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Decision 97-03-067 March 31, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

In the Matter of the Joint Application of Pacific Telesis Group (Telesis) and SBC Communications, Inc. (SBC) for SBC to Control Pacific Bell (U 1001 C), Which Will Occur Indirectly as a Result of Telesis Merger With a Wholly Owned Subsidiary of SBC, SBC Communications (NV) Inc.

Application 96-04-038
(Filed April 26, 1996)

(See Appendix A for a List of Appearances;
Additional Appearances: Working Assets Funding Services, Inc.)

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OPINION

Summary

We approve the merger of Pacific Telesis Group (Telesis) and SBC Communications, Inc. (SBC) (Applicants). We evaluate the potential competitive impacts of the proposed merger under the purview of Public Utilities (PU) Code § 854 and find that the merger is unlikely to adversely affect competition in California.

As a condition of our approval, we require Pacific Bell (Pacific) to refund to ratepayers the short term and long term economic benefits of the merger in the amount of $248 million over five years. The $248 million will be distributed in the form of $213 million in surcredits and $34 million to fund the Community Partnership Commitment.

The amount is half of the total forecasted economic benefits of $495 million.

Finally, we direct Pacific, notwithstanding the status of the merger proposed in this application, to comply with provisions of General Order (GO) 133B, which governs customer service quality.

I. Background

A. Procedural Background

1. The Application, Protests, and Evidentiary Hearings

On April 26, 1996, SBC and Telesis filed a joint application with this Commission pursuant to Public Utilities Code § 854.[1] This application requests that the Commission approve a change in the control of Pacific from a wholly-owned subsidiary of Telesis to a second-tier subsidiary of the combined company which will result from Telesis' planned merger with SBC. The application states that the combined company will be owned approximately 66% by SBC's current shareholders and 34% by Telesis' current shareholders. Generally, the merger will be accomplished through an exchange

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[1] Unless otherwise stated, all statutory references are to the California Public Utilities Code.

of stock of the two companies and will result in Telesis surviving as a wholly-owned subsidiary of SBC.[2]

On May 30, 1996, the following five parties filed timely protests: (1) the Office of Ratepayer Advocates (ORA, known as the Division of Ratepayer Advocates when it filed the protest); (2) The Utility Reform Network (TURN, known as Toward Utility Rate Normalization when it filed the protest); (3) the California Telecommunications Coalition and the Association of Directory Publishers[3] (the Coalition and ADP); (4) TCG; and (5) ICG. In addition, a number of other parties raised concerns about the merger and intervened. On June 10, 1996, SBC and Telesis filed a joint response to the protests. Subsequently, ICG and TCG withdrew their protests on September 30 and October 2, 1996 respectively.

The two Assigned Commissioners, President Conlon and Commissioner Neeper, and the two assigned Administrative Law Judges (ALJ), ALJ Malcolm and ALJ Econome, held the first prehearing conference on June 19, 1996, and soon thereafter, set a procedural schedule. Applicants served their testimony on July 3, 1996. ORA and intervenors served their testimony on September 30, 1996. Applicants served their rebuttal testimony on October 15, 1996.

In addition to ORA, the following intervenors served testimony: ADP; AT&T Communications of California, Inc. (AT&T) and MCI (jointly); the Disabled Veteran Business Owners and Disabled Veterans in the State of California (DVBE); Greenlining Institute and Latino Issues Forum (jointly) (Greenlining); the Hispanic

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[2] The transaction would create a "pooling of interests" for accounting purposes.

[3] The Coalition's protest states that each member joining the protest separately protests the application and seeks to become an independent party to the proceeding. For convenience, the grounds for the protest are stated in a single, joint document. The Coalition members joining in the protest are: AT&T Communications of California (AT&T); California Association of Long Distance Telephone Companies; California Cable Television Association; MCI Telecommunications Corp. (MCI); Teleport Communications Group (TCG); and ICG Access Services, Inc., now known as ICG Telecom Group, Inc. (ICG). TURN, TCG, and ICG filed separate protests to the application.

Association of Corporate Responsibility (HACR); various intervenors represented by Public Advocates, Inc.;[4] TURN; and Utility Consumer Action Network (UCAN). In addition, the City and County of San Francisco also initially sponsored the testimony of one of UCAN's witnesses, Francios Bar.

The City and County of San Francisco, Public Advocates, Inc., the DVBE, and HACR, chose not to actively participate in the evidentiary hearings because these groups indicated that they had resolved their concerns regarding the merger with Applicants by various separate agreements or assurances Applicants made with these parties. At the hearings, Greenlining also supported the merger as a result of a separate agreement with Applicants but continued to sponsor testimony. In addition, on October 24, 1996, the Communications Workers of America, AFL-CIO (CWA) wrote a letter to the assigned ALJs withdrawing its opposition to the merger, and stating that CWA has decided to fully support the merger application.

The Commission held 23 days of evidentiary hearings from October 24 to November 26, 1996. The parties filed opening briefs on December 20, 1996. The Attorney General of the State of California (Attorney General) filed his advisory opinion, pursuant to § 854(b)(3), on December 31, 1996. The parties filed reply briefs on January 14, 1997 at which time the case was submitted.[5]

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[4] Public Advocates, Inc. represents the following intervenor groups: Southern Christian Leadership Conference; National Council of La Raza; Korean Youth and Community Center; Association of Mexican-American Educators; California Association for Asian-Pacific Bilingual Education; Korean Community Center of the East Bay; Filipinos for Affirmative Action; and Filipino Civil Rights Advocates. For ease of reference, we will refer to the above groups jointly as Public Advocates.

[5] In addition to the parties listed above, many of whom participated in the briefing schedule, the California Cable Television Association filed a separate brief and the California Trade and Commerce Agency filed one page comments.

In the following sections, we summarize the parties' positions and evaluate the record developed in this case against the provisions of § 854. The record in this case is voluminous.[4] We therefore devote ourselves to the chief points of contention.

2. Public Participation Hearings

The Commission held seven public participation hearings throughout the state in September, October, and December 1996. The Commission held these hearings in Eureka, Fresno, Pasadena, Riverside, Sacramento, San Diego, and San Francisco. These hearings were well attended, particularly in San Francisco and Pasadena where between 40 and 50 persons spoke at each hearing. Many representatives from community organizations and some individuals attended the hearings and most supported the merger.

A few speakers voiced concern over a possible increase in utility rates and the effect of the merger on utility stock value. One speaker urged Pacific not to neglect the rural areas as a result of the merger. Another expressed concerns that Pacific's employees would suffer as a result of merger with a company whose salaries are substantially lower than Pacific's.

We wish to express our appreciation to all of the individuals who took the time to attend the public participation hearings or to write us with their comments. We duly considered these views in our deliberations on this matter.

