. This is true despite the Commission opening the transport market to competition in 1995 and the existence of several viable facilities-based carriers in this high capacity market. On the interstate side, revenues are also up increasing 5.6% over last year. Despite competition, Pacific has seen its access minutes and its access revenues increase.

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[2] Pacific Telesis Press Release *Pacific Telesis Reports Record Setting Increases IN New Customer Lines in Second Quarter*, July 18, 1996.

[3] Phil Quigley Letter to Shareowners, February 23, 1996

[4] Ibid

[5] UBS Securities Analysis and Buy Recommendation of Pacific Telesis, July 9, 1996

> " Accelerated demand for data services continued in the second quarter, as intensified marketing efforts drew more customers to Pacific Bell's FasTrak service family, including Integrated Services Digital Network (ISDN), Frame Relay, Switched Multi-megabit Digital Service and Asynchronous Transfer Mode. New lines placed in service for ISDN, ideal for high-speed telecommuting and Internet access, grew 129.4 percent year over year. Demand for high-capacity DS1 and DS3 lines is skyrocketing. DS1 lines grew three times as fast, and DS3 lines grew twice as fast, as the growth of both facilities at this time last year."[6]

Pacific's market in these high value services is booming. These are the type of high volume, high value services that should face the first impact from the Commission competitive policies.

Targeted promotions to consumers increased sales of custom calling services beyond the 7.5 million mark, an increase of 23.4 percent. Call Return, for example, which Pacific Bell introduced on a "pay-per-use" basis in April, is producing more than $5 million of revenue per month. Voice mailboxes in service reached 1.6 million as of the end of the second quarter 1996, generating year over year growth of 24.0 percent. In July, Pacific Bell also launched its Caller ID service, which has experienced tremendous success in other regions and which Pacific anticipates to be a $50 million market in two years. Because of the strong growth in these and other service Pacific faced an increase in Other Service Revenues of 6.4%.[7]

Revenues for Pacific increased for the first half of 1996 by $242 million over the same period last year. Revenues for the first half of 1996 exceed 51% of the revenues the company received in 1994 prior to IRD and IntraLATA toll competition. Given the rate of growth in so many areas of the services offered by Pacific Bell, it is very likely that Pacific Bell revenues will be stronger than prior to the introduction of competition.

After reviewing this publicly available information, I can find no reason to conclude that Pacific's financial integrity is at risk because of our local competition rules, nor can I find that given these earnings and revenue figures that Pacific's opportunity to earn has been impaired. In my view, the financial condition of Pacific is healthy and growing.

The constitution of the United States, as amended by the bill of rights protects against the confiscation of property by government has come to mean that regulators must not regulate in a fashion that denies an individual or a corporation a fair return on capital dedicated to public service and subject to regulation. I have taken a solemn oath to up-hold this constitutional

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[6] Pacific Telesis July 18, 1996 Press Release

[7] Ibid

protection. This commission has an obligation to regulate in a manner that prevents such a taking of public property. I believe we have. The rules we have adopted for local competition and the rules governing our regulation of the incumbent local exchange carrier provide the utility with a fair opportunity to earn. If I believed otherwise, I would be obligated to revise those rules so as to allow for such an opportunity.

If Pacific or GTEC felt that the Commission's decisions regarding depreciation had deprived it of an opportunity to earn a fair return, Pacific should have filed for a rehearing of those decisions which established the depreciation schedules currently in place. However, Pacific did not file such an appeal. Hence, they should not be allowed to argue that that past decision resulted in a taking. In fact, this Commission clearly stated its intention to open all markets to competition by January 1, 1997 in November and December of 1993. Since that time, the LECs have had two opportunities to file represcription applications. The Commission has acted on both of those, granting the requests of the utilities. Yet, the incumbent LEC's have not sought to appeal these decisions.

The Commission explicitly outlined the parameters under which conditions Pacific and GTEC could apply to increase their rates. GTEC and Pacific would be allowed in increase their rates if their earnings fell below a certain benchmark for two consecutive years. This framework was not found to be unreasonable or unfair.