B. Burden of Proof

Section 854(e) requires that the Applicants have the burden of proof by a preponderance of the evidence to demonstrate that the requirements of §§ 854(b) and (c) are met. As we stated in our first case interpreting § 854's standard of proof in *Re SCEcorp*, 40 CPUC2d 159, 172:

> "Burden of proof is the 'obligation of a party to establish by evidence a requisite degree of belief concerning a fact in the mind

[4] The record in this case consists of 236 exhibits, with 38 witnesses testifying orally and in writing. The transcript is well over 3500 pages.

of the trier of fact or the court.' (Evidence Code § 115.) In the context of this case, Applicants have the burden of convincing the Commission that the specific requirements of § 854 have been satisfied. Failure of the Commission to be persuaded by the evidence on the required elements of § 854 prevents the Commission from making the findings required under the statute, and compels denial of the merger. When combined with the burden of proof, the requirement of § 854(e) that Applicants prove each element of Subsections (b) and (c) by a preponderance of the evidence means that evidence in support of Applicants' position, when weighed with that opposed to it, must have the more convincing force and the greater probability of truth. (1 Witkin, California Evidence (3d. Ed. 1986) § 157, and cases cited thereunder.) The standard California jury instruction on preponderance of the evidence is:

"'Preponderance of the evidence' means evidence that has more convincing force than that opposed to it. If the evidence is so evenly balanced that you are unable to say that the evidence on either side of an issue preponderates, your finding on that issue must be against the party who had the burden of proving it. (California Jury Instructions, Civil, (BAJI 7th Ed.), No. 2.60.)

"Black's Law Dictionary defines 'preponderance' as '[g]reater weight of evidence, or evidence which is more credible and convincing to the mind[; t]hat which best accords with reason and probability."

In this case, we require Applicants to meet their burden of proof and apply the standard of preponderance of the evidence, as required by § 854(e), in assessing the evidence in this proceeding.

C. The Proposed Merger

On April 1, 1996, Telesis and SBC announced their intention to merge the two companies. Their agreement anticipates that Telesis would become a wholly-owned subsidiary of SBC and that Pacific would continue to be a subsidiary of Telesis. The merger would be accomplished by way of an exchange of stock, whereby the combined company would be owned approximately 66% by SBC's current shareholders and 34% by Telesis' current shareholders. The merger agreement does not anticipate any transfer of property or a purchase of assets.

The objective of the merger, according to Applicants, is to improve the competitiveness of both companies as telecommunications markets become subject to competitive entry and technological innovation. The merger would create a single telecommunications company with various products and services in a variety of markets. SBC owns local exchange companies in Texas, Missouri, Oklahoma, Kansas and Arkansas. SBC has extensive business interests in cellular services in 27 markets other than California, services which Telesis discontinued by spinning off its cellular subsidiary in 1995. SBC also owns cable operations and shares of telecommunications businesses in Mexico, Chile, South Korea, Australia, France, South Africa and Israel. The combined assets of the two companies would be approximately $22 billion.

Applicants explain that the merger agreement follows a process of strategic analysis initiated by Telesis management in summer 1995. At that time, Salomon Brothers analyzed long term trends in the telecommunications industry and potential strategic opportunities for Telesis. Salomon Brothers identified four major trends: (l) accelerating pace of change; (2) integration of telecommunications and other services; (3) increasing level of competition; and (4) the spread and interconnection of technology and markets worldwide. With this background, Salomon Brothers concluded that Telesis should merge with another telecommunications company in order to remain a serious competitor given its financial resources and changes in the industry.

Following a presentation to the Telesis Board of Directors in October 1995, Telesis' chairman contacted SBC's chairman concerning a potential merger. Shortly after passage of the Telecommunications Act of 1996, the companies met to explore a "business combination" in earnest. The companies conducted a due diligence review to evaluate the possible effects of a merger. The Applicants state that this review satisfied both companies that a merger would create a successful competitor by expanding the scope and scale of the companies' respective operations, improving Telesis' financial standing and taking advantage of the companies' complementary skills and strengths in operations and marketing.

On March 31, 1996, SBC's board approved the merger. On April 1, 1996, Telesis' Board approved the merger. On July 31, 1996, Telesis' shareholders voted to approve the merger. Subsequently, the Department of Justice reviewed the merger proposal and announced on November 5, 1996 that it had concluded that the merger would not violate federal antitrust law. The Federal Communications Commission (FCC) approved the merger January 31, 1997 following review of potential competitive impacts.

D. *Applicability of § 854*

1. Overview of § 854[7]

SBC and Telesis, sometimes referred to as Applicants, filed this application pursuant to § 854. Applicants concede that §§ 854(a) and (c) apply to this transaction, but challenge the applicability of § 854(b). Before addressing this specific argument, we present an overview of § 854 to put our inquiry regarding this application into perspective.

Section 854(a) provides that no person or corporation shall merge, acquire, or control either directly or indirectly, any public utility organized and doing business in this state without first seeking authorization from the Commission. The Commission may define what constitutes merger, acquisition, or control activities subject to this section. Any merger, acquisition, or control without prior authorization by this Commission is void and of no effect.

Subsections (b) and (c) of § 854 set out some specific requirements that the Commission must meet before approving the merger, acquisition, or change in control of large California electric, gas, or telephone utilities. Subsection (b) requires the Commission to find that the proposed transaction provides benefits in the short and long term and to equitably allocate, where the Commission has ratemaking authority, the total short and long term forecasted economic benefits between shareholders and

[7] A complete copy of § 854 is attached to this decision in Appendix B.

ratepayers. The statute states that ratepayers shall receive not less than 50% of those benefits. The Commission must also find that the transaction will not adversely affect competition. The Commission must request an advisory opinion from the California Attorney General on this issue.

Subsection (c) requires the Commission to find that the transaction is in the public interest, after considering and balancing seven criteria:

- maintain or improve the financial condition of the resulting utility;
- maintain or improve the quality of service to ratepayers;
- maintain or improve the quality of management of the resulting utility;
- the effect on union and nonunion employees;
- the effect on shareholders;
- the benefits to state and local economies and to the communities served by the resulting utility; and
- the Commission's ability to regulate and audit utilities.

If significant adverse consequences are identified, the Commission must ensure they are mitigated.

Subsection (d) requires the Commission to consider reasonable options to the transaction, including not allowing the proposed merger, acquisition, or change in control. Subsection (e) addresses burden of proof, which we discuss above.

Subsection (f) provides additional criteria for the Commission to use in determining whether the acquiring utility involved in the merger, acquisition, or control is of a size that brings it within the coverage of §§ 854(b) and (c). Subsection (g) exempts the formation of a holding company from subsections (b)(1) and (b)(2). Subsection (h) cover addresses certain transactions which may result from electric industry restructuring and is not relevant to this transaction.

2. Applicability of § 854(b)

The Commission examines mergers, acquisition or control activities on a case-by-case basis to determine the applicability of § 854. (See, e.g., *Re SCEcorp*, 40

CPUC2d at 166, n.1.) Applicants concede that §§ 845(a) and (c) apply here, but challenge the applicability of §§ 854(b). We conclude that § 854(b) applies to this transaction.[8]

SBC and Telesis argue that the proposed merger of Telesis with a subsidiary of SBC will result in an indirect transfer of control of Pacific, the principal company operated by Telesis. They agree that this transfer requires the Commission's approval pursuant to § 854(a) in light of the criteria set out in § 854(c). However, they argue that § 854(b) does not apply to this transaction.