On the issue of which earnings should be counted in determining the "total picture" of the change wrought by the recent changes in the regulation of the telecommunications industry, the decision of the majority concludes that we look exclusively to those lines of business subject to Commission rate- setting. This approach excludes revenues from those services which have been moved to category III under NRF, as well as those which were not part of the historical scope of the regulated business. I am concerned that included within this excluded category are the revenues that the LEC anticipates earning as a long-distance carrier. If this is the case, the majority would have us ignore the prize which Pacific sought as the animating goal of the very changes it confronts. In reaching this conclusion, the majority relies upon *Calfarm Insurance Co. v. Deukmejian*, 48 Cal3d 805(1989). Reliance on this decision is misplaced. In *Calfarm*, the insurance companies subject to proposition 103 sought to exclude from the affects, test lines of insurance which they had historically offered, but which fell outside the terms of the approved initiative. The majority decision seeks to exclude from the consideration of whether our evolving regulatory scheme allows the utility a fair opportunity to earn benefits which accrued to Pacific as a result of the change. Parties that present us with a claim for compensation for the pain caused by local competition but also ask us to ignore the gain that was explicitly part of the "deal" seek to draw a veil of fiction over the face of fact. Such an approach is anti-factual and ignores the symmetrical *quid pro quo* of the opening ALL markets to competition which was and is the commission's policy.

## Balancing the Interests of All

I feel that is my obligation, and the obligation of this commission to review the claims made by the incumbents with the greatest of care. Just as we are obligated to allow these carriers an opportunity to earn a fair rate of return, we are also obligated to protect the public interest and to insure that the rates for telecommunications services offered by these LECs and others remain "just and reasonable".

There is only one way that Pacific Bell can recover costs associated with "franchise impacts" and that is by raising the cost of telecommunications services in California. Either Pacific Bell is allowed to raise its own rates, or the Commission will allow recovery via a All End-User Surcharge (AEUS). Either way, the cost of telecommunications services in California will increase. Allowing Pacific to recover so called impaired investments will have the same impact on the state's economy as a tax and an increased hurdle for new entrants into the market.

Such recovery will raise the cost of telecommunications in California. This will negatively impact those California businesses that are in telecommunications intensive businesses, including the rapidly growing but nascent multi-media and Internet services businesses, the most promising sectors of our economy. Not only will higher telecommunications prices negatively impact the information age industries upon which California's future rests, inflated prices adversely impacts this sector disproportionately relative to other industry sectors.

Moreover, the increased price of telecommunications that would result by granting the LEC request for franchise impacts would have the result of lowering the disposable income of California. This will have a secondary effect of lowering the demand for other goods and services in California and reducing the profitability of California companies.

There can be no doubt that the higher rates that result from compensation will result in fewer jobs and will hinder economic growth and investment in California. The only debate is by how much. We do not know the magnitude of the impact granting compensation for local competition will be. However, we do know, with certainty that it will dampen economic growth, and job creation.

The decision of the majority creates a great deal of uncertainty in the marketplace. This level of uncertainty will serve as a barrier to entry in California. Potential entrants need to know, with some certainty the regulatory structure in the marketplace. The decision of the majority leaves the question of franchise impacts hanging over the marketplace for a period of time that feeds investment uncertainty.

If compensation is granted, the competitiveness of the market may be compromised, if other entrants are forced to bear the cost of recovery. For example, if compensation is granted and the funds are raised via a end-user surcharge, rather than recovery through the rates of the LEC, new entrants will face this cost. Hence this cost would be a barrier to entry.

For this plethora of reasons, I believe that the Commission must carefully weigh the claims of the incumbent LEC's claiming compensation for our regulatory program. We, as a Commission, have an obligation to balance the interest of the public with that of the carriers we regulate. We, as a Commission, have an obligation to promulgate rules for local competition that are fair to all competitors, not just the incumbents. We, as a Commission, have an obligation to ensure we set rates at levels that are just and reasonable yet provide an opportunity to earn a fair return. Unlike the majority, I believe that we have done so. I am convinced that our current regulatory structure provides the incumbent monopolies the opportunity to earn a fair return on their investment as required by the Constitution of the United States. If I believed otherwise, I would not have voted for our rules governing the opening of local markets to competition.

In conclusion, the scope of this proceeding was limited to "the issue of whether the rules that 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." (D.95-07-054, slip op., pp 33.) In addition, the objective of the case was not to determine the extent of any takings, rather simply to determine if our regulatory program affords Pacific and GTEC and opportunity to earn a fair rate of return.

The majority reaches the conclusion that "We cannot find at this time that our local competition rules have changed our regulatory structure so drastically as to have violated our obligation to ensure an opportunity to earn a fair return on investment and a fair opportunity to recovers invested capital for either GTEC or Pacific." (Conclusion of Law 71.) I also reach that conclusion. However, I differ from my colleagues who voted in the majority, allowing the incumbent monopolies another chance to reassert their claims, claims that may produce results that may chill the growth of competition in the telecommunications sector and its allied sectors throughout the California economy.

Dated September 20, 1996 in San Francisco, California.

/s/ Jessie J. Knight, Jr.
Jessie J. Knight, Jr.
Commissioner

## Commissioner Josiah L. Neeper Dissenting

I dissent primarily because the record is insufficient to warrant the conclusions reached in the majority decision. As submitted to us with facts that are material and in dispute, this decision does *not* persuade me to support a dismissal of the petition.

The dismissal of the petition under the circumstances of disputed issues is tantamount to a summary dismissal. The standard to grant or deny a petition to modify is articulated in the Commission's Rules of Practice and Procedure 47(h). Rule 47(h) states that "In response to a petition for modification, the Commission may modify the decision as requested, modify the affected portion of the decision in some other way consistent with the requested modification, set the matter for further hearings or briefing, <u>summarily deny the petition on the ground that the Commission is not persuaded to modify the decision, or take other appropriate action</u>." (*underline supplied*)

We must consider whether we can dispose of the Petition now and in summary fashion. To dispose of the petition in this manner, we must consider the facts presented to us and determine that we are not persuaded to modify the decision, and hence deny the petition.[1]

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[1] *Re Pacific Gas and Electric Company*, 45 CPUC 2d 178, 180 (1992) (D.92-07-078). In that decision, the Commission found that summary judgment is a means of disposing of an action without trial where there are *no disputed* issues of material fact. (*Id.*)

This Petition has been met with a number of opposing responses. These responses intentionally put in dispute the important, material facts proposed by the Petitioners and the conclusions drawn by Petitioners from the underlying data. Are the disputed facts material? The Petitioners and Respondents both argue for this materiality. Obviously, the Respondents do not stipulate that the facts asserted by Petitioners are correct, so as to permit us to make a final decision providing some relief for Petitioners. If the facts are as the Respondents assert, there is far less basis for any decision granting relief to Petitioners. We must then first conclude that the disputed facts are material to a decision in the matter. Secondly, we must conclude that disputes among the parties concerning material facts prevent a disposition of the Petition at this time either in favor of or against it based on a summary judgment type action.

An alternative consideration of summary disposition is appropriate. Can we conclude that Petitioners are entitled to no relief whatsoever, even if all the facts are accepted as the Petitioners assert them, including all the inferences and conclusions to be fairly drawn based on those facts? My conclusion is that it is not clear that Petitioners would be entitled to all the relief they seek. It is not clear they would be entitled to *no* relief, either. They may well be entitled to some relief subject to their proving their allegations that the Commission's estimate of factors that affected their revenues differ radically from what the Petitioners have actually now experienced. The lack of clarity comes from the fact that the complex facts asserted by Petitioners are incomplete for appropriate resolution in light of the broad discretion we have in acting on a Petition to Modify. The factual record in this respect needs supplementing, and factual disputes require resolution.

In denying the Petition, the majority decision relies on several assertions that are used as bases for denial of the Petition. Each of these issues are disputed by the parties. First, what did the Commission intend by a "revenue neutral" rate design in Decision 94-09-065 (the IRD Decision)? Are applicants asking for a revenue adjustment mechanism they previously opposed? Also interjected in this Petition is whether the Commission's decision to GTEC's request for rehearing in 1992 settled at least GTEC's part of the Petition. I will briefly express my views on each of these issues.