SBC and Telesis argue that the Legislature's use of the word "utilities" in § 854(b) and "entities" in § 854(c) was deliberate, and establishes an abbreviated standard of review for transactions involving only "entities" with more than $500 million annual revenue. Since the parties to the transaction are Telesis and SBC, neither of which is a regulated utility subject to the Commission's jurisdiction, Applicants believe § 854(b) is inapplicable here on its own terms. Applicants raised this argument at the first prehearing conference and several intervenors suggested that the Commission make a preliminary determination of the applicability of § 854(b) because a difference of opinion on this issue might affect discovery. However, Applicants agreed to proceed with discovery and the evidentiary hearings as if the entirety of § 854(b) applies, and reserved their legal arguments as to the statute's inapplicability for briefing at the conclusion on the evidentiary hearings.

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[8] Section 854(b) provides in relevant part:

> "Before authorizing the merger, acquisition, or control of any ... telephone utility organized and doing business in this state, *where any of the utilities that are parties to the proposed transaction* has gross annual California revenues exceeding five hundred million dollars, ($500,000,000), the Commission shall find that the proposal [meets the requirements of subsections (b)(1)-(3)]." (emphasis added.)

Section 854(c) provides in relevant part:

> "Before authorizing the merger, acquisition, or control of any ... telephone utility organized and doing business in this state, *where any of the entities that are parties proposed transaction* has gross annual California revenues exceeding five hundred million dollars ($500,000,000), the Commission shall consider each of the criteria listed in paragraphs (1) to (8), inclusive, and find, on balance, that the merger, acquisition, or control proposal is in the public interest." (Emphasis added.)

SBC and Telesis explain that § 854(b) was revised by the Legislature in 1995, and that the Legislature selected the term "utilities" in subsection (b) and the different term "entities" in subsection (c) in passages otherwise identical. Applicants argue that the text of the statute is clear – that subsection (b) applies only when the transaction is occurring at the utility level, while subsection (c) applies to a broader category of transactions.

No other party supports Applicants' position. Intervenors such as ORA, UCAN, TURN, and Public Advocates oppose Applicants' position, arguing that § 854(b) applies to this transaction.

In order to determine whether § 854(b) applies here, we first examine the actual language of the statute. In examining the statute's language, decisionmakers should give the words of the statute their ordinary, everyday meaning. If the meaning is without ambiguity, doubt, or uncertainty, then the language controls. Only if the meaning of the words are not clear, decisionmakers should take the second step and refer to the legislative history. (See, e.g., *IT Corp. v. Solano County Bd. of Supervisors*, 1 Cal.4th 81, 98 (1991).)

We agree with intervenors that the plain language of subsection (b) is clear, and applies where a utility of a specified financial size is a party to the proposed transaction. The issue for us to determine, based on the specific facts of this case, is whether Pacific is a party to the proposed transaction within the meaning of § 854(b). We conclude that it is.

Although the transaction is technically structured as a merger between SBC and Telesis, the practical result of the proposed transaction, if it is consummated, is that it involves Pacific. Applicants' own witnesses confirm that Pacific represents 90% or more of Telesis' assets. Additionally, ORA states:

> "A review of the FCC, ARMIS report for year end December 31, 1995, shows that the total assets of PacBell, before accumulated depreciation, represents $26.16 billion. This is approximately 96% of the $27.22 billion of PTG's [Telesis] consolidated total assets, before accumulated depreciation, as indicated in their annual report to shareholders (see

> Exhibits to the Joint Application, Exhibit F, p. F-20). Similarly, the FCC ARMIS report for year end December 31, 1995 shows PacBell had 44.06 thousand employees. This is approximately 90% of PTG's 48.89 thousand employees at year end 1995 (see Exhibits to the Joint Application, Exhibit E, SEC form 10-K, p. 13). In stark contrast, the Telesis holding company only has approximately 440 employees which, after the merger, in all likelihood will be reduced in size in order to avoid duplication with SBC holding company activities (Exhibit 1, p. 12/PTG witness Dorman)." (ORA Opening Brief at p. 12, footnote omitted.)

Pacific is key to the merger. One of several principal reasons SBC pursued the transaction is to add 15.8 million telephone access lines to its existing 14.2 million telephone access lines. SBC also considered that the merger "would create the second largest telecommunications company in the United States, with the size, geographic and product diversity and complementary competencies to better serve customers and to position SBC for a continuing leadership role in the telecommunications industry of the 21st century." (Exhibits to the Joint Application, Exhibit F, SEC Form SBC-4 at pp. 19-20.) The Applicants' evidentiary presentation is largely based upon the economic benefits to be realized from the joint and combined operations of Pacific and Southwestern Bell telephone (SWBT).

We focus on substance rather than form in determining whether Pacific is a party within the meaning of § 854. (California Civil Code § 3528.) This is analogous to application of the legal doctrine of "piercing the corporate veil" as necessary properly to account for the substance rather than the form of this transaction. (See, e.g., *City of Los Angeles v. Public Utilities Commission* 7 Cal.3d 331, 342-344 (1972), citing *Pacific Telephone and Telegraph Company v. Public Utilities Commission*, 62 C.2d, 634, 659-662, which held that a utility could not through corporate instrumentalities obtain a greater rate of return than the utility would be entitled to, absent the separate corporate enterprises. *City of Los Angeles* stated that the "utility enterprise must be viewed as a whole without regard to the separate corporate entities... ." (*City of Los Angeles v. Public Utilities Commission*, 7 Cal.3d at 344. See also *General Telephone Co. v. Public Utilities*

Commission, 34 Cal.3d 817, 826 (1983).)) In light of the above discussion, we find that Pacific is a party to the transaction within the meaning of § 854(b).

Our interpretation is also consistent with the statute as a whole. The Applicants' narrow reading would imply that only when a utility is a signatory to the merger documents do the parties bear the burden of proving compliance with § 854(b). However, § 854(e) provides that "[t]he person or corporation seeking acquisition or control of a public utility organized and doing business in this state shall have the burden of proving by a preponderance of the evidence that the requirements of subdivisions (b) and (c) are met." A broader, rather than technically narrow interpretation of § 854(b) is consistent with § 854(e), since § 854(e) places the burden of proving compliance with § 854(b) on the person or corporation seeking acquisition or control of the public utility, not solely on the utility.

Our interpretation is also consistent with § 854(g). Section 854(g) provides that §§ 854(b)(1) and (2) do not apply to the establishment of a holding company. This is consistent with Commission precedent which reviews an application to form a holding company under the standard of ratepayer indifference, not on whether the holding company's formation will provide ratepayer benefits.[9] It would create a contrary result if a utility could avoid the application of § 854(b) on the basis of its corporate structure. Moreover, under such an interpretation of § 854, any applicant for authorization to form a holding company structure would certainly fail to meet the ratepayer indifference test, since such a formation could be used to circumvent § 854(b) in future mergers.

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[9] See *Application of Roseville Telephone Company for Authorization to Implement a Plan of Reorganization Which Will Result in a Holding Company Structure*, D.96-07-059, slip op. at p. 9.