*- Revenue neutrality*

The majority decision's analysis of "revenue neutrality" disregards the unanswered question that whether the Commission, in establishing a revenue neutral rate rebalancing, would ignore an egregious difference between forecast and the reality later experienced in any of the elements of its rate design. Clearly, the Commission did not guarantee revenue neutrality for each rate element in the IRD rate rebalancing. The Commission sought revenue neutrality in the overall cumulative effect of all changes; no single rate element was guaranteed the forecasted revenue. However, this does not mean that the Commission should not review its actions whether a single rate design by itself may warrant an examination of the Commission's rate rebalancing effort to determine whether it committed an egregious error compared to reality later experienced.

In the Petition before us, applicants assert that the Commission had committed an error of such magnitude in the estimates adopted for *toll* and *switched access* services compared to reality later experienced that an update should be made to make them whole. Respondents urge us to deny the Petition alleging, among other things, that "revenue neutrality" must consider other revenue changes; although, they point to scant examples and provide us with no concrete facts. A few examples will suffice to show the inadequacy of the record.

First, opponents of the Petition allege that other factors exist that could have affected applicants toll volumes and revenues and subsequently led to shortfalls in revenues. Several factors vie for candidacy in this respect, including the state of the economy and loss due to competition. However, none of these were substantiated so as to be of any probative value.

Second, while there may be reason to believe that in at least some areas the deviation of actual revenues from IRD-forecasted revenues will have been to Pacific's and GTEC's benefit, potentially offsetting revenue shortfalls in toll and switched access, Respondents do not provide us with persuasive evidence. For example, as ORA states, the estimate used in the IRD for access lines for Pacific and GTEC was based on 1989 and 1990 data. ORA claims actual numbers may be higher. However, despite the interest their assertion raises, the lack of concrete data on its quantifiable effect makes the claim of little if any value in deciding the merits of the Petition. Opponents of the Petition provide us only with hints of the factors to which we should attribute the alleged shortfall in revenue. These are at best inconclusive claims to potentially causing the claimed shortfall, but they lack the necessary probative value to allow us to arrive at reliable conclusions. In the end, we are left with more questions than answers.

*- IRD Decision's rejection of a "true-up" Mechanism*

The majority decision mentions the Commission's rejection of what the decision calls a "true-up." This apparently refers to a balancing account that certain parties proposed in the IRD proceeding to protect ratepayers against the risk of a windfall to Pacific and GTEC. The Commission rejected this proposal, stating it did not adopt the LECs' proposed elasticity estimates stating "we have thus reduced the risk that is cited as the justification for the balancing accounts...." This, in effect, implies that the elasticity estimates adopted by the Commission were so sufficient that they obviated the need for protecting ratepayers by a balancing account. The flip-side of this decision is that the LECs might have been exposed to a greater level of risk due to factors that assured ratepayer protection.

*- GTEC's Rehearing Request*

The Commission's decision on GTEC's rehearing petition is mentioned as if GTEC is having two bites of the apple. The alleged facts are actually different. In dismissing GTEC's request in D.96-02-023, the Commission focused its attention on the validity of the process we applied in selecting the elasticity factor adopted in the IRD decision. I continue to believe, as the rehearing decision stated, that the Commission's determination of the estimates were valid given the information available to us at the time. However, our analysis in the rehearing decision did not address the issues related to "revenue neutrality" goals and the effect of the alleged revenue shortfall on overall net income for GTEC. In this regard, we note that aside from the validity of the elasticity estimate selection process, there remains an issue of whether the process, however correct, produced egregious margins of error compared to later experienced reality that may have substantially reduced revenues for the LECs as they claim.

An open and still unanswered question is whether Petitioners' request for modification of the decision is to protect themselves from competitive loss in toll calling and switched access, as respondents claim, or whether there may have been an unforeseen circumstance that created shortfall in revenues and if proven the Commission could have acted to correct. The proposed decision does not test the validity of any of the questions and assertions underlying the Petition; neither does it give the parties the necessary opportunity to present evidence to substantiate their claims or does it conclusively resolve the disputed issues. It is in the light of these disputed issues the majority decision denies the Petition.

A denial of the Petition on the grounds propounded by the opponents of the Petition and as articulated in this decision ignores the possibility that the Commission may only have anticipated the possibility of a substantially lesser shortfall in estimated revenues compared to reality later experienced. The elasticity factors adopted by the IRD decision may indeed be what could be best established based on the record presented at the time. But correct processes can produce incorrect results. Or, in this case, the margin of error expected by the IRD decision could turn out to be beyond what the Commission expected in its forecasts.

On the other hand, it is also equally possible that further hearing on the Petition could have shown that Petitioners' claim is insupportable and hence could have led to the denial of the Petition. However, to the extent parties allege that the Commission had committed an error in their claims and the record does not establish that their allegations are unfounded, they must be given a day in court to show their case; the burden of proof is obviously on applicants. By denying the Petition in a summary fashion, the Commission is in a sense denying applicants opportunity to be fully heard.

For all the above reasons, I will dissent.

/s/ Josiah L. Neeper
Josiah L. Neeper
Commissioner

San Francisco, California
February 19, 1997

11-8

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An open and still unanswered question is whether Petitioners' request for modification of the decision is to protect themselves from competitive loss in toll calling and switched access, as respondents claim, or whether there may have been an unforeseen circumstance that created shortfall in revenues and if proven the Commission could have acted to correct. The proposed decision does not test the validity of any of the questions and assertions underlying the petition; neither does it give the parties the necessary opportunity to present evidence to substantiate their claims or does it conclusively resolve the disputed issues. It is in the light of these disputed issues the majority decision denies the petition.

A denial of the petition on the grounds propounded by the opponents of the petition and as articulated in this decision ignores the possibility that the Commission may only have anticipated the possibility of a substantially lesser shortfall in estimated revenues compared to reality later experienced. The elasticity factors adopted by the IRD decision may indeed be what could be best established based on the record presented at the time. But correct processes can produce incorrect results. Or, in this case, the margin of error expected by the IRD decision could turn out to be beyond what the Commission expected in its forecasts.

On the other hand, it is also equally possible that further hearing on the petition could have shown that petitioners' claim is insupportable and hence could have led to the denial of the petition. However, to the extent parties allege that the Commission had committed an error in their claims and the record does not establish that their allegations are unfounded, they must be given a day in court to show their case; the burden of proof is obviously on applicants. By denying the petition in a summary fashion, the Commission is in a sense denying applicants opportunity to be fully heard.

For all the above reasons, I will dissent.

Josiah L. Neeper
Commissioner

San Francisco, California
February 19, 1997

A. 87-11-033
D. 97-02-049

## COMMISSIONER JESSIE J. KNIGHT, JR., CONCURRING:

I concur in this decision which denies the request by Pacific Bell (Pacific) and GTE California (GTEC) to modify D. 94-09-065, the Implementation Rate Design (IRD) Decision.

In their petitions, Pacific and GTEC allege that our IRD decision adopted a forecasted estimate for increased toll and switched access usage that has proven to be far less than actual market results. The petitioners request an increase in prices to recover millions in alleged lost revenue. This decision denies Pacific and GTEC's request for numerous reasons which I fully endorse.

First, if the Commission were to grant the petitioners' request, this could allow a rate increase on the most inelastic services not currently subject to competition. As the Office of Ratepayer Advocates has noted, it is improper to use a petition to modify as the vehicle for a rate increase. Rather, if Pacific and GTEC wish to pursue a prospective increase on rates, they should do so by means of an application pursuant to Commission rules, with the attendant notice requirements. This would allow balanced examination of the parties' alleged losses.

Second, the Commission has already rejected allegations of procedural error and lack of evidence in adopting toll elasticity estimates. In D.96-02-023, we denied GTEC's application for rehearing of IRD and we explicitly discussed how the record supported the elasticity estimates we adopted.