> "[W]e adopted a standard of ratepayer indifference to the effects of a holding company reorganization. Accordingly, when a utility seeks to reorganize under a holding company structure under PU Code Section 818 or Section 854, we do not require it to demonstrate more than that (1) a valid business purpose exists, and (2) the reorganization may be accomplished and future operations conducted pursuant to conditions that will be adequate to protect the public interest." (*Id.*)

Applicants' § 854(b) argument is focused on the subsections of § 854(b) concerning the identification and allocation of economic benefits (subsections (b)(1) and (2)), rather than at addressing adverse effects on competition. (subsection (b)(3).) Applicants concede that the Commission should analyze the impact of the proposed transaction on competition as mandated by § 854(b)(3), but only because the Commission is required by independent authority to consider the effect that its decision will have on competition.

Northern California Power Agency v. Public Util. Com., 5 Cal.3d 370, 379-380 (1971) provides that the Commission must take into account the antitrust aspects of applications before it. However, it states that the Commission should do so by a balancing test, "plac[ing] the important public policy in favor of free competition in the scale along with the other rights and interests of the general public."

Section 854(b)(3) is more specific and does not provide for a balancing test. The Legislature mandated that the Commission make a finding in certain mergers that the proposal will not adversely affect competition, and mandated certain, specific outcomes if it is determined that the merger will adversely affect competition, namely, to adopt mitigation measures to avoid this result or to deny the merger. It would elevate form over substance to conclude that the Legislature was more concerned with competition if the utility was a party to the transaction absent the holding company structure but was less concerned about competition when a holding company was involved.

We therefore determine that § 854(b) applies to this transaction in its entirety. Because we base our determination on the statute's plain meaning, it is unnecessary to address the remainder of the parties' arguments. We similarly do not address ORA's arguments that the Commission can quantify and equitably allocate benefits under *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission*, 485 F.2d 786 (D.C. Cir. 1973) and the New Regulatory Framework (NRF), because it is unnecessary to reach these issues in light of our determination above that § 854(b) applies to this transaction.

II. Requirements of § 854

A. *Economic Benefits of the Merger*

Section 854(b)requires that "(b)efore authorizing the merger acquisition, or control of any...telephone utility doing business in this state, where any of the utilities that are parties to the proposed transaction has gross annual California revenues exceeding five hundred million dollars, the Commission shall find that the proposal does all of the following: (l) Provides short-term and long term economic benefits to ratepayers. (2) Equitably allocates, where the Commission has ratemaking authority, the total short-term and long-term forecasted economic benefits, as determined by the Commission, of the proposed merger, acquisition, or control, between shareholders and ratepayers. Ratepayers shall receive not less than 50 percent of those benefits."

Next we will apply the requirements of this section to the proposed merger to determine a forecast of the economic benefits of the proposed merger and an appropriate method for allocating a fair share of those benefits.

1. Short Term and Long Term Economic Benefits

a) *Organization of The Discussion*

Having found that §§ 854(b)(1) and (2) apply to the proposed merger, there are five interrelated questions we need to address in this section to determine that the merger meets the requirements of these subsections. These are: (1) Allocation of Benefits—what means should the Commission use to pass on economic benefits to consumers—market driven allocation of economic benefits versus rate reductions or surcredits, (2) Benefits from Services—what services should be included to determine short and long-term benefits as required by § 854, (3) Definition of Short Term and Long Term—what periods constitute short- and long-term to estimate economic benefits, (4) Calculation of Benefits—what method should we use to determine merger savings, and (5) Benefit Allocation—what allocation ratio should we use to apportion economic benefits between ratepayers and shareholders.

The resolution of the first and second issues are closely interdependent . Because of the interrelationship between the two issues, we will combine our discussions under the overall framework provided by § 854 and proceed with the remaining issues.

(1) Allocation of Benefits

Applicants' Proposal

Applicants propose that the anticipated benefits of the merger will flow through to ratepayers in the form of lower prices for telecommunications services. Applicants' position rests on the assumption that competitive markets will assure lower prices as Pacific seeks to protect itself from a loss of market share in relevant markets. Applicants point to AT&T and MCI documents to demonstrate an expectation that Pacific will lose market share over the coming years in most of Pacific's telecommunications markets.

Applicants' witness Gordon states several reasons why regulated rates should not be reduced to recognize the benefits of the merger. First, price reductions would lead to "double counting" of benefits, because, Gordon states, any such benefits would be in addition to price reductions imposed by competition. According to Gordon, competition will "guarantee" that at least half of the forecasted economic benefits will be passed on to ratepayers.[10] Second, Gordon argues that flowing through of cost savings by way of lower rates for services whose prices are dictated by market forces will create an inefficient market.[11] Third, Gordon observes that the merging companies intend to use cost savings to employ "pricing flexibility" to "capture the growth potential and pro-competitive effects of the merger." Applicants propose that the anticipated benefits of the merger will flow through to ratepayers in the form of lower prices for telecommunications services.

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[10] See Exhibit 80, Witness Gordon, page 43.

[11] *Ibid.*

(2) ORA's Proposal

ORA proposes half the benefits be passed through to ratepayers in the form of a surcredit to all of Pacific's regulated services. ORA disputes Applicants view that the Commission should assume competitive markets will ensure these benefits are flowed through to ratepayers.

(3) TURN's Proposal

TURN recommends that merger-related benefits, even those estimated for as long as twenty years, be allocated to ratepayers over a five year period. TURN proposes the five year period in recognition that regulation could change after that period and consistent with Pacific's request to recover depreciation charges in the "franchise impacts" proceeding (I.95-04-044) over five years which it would otherwise have recovered over a longer period. TURN also opposes Applicants' proposal to rely on competition to flow through benefits to ratepayers. TURN explains that competitive markets do not put pressure on a single firm to pass along extraordinary cost savings and permit firms to retain such cost savings as profits.

(4) Discussion

We will begin our analysis with the definition of the term "ratemaking authority" as it refers to our legal jurisdiction. Currently, we have regulatory jurisdiction over all categories of telecommunications services that Pacific provides, including Category I (fixed price services—basic monopoly services), Category II (flexible priced—discretionary or partially competitive services), and Category III (services with maximum pricing flexibility—fully competitive services). While we recognize that our regulatory jurisdiction gives us the discretion to include all these services to determine economic benefits, we have recognized that the type of ratemaking applied to the particular service ultimately determines how benefits will be passed through to ratepayers. Our policy preference for market forces to set prices and to provide improved service to consumers has been well established. Plenty of evidence exists to support our policy preference.

From the outset we recognize, as we did in previous merger cases, that where market forces exist, we prefer that competition, instead of regulatory fiat, drive realized benefits to consumers through reduced prices and improved services. The policies we have adopted to open the telecommunications market, and the actions of the Congress in its enactment of the Telecommunications Act of 1996 have fundamentally changed the regulatory and market environment in which Applicants will provide telecommunications services. Today Applicants face aggressive and imminent competition from many corners of the market: long distance service providers such as AT&T, MCI, and Sprint who have nationwide operations and facilities; alternative local access providers, such MFS and Teleport, who have begun offering competitive alternatives to high-volume business users; facilities-based wireless providers; and cable operators such as Time Warner and U.S. West/Continental Cable, who own facilities throughout most communities across the country. All of these and other potential competitors are positioning themselves to offer "one stopping shopping" for a variety of telecommunications services, almost all of which Applicants are already offering or intend to offer. As competition intensifies, the benefits of a competitive market will ensue to consumers by allowing them to select packages of services that suit their needs and their pockets.