Third and most significantly, I do not support reopening the IRD case to examine potential error in an elasticity estimate because when the Commission adopted the estimate and corresponding formula in IRD, we knew a priori that the forecast was bound to deviate from actual results. The IRD decision specifically rejected any future "true-up" of the revenues resulting from IRD because the Commission explicitly feared that a true-up would blunt competitive incentives. The Commission strongly stated that it should not protect incumbent monopolies with future true-ups if they failed to adequately compete in the new market structure. In fact, the petitioners argued against a true-up in their testimony on the original case. They now attempt to recraft their point of view when the results work against their present circumstances.

The Commission's IRD decision did not promise or guarantee revenue neutrality, but gave the companies the opportunity to increase revenues and improve earnings. IRD was a carefully crafted policy package, not an assurance of explicit outcomes on individual rate elements. As companies in our New Regulatory Framework (NRF), both Pacific and GTEC have pricing flexibility, the ability to enter contracts, and the advantage of carrying all default traffic. In a petition to modify IRD, Pacific and GTEC bear the burden of demonstrating that their respective overall rate designs have failed to achieve revenue neutrality. It is not an inconsequential observation that neither company has even alleged that the IRD package has failed. In my judgment, the petitioners have been unpersuasive in their quest to deviate from these prior decisions.

Furthermore, it would be improper in hindsight to establish criteria for a "reasonable" deviation from earlier estimates when the Commission rejected this notion earlier. If the Commission were to reopen its IRD proceeding as the petitioners suggest to determine whether revenues were beyond a "foreseeable" margin of error, an endless cycle of hindsight analysis of decisions which all participants had relied upon as final would be unnecessarily created. Nothing extraordinary or unforeseeable has occurred that warrants a reopening. This is not in the public interest and certainly provides an unnecessary protection for the incumbent local exchange carriers and would serve to raise the level of risk for new entrants. The Commission's new regulatory framework has established a process whereby Pacific and GTEC may seek a rate increase if their rate of return falls below an established trigger level. This is the proper means to handle their current request.

Fourth, I am not convinced that it would ever be possible to distinguish the source of the revenue losses Pacific and GTEC claim. Alleged losses can be attributed to a variety of factors, including a negative variance in forecasting error in the IRD formula, general economic conditions, and the inability of the companies to preserve the same universe of customers in a newly competitive environment. In fact, in order to determine the merits of their claim, the Commission would have to examine the entire post-IRD intraLATA toll market, including all carriers providing intraLATA toll -- not just the results of Pacific and GTEC. This would be a monumental undertaking. Absent this level of scrutiny, the Commission could never know with certainty that other toll carriers had not merely outstripped the performance of Pacific and GTEC.

In contrast, if the Commission reopened the IRD case for the narrow purpose of examining toll elasticity, this would completely ignore the other areas where these companies may have surpassed our earlier estimates. For example, Pacific has recently reported revenues of $639 million in intrastate toll revenues for the first six months of 1996 (a 3.9% increase over the first six months of 1995). In the second quarter of 1996, Pacific's intraLATA toll revenues increased by 7.7% over the same period in 1995. These numbers appear to indicate that growth in toll markets is outstripping any losses to competition that Pacific has faced, even with a 6% loss of market share. Indeed, recent published reports highlight how increasing demand for services such as Internet access and caller ID have boosted incumbent local exchange company profits. Pacific Telesis in particular has benefited from this surge in demand for internet service, with year-end net income up 22% percent over 1995. It is certainly possible that this increased demand alleviates some of the alleged shortfall Pacific and GTEC claim in their petition.

Finally, I note that my concurrence on this decision is consistent with my recent dissent on the Franchise Impact case ,D. 96-09-089 (see attached). While I still maintain my original position regarding franchise impacts, I note that the majority of this Commission voted in that decision to allow a further look at the claims of monetary impacts to the monopoly franchise. Therefore, I would concede that procedurally, the request denied herein is more appropriately considered in that venue. It is far more rational to employ a holistic approach to the issue of monetary impacts and avoid fragmenting any alleged impacts into a forest of smaller proceedings.

I have carefully considered the companies' requests. In the interest of preserving the integrity of the IRD decision, and our process in arriving at it, I reject reopening the case in the manner suggested. Therefore, I concur in the decision of my colleagues.

Dated February 19, 1997 in San Francisco, California.

Jessie J. Knight, Jr.
Commissioner