The removal of regulatory barriers to competition and pricing of monopoly services for resale and unbundling of bottleneck functions this Commission and the FCC have engaged in for the last several years are intended to create a competitive telecommunications market that produces benefits to consumers through market pressures instead of the traditional ratemaking process. Competitive markets and the resulting competitive prices and services, where they exist, are the most efficient means of ensuring that customers receive short- and long-term benefits. Our view of the evolving telecommunications market and abiding preference for market discipline, where it is present, to regulatory mandated rate reductions have been consistently applied under the purview of § 854 to previous merger cases that we decided in the past.

In the merger between McCaw Communications and AT&T, we agreed with the Applicants in that case that "competitive price pressures and service competition are the appropriate mechanisms to use to assure that the net benefits are passed on to ratepayers."[12] (D.94-04-042, 54 CPUC2d, 52). We noted that we had used competitive mechanisms to a great degree in regulating the two industries, and recognized there was evidence that competition, in the industry segments it was present, has produced lower prices and improved service. (*id.*)

In the GTE/Contel merger, we recognized the imminence of competition and concluded that in addition to surcredits, we could in part "[r]ely on market discipline to return a large portion of the qualitative and quantitative benefits to consumers." (See D.96-04-053, page 12.) We also noted our expectation that GTE California Inc.'s (GTEC) new and current customers would benefit from the NRF mechanism which permits GTEC to pass on merger related cost reductions to its customers through lower prices.

Moreover, it is also instructive to note that our approach to regulation, where competition was present, has been generally consistent in all competitive segments of the telecommunications market. For example, in our review of the regulatory framework of cellular telephone service (D.90-06-025), we adopted a forward-looking policy for an industry facing at the time limited competition due to a duopoly market structure. Our preferred policy for that industry reflected a basic philosophical direction to rely on competitive forces to set prices for cellular service and to promote the most rapid expansion of service and use of new technology that is reasonably possible.[13]

Today, the potential for competition to intensify in all sectors of telecommunications services is considerably higher than when we granted the

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[12] D.94-04-042, 54 CPUC2d, 43, 52.

[13] D.90-06-025, 36 CPUC2d, 464, 470-471.

merger of McCaw with AT&T, and when we adopted a reformed regulatory framework for cellular companies, which since then has undergone full deregulation. Competitive forces are also increasingly more intense today than they were last year when we adopted the merger of GTEC with Contel. There is every reason, and evidence, that competition wherever it exists, will ensure the flowing of savings and benefits to consumers.

In the case before us, the current and prospective markets in which Applicants plan to participate are at varying degrees of competition. For example, basic service is still not a sufficiently competitive service; whereas, long distance service is.[14] In this sense, the general market for Applicants is a hybrid one unlike those that we considered in the McCaw/AT&T merger case. In the latter, both markets were considered competitive, albeit at different levels, but nonetheless, due to the mode of regulation applicable to them, our conclusion followed that the proper ratemaking method to pass through benefits to consumers would be competitive pressure. In the case of SBC and Telesis, we are faced with a novel market situation where the market is fast evolving and currently happens to contain segments that cover the spectrum from competitive services to monopoly services. Given this hybrid market structure and the uncertainty about the duration of the status quo, it would be illogical and superfluous to require that the savings resulting from all services and operations be passed on to consumers through mandated rate reductions. In this respect we agree with Applicants, in part, that some of the savings will be ultimately flowed through to consumers due to market forces. However, we do not believe, as Dr. Gordon claims, that services on which Pacific has market power are such at a competitive level either at this time or in the immediately foreseeable future (as determined for this purpose in

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[14] In D.93-02-010, we granted the request of AT&T for more pricing flexibility on the ground that effective competition existed in the market for the intrastate interLATA market. And we noted that "We believe that the additional flexibility granted today will result in more benefits to customers than burdens. (D.93-02-010, 48 CPUC2d, 31, 62.)

this case) that a "flow through" of savings from these services will be realized due to competition to satisfy the requirements of § 854.

For the above reasons, we conclude that for the purpose of this case, our consideration as to how to pass on merger related savings is dependent upon the type of service and the type of regulation to which it is subject. Accordingly, benefits from services and their associated operations to be included in determining the quantifiable and shareable merger-related savings will be limited to those savings that we can reliably attribute to services and related operations that are not sufficiently competitive at the present and in the foreseeable future.

2. Benefits From Services

We will now briefly summarize the positions of the parties and analyze each of the current and prospective service categories offered or planned to be offered by Applicants to determine whether we should include it in the calculation of benefits.

a) Applicants' Estimates

Applicants estimate certain cost savings associated with the merger which they believe will occur as a result of economies of scope and scale. Applicants estimate those benefits associated with certain of Pacific's regulated operations, assuming that competitive markets will ensure that the benefits of the merger will flow-through to ratepayers in the form of lower prices. Applicants also believe that ratepayers will receive the benefits of the merger as a result of Applicants' public statements with regard to improved service, locating company headquarters in California and the creation of a technology infrastructure fund, among other things.

(1) Witness Nelson and Witness Cicchetti

Applicant's witnesses Richard Nelson and Dr. Charles Cicchetti estimated cost savings which would accrue to Pacific's regulated operations. Witness Nelson, who is a manager employed by Pacific, estimates about $366 million in cost savings between 1998 and 2003. Nelson believes these savings would occur as a result of eliminating duplication and capturing economics of scale. Nelson's estimate is

net of implementation costs. The final amount that he recommends be flowed-through to ratepayers is $183 million. Nelson explains that his estimate of savings goes out only 5.6 years, until mid-2003, because he anticipates that after that time Pacific's prices will no longer be subject to regulation by the Commission.

Nelson arrived at his estimate by assessing the percentage of a department's costs that might be subject to cost savings and then assessing the percentage of those costs that might be actually saved. For example, Nelson estimates that 100% of marketing costs might be subject to merger-related savings. Of those costs, he believes the merger will reduce costs by 10%. He believes no cost savings will be achieved by the merger in the area of advertising because competition imposes increasing advertising costs of Pacific. Nelson's analysis was based on his experience at Pacific working on budgets and operations. Applicants argue that Nelson's analysis is "aggressive" and the only one relevant to this proceeding.

Nelson prepared his cost savings estimates during the four days prior to the meeting of Pacific's board at which the board voted to approve the merger. Subsequently, Pacific hired the consulting services of Arthur Andersen to confirm Nelson's estimates. Cicchetti of Arthur Andersen[15] concurred with Nelson's estimates of savings associated with the merger. Cicchetti based his analysis on the Arthur Andersen report that was conducted by interviewing the managers of several Pacific operating divisions.

ORA expresses "serious doubts" about Nelson's analysis, arguing that Nelson conducted his analysis for the sole purpose of reducing the estimate of merger benefits that would be allocated to ratepayers under § 854. In support of this argument, ORA observes that the analysis was not part of the merging parties' decision-making process, and that Nelson conducted his analysis after the merger parties had agreed in principle to merge and after SBC had conducted its "due diligence" assessments.

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[15] Cicchetti is no longer an employee of Arthur Andersen.

ORA also criticizes Cicchetti's analysis as not credible, observing that Cicchetti failed to review any SBC analyses or reports and spent only 51 hours confirming Nelson's estimates. ORA argues that Cicchetti is not a credible witness on these matters because he had never previously analyzed mergers of telecommunications companies.

ORA believes Nelson's assumption that Pacific will no longer be subject to rate regulation after 2003 is unrealistic considering that Pacific's own documents suggest Pacific will retain market dominance until well after that date.

TURN presents similar criticisms of Applicants' estimates of net benefits. TURN believes Applicants' analysis is biased because it assumes large implementation costs in the early years and cost savings which are realized slowly, thereby underestimating the long run benefits of the merger. TURN argues that the assumption that pricing regulation will end in 5.6 years is unrealistic and that in any event, Pacific's method of quantifying benefits is contrary to § 854, which requires quantification of total forecasted benefits, not just those which occur prior to some event. TURN observes that extending Nelson's calculation to 20 years of benefits triples his estimate of benefits to $742 million. TURN recommends a twenty year estimate on the basis that such a period is supported by the legislative history of § 854, as discussed in *Re SCEcorp*, Decision (D.) 91-05-028, 40 CPUC2d 159, which denied approval of the merger between Southern California Edison Company and San Diego Gas and Electric Company.

(2) Witness Grundfest

On rebuttal, Applicants presented the testimony of Joseph Grundfest, a consultant hired to review ORA testimony. Grundfest believes that the benefit of the merger to shareholders should be measured by comparing the combined stock prices for the merging companies on the date the merger was announced to the prices in effect immediately before the announcement. Grundfest observes that although the value of Pacific stock rose following the announcement of the merger agreement, the value of SBC's stock fell commensurately, representing a

"wealth transfer" from SBC shareholders to Pacific shareholders. Grundfest observes that the stock market is the most accurate predictor of value, incorporating all publicly-known information relevant to the merger.

ORA argues that Grundfest's testimony is, in effect, nonsensical because it ignores the testimony of other Applicant witnesses and fails to recognize that the merger could not be justified, as a business matter, if shareholders and officers did not expect substantial benefits as a result. ORA observes that the stock market may be a good predictor of value on the basis of publicly available information, but cannot incorporate the privately-held information which the officers and boards of both Pacific and SBC have kept in confidence.

b) ORA's Estimates

ORA suggests the merger benefits estimated pursuant to § 854 must include several components which Applicants' analysis omits. For example, ORA believes the economic benefits which should be allocated to ratepayers include those cost savings realized from the increased purchasing power of the combined companies and the reduced cost of capital resulting from the greater financial strength of SBC. ORA also argues that ratepayers should receive the benefits associated with implementing "best practices,"[14] observing that even though SBC could implement best practices without the merger, Applicants have consistently justified the merger, in part, on the basis that SBC may take advantage of Pacific's expertise in improving operational efficiency. According to ORA, this expertise represents an economic benefit and that Pacific should not give away this valuable asset which has been financed by ratepayers.

ORA presents several methods for estimating economic benefits. Its witness Bradford Cornell estimates the present value of the merger cost savings by using the estimates prepared by Lazard Freres for SBC and Salomon

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[14] "Best practices" refers to efficient management of operations.

Brothers for Telesis. The estimates of these investment bankers were created as part of the due diligence review undertaken by the Applicants during the process of deciding whether the companies should merge.

Cornell calculates his estimate by using Salomon Brothers' estimates of cost savings for each operational unit in the combined company. Cornell then updates this estimate to 1995 and calculates a present value by using a 10% discount rate for a ten year period. Cornell explains the ten year period is the same used by Lazard Freres and Salomon Brothers. He estimates total savings for both companies of $3.68 billion. Reducing this amount to account for savings accruing only to Pacific's intrastate assets, his final present value estimate is $1.58 billion. To this, Cornell adds $358 million in cost savings associated with Pacific's capital expenditures and Yellow Pages operations for a total estimate of economic benefits of $1.938 billion. Savings to Yellow Pages would occur as a result of economies of scope and scale following the merger.

Cornell presents other methods for calculating benefits of the merger. He calculates a "merger premium" as the difference between Telesis' shareholder equity before the merger announcement and after the merger announcement. Calculating the difference, applying an allocation factor for intrastate assets and adding Yellow Pages benefits yields an estimate of economic benefits of $3.13 billion.

Using a different methodology, Cornell adjusts Nelson's estimate by adding in Yellow Pages benefits, Category III benefits, capital savings, "best practices" savings, and tax benefits. Cornell then forecasts the savings over ten years, rather than the 5.6 years Nelson applied. His estimated savings using this method is $1.2 billion after accounting for the intrastate allocation and adjusting for inflation.

ORA proposes using the methodology which applies the analyses of Salomon Brothers and Lazard Freres, which ORA believes are the best available and, unlike the estimates presented by Nelson and Cicchetti, are those relied upon by the Applicants in deciding whether to merge.

Applicants argue that the ORA's use of the Salomon Brothers and Lazard Freres analyses to calculate merger benefits under § 854 is inappropriate. They argue that those analyses include cost savings associated with long distance, wireless and other unregulated lines of business. Applicants also observe that those analyses assume many more cost savings for SBC than Pacific. Applicants argue that when the Lazard Freres and Salomon Brothers numbers are adjusted to estimate only the savings from Pacific's core businesses for a 5.6 year period, cost savings are actually lower than Nelson's.

c) *TURN's Estimates*

TURN's witness Terry Murray believes ratepayers should receive $977 million in forecasted Category I and Category II cost savings. Murray reaches this estimate by using the average of Nelson's original estimates and the estimates presented by Arthur Andersen and assuming a twenty year time horizon. Murray believes this is a conservative estimate which does not incorporate some anticipated benefits, among them, capital savings and savings from unregulated products and services. Murray argues § 854 does not permit the Commission to distinguish between regulated and unregulated services for purposes of allocating merger benefits to ratepayers. The savings from Category III service savings alone Murray estimates to be about $200 million. Using a twenty year time horizon for Nelson's estimate of savings related to unregulated services of $575 million, Murray estimates total savings of $2.058 billion.

Murray observes that her estimate of benefits associated with regulated services is 2/3 of the savings that would have accrued to ratepayers over the next five years if the Commission had retained a 5% productivity factor as part of the New Regulatory Framework price-cap formula. Murray believes the merger can achieve these levels of productivity which are comparable to those it achieved in the recent past.

d) UCAN's Position

UCAN comments that the Commission must identify and pass along actual benefits arising from the merger. UCAN believes that § 854 "benefits" include more than simple cost savings. UCAN argues that merger savings should include capital cost savings, that competition will not guarantee that ratepayers receive half the economic benefits of the merger, and that a twenty year time line is a reasonable estimate of "long run" under § 854. UCAN observes that two comparably sized regional Bell Operating Companies (RBOCs), NYNEX and Bell Atlantic, have estimated costs savings attributable to their merger to exceed one billion dollars.

e) Discussion

(1) Category I and II Services

Given the varying degree of competition in the different sectors of telecommunications services, we do not find persuasive justifications in Applicants' claims that both short- and long-term benefits, and by implication from all segments of their services, will be passed on to consumers through market driven price reductions. Obvious exceptions to Applicants' claim are Category I and Category II services. These services although facing imminent competition from competitors via resell, unbundled services, and facilities-based competition including wireless, have not yet experienced meaningful competition and as a consequence are not yet categorized as competitive services. We shall include these services in the calculation of savings to be shared between ratepayers and shareholders.

(2) Category III Services

In the case of Category III services, we have declined to assert our regulatory authority to oversee rates for these services for one of two reasons: (1) if the service has been detariffed due to statutory requirements or federal preemption, or (2) if the local exchange carrier shows that it retains insignificant market power. These services include, among other services, Yellow Page directory (discussed in a following section), and enhanced services. Category III services are fully competitive; and hence, Pacific and GTEC have been accorded the maximum pricing

flexibility allowable by law for all services that fall under this category. It is based on this presumption that Category III service are excluded even from the sharing mechanism established for monopoly services. Accordingly, we shall exclude all savings associated with Category III services from our calculations of savings for rate reduction purposes because savings that may result from these services as a result of the merger will be passed on to consumers due to market forces.

(3) Long Distance Services

The Commission's regulatory authority over long distance services and whether to include these services in the determination of economic savings are not in question. Our task, as in the preceding services, is to resolve the principal question whether we should allow competitive market forces or mandated price reductions (or surcredits) to drive savings in this segment of the market to consumers

In our consideration of the savings from long distance services the combined company plans provide we are reminded by the record before us that, as a matter of fact, neither SBC nor Telesis owns any market share in the long distance market in California at this time. Still, § 854 requires us to consider forecasted benefits from this service.

When and if Applicants enter the long distance market as they propose, they will face formidable competitors in the likes of AT&T, MCI, Sprint Communications Company, L.P., and with lesser participation numerous other national companies and hundreds of resellers. The long distance market is a competitive market. And as we noted in the GTEC/Contel, and AT&T McCaw merger decisions, the type of regulatory mechanism applicable to the merging companies should be considered in evaluating mergers. [17]

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[17] See D.96-04-053, 11.

The long distance segment of Applicants' business, notwithstanding the fact that this aspect of their business is simply a business prospectus, will, when and if it materializes, be engaged in a fiercely competitive market where price competition is robust. In D.93-02-010, we granted the request of AT&T for more pricing flexibility on the ground that effective competition existed in the market for the intrastate interLATA market.[11] And we noted that "We believe that the additional flexibility granted today will result in more benefits to customers than burdens." (48 CPUC2d at 62.) By the time Applicants actually enter that market, the long distance market as we know it today is likely to be even more competitive. Counting any savings from the prospective business of Applicants where there is full competition will unfairly disadvantage Applicants by giving competitive advantage to their would-be competitors and distort the market.

(4) Yellow Page Directory

With regard to Yellow Pages, § 728.2 requires the Commission to consider revenues and expenses" of Yellow pages advertising "for purposes of establishing rates for other services offered by telephone corporations." That section also limits the Commission's ratemaking authority except under certain circumstances. Under § 728.2, we do not have "ratemaking authority" over Yellow Pages at this time and under existing circumstances. For that reason, we do not include Yellow Pages cost savings in our calculation of economic benefits.

(5) Capital Savings

We disagree with Applicants' suggestion that no capital savings will accrue as a result of the merger. To the contrary, the evidence in the

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[11] In analyzing market power in D.94-04-042, we commented on the dynamic nature of the telecommunications market noting the decline in market share of AT&TC from about a nearly 100% of the market a decade earlier to about 60% at that time. (54 CPUC2d at 54.) We also were aware that for the intrastate interexchange market, the market shares of two of AT&T's competitors had increased while AT&TC sustained a consistent and sometimes dramatic decrease in market share. (48 CPUC2d at 46-47.)

record including Applicants' own witness show otherwise. If, for example, the merged company locates a single administrative headquarters in California, as Applicants propose, it will forego capital costs associated with a separate building elsewhere, including office equipment and other plant which would be required for two headquarters. A study conducted by SBC assumes an average of 3% savings to the merged company as a result of additional leverage in purchasing. Over the long term, we would expect such benefits to be substantial since the merged companies have assets exceeding $22 billion. Contrary to Nelson's assumption, such benefits of the merger are tangible even if they accrue as a result of purchases which have not yet been made. We do agree with Nelson, however, that a reasonable way to estimate capital savings is to determine the lower carrying costs associated with a reduced capital base.

To separate the savings attributable to non-competitive (Category I and II) services from those associated with competitive (Category III) services, we will apply the same allocation factors Nelson used in his testimony (See Exhibit 36, page 21). Applying the 17% separation factor, for noncompetitive portions, we obtain $30 million for allocable savings from capital expenditures.

(6) Best Practices

Best practices represent changes in efficiency of the processes of a company to develop and provide products and services. Mr.Nelson included $53 million in potential savings that might be achieved from adopting SBC's best practices.[11] Mr. Nelson later concluded that any potential savings attributable to best practices were not in fact attributable to the merger and could be achieved by Pacific independently, without the merger. We agree to the exclusion of best practices from benefit calculation because Pacific's track record in cost savings indicates that it is

[11] Exhibit 36, page 16.

capable of achieving further cost savings by reengineering itself as it has done in the past through the aid of reengineering consultants.[20]

PacBell has engaged in a significant core process reengineering initiative to achieve best practices and the resulting cost savings.[21] We shall therefore exclude savings from best practices in determining shareable economic cost savings.

3. Definition of Short Term and Long Term

In determining economic benefits, § 854 requires us to consider both short-term and long-term benefits; however neither the statute nor its history specifies the duration of these periods. Parties in this proceeding propose widely varying duration for long-term with equally disparate explanations for basis of their determinations. In our analysis of the statute's requirement we will begin with the historic analysis of short and long-term definitions to shade light on what factors we should consider to determine these periods.

In the proposed merger of Southern California Edison Company (Edison) and San Diego Gas and Electric Company (SDG&E), we noted "for purposes of [that] proceeding, the short term should relate to the current general rate cycle of three years."[22] The rational for this was that electric rates were routinely set every three years based on a three-year forecast of costs.

In defining long-term, which we found to be more problematic, because, in part, its theoretically definition could go as far as infinity, we emphasized that the "the definition of long term may vary with circumstances of each individual case." We went further and said that "We decline to define the long term for all future cases. The appropriate definition of the long term for a merger involving

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[20] Exhibit 35, page 14.

[21] Exhibit 35 - Cicchetti pages 12 and 13.

[22] 40 CPUC2d, D.91-05-028, 173.

telecommunications companies, for example, may differ from the definition for merger of energy utilities."[23] With this caveat, we set a standard applicable specifically to that merger and concluded that long term should recognize the normal planning horizons of electric utilities and the nature of benefits claimed by Applicants in that merger. Our inclination to adopt planning horizons, as described in that decision, was, in part, driven by SDG&E's and Edison's claim that the merger produced resource planning benefits.[24]

The parties in this proceeding suggest several widely variant definition of long term. UCAN's witness, Murray, recommends a period of 20 years for a definition of long term in order to ensure that we capture the full range of long-run benefits of the merger. The witness also bases her recommendation in part on our reliance upon energy utilities' planing horizons in the SDG&E/Edison merger proceeding without establishing why planning horizons should also be established in telecommunications. Similarly, UCAN also supports a 20 year span for long term calculation of benefits. ORA's witnesses rely on Salomon Brothers and Lazard Freres use of 10 years to calculate their proposed benefits. We reject these estimates because none of them recognize the pace of change and the inherent uncertainty in telecommunications market which we consider important in defining long term for telecommunications services.

Telesis' witness, Nelson, recommends a 5.6 year period for long term calculation based on the assumption that the rapidly changing telecommunications industry will evolve such that it will no longer be subject to price regulation after this period. To support his proposal Nelson mentions that: (1) in the long distance market, AT&T was granted pricing flexibility in about nine years, after the divestiture of the Bell System in 1984 and argues that the competition Pacific

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[23] *Id.*

[24] *Id.*

faces in intraLATA market is far more formidable compared to what AT&T faced at the time of divestiture. Cicchetti reduces Nelson's 5.6 years to five years on the basis that once markets are opened for competition, the time period for competition is short. He cites the gas industry, the airline industry, and the long distance telecommunications markets as demonstrative examples. Secondly, Cicchetti refers us to our decision in the GTEC/Contel merger in which we adopted three years and five years to calculate short term and long term benefits, respectively. We believe these are sound considerations for defining "long term" in this case.

Our attempt to define long term for telecommunication market at this time, is necessarily tied to the circumstances prevalent in this industry. In telecommunications, competition and the type of ratemaking we apply to the industry take paramount precedence to planning horizons. In this sense, we agree with the views of Telesis' witnesses Nelson and Cicchetti who emphasized the method of ratemaking applicable to the industry as well as the level of competition present to be the principal factors in defining long term for telecommunications industry. This view is supported by the GTEC/Contel merger decision in which we adopted a five years long term period proposed by the parties in that case through a settlement and consistent with the philosophy articulated by the SDG&E/Edison merger decision. In adopting the definition of long term on the GTEC/Contel case, we noted that the proposed definition was "reasonable in this proceeding since the telecommunications industry is changing rapidly and it is nearly impossible to predict with any degree of certainty what the telecommunications industry will look like five years hence."[25]

Nearly three years later, today we look back and recount, with some astonishment, that since the adoption of that decision numerous historical events have happened that have fundamentally changed the telecommunications market as we know it today. We opened the local telephone market for resell competition last year, and licensed over 60 competitive local carriers to compete with the incumbent LECs.

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[25] 54 CPUC2d D.94-04-053, at 284.

Among these new entrants are such formidable competitors, such as AT&T, MCI, and Sprint who have entered the local exchange market to compete with the incumbents. In the same year, Congress enacted a landmark decision ordering a complete opening of the local and long distance markets for full competition. The wireless market has been met with increased competition due to the entry of new generation wireless service providers and continues to pose a threat to the wireline local exchange service. The rates of technological change and evolution of the telecommunications market make it even much harder today than it was three years ago to reliably predict what the telecommunications industry will look like five years from now let alone ten and twenty years. We note that our skepticism for a long term definition that exceeds five years, is, in fact, shared by TURN and ORA.

Both TURN and ORA, while arguing for twenty and ten years definition for calculation of long term benefits, actually would like us to amortize the benefits over a period of five years only. ORA's witness, Dr. Selwynn, describes that "Given the uncertainties of the form of regulation that will persist into the future, it would be appropriate to recover the full NPV of cost savings over not more than five (5) years beginning in 1998. This approach insulates ratepayers both from the timing of implementation costs and benefits, as well as from changes in the form of regulation that may occur in the future."[26] Similarly, TURN's witness Murray recommends a five-year benefit recovery period while urging the Commission to determine benefits based on a 20-year definition of long term.[27] For all these reasons, we will adopt Nelson's 5.6 years to calculate the long term benefits of the merger in this case.

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[26] Exhibit C-176, Dr. Selwyn, page 124.

[27] Murray testifies that:

> "[P]acific apparently believes that price legislation, and therefore the ability to mandate a pass-through of savings, will end in no more than 5-6 years. While I do not endorse that finding, it is appropriate to require Pacific to return the full amount of required merger benefits to ratepayers in a period no longer than the maximum period that Pacific believes such a flow-through can occur." Exh. 225, Murray, p. 33.

4. Calculation of Savings

Next we will determine what method to use in calculating benefits. The parties relied upon three basic approaches: (1) budget analyses presented by Nelson and Cicchetti, Applicants witnesses; (2) changes in stock market prices and; (3) the analyses of Applicants' investment bankers, Lazard Freres and Salomon Brothers.

We first reject analyses which rely upon changes in stock market prices. The stock market may be in some cases a reliable indicator of market expectations because the stock market is generally considered to incorporate all publicly available information relevant to a firm's profitability. The theory is not readily applicable here because stock market analysts did not have access to much of the information relevant to the effects of the proposed merger on the date shareholders were most likely to react to the merger proposal, that is, April 1, 1996. As this proceeding demonstrates, few yet have such information and numerous experts disagree on the potential benefits of the merger in spite of their access to confidential documents and analyses which stock market analysts will never have.

In any event, we would discount the testimony of Applicants' witness Grundfest with regard to stock prices on the basis that it contradicts the testimony of several other Applicants' witnesses. For example, while Grundfest argues that the Commission should rely on stock market prices to find that there are no shareholder benefits associated with the merger, Cicchetti testified that the stock price response to a merger announcement is irrelevant to a determination of economic benefits of a merger. Grundfest's testimony that the stock market is a best predictor of merger benefits ignores the Applicants' argument presented on brief, proposing that Nelson's testimony "is the only legally and economically sound forecast of the maximum potential economic benefits under § 854(b)(2)." Finally, Grundfest's testimony that an analysis of merger benefits must incorporate the effects on both Pacific and SBC contradicts the testimony of Nelson and Cicchetti who argued that the Commission may not consider the impacts of the merger on SBC.

Cicchetti's analysis, based on his experience in more than 20 utility merger studies, makes useful contributions to the debate. Cicchetti participated in the

Arthur Anderson report serving as the advisory partner on the case. His analysis is an independent analysis of synergy-savings which updates Nelson's calculations and provides checks and verifications of Nelson's assumptions. Interviews with managers regarding how a merger might affect their operations are additional reality checks to Nelson's analysis of potential cost savings. The managers and directors of Telesis are the ones responsible to carry out Telesis' cost-saving measures. We shall review Nelson's testimony in conjunction with Cicchetti's updates as provided in his rebuttal.

Salomon Brothers and Lazard Freres analyses are estimates which Applicants' boards, in part, relied upon in reviewing the potential benefits of a merger and were undertaken by experts who are adept at analyzing the effects of mergers. The problem with these analyses, however, is that we have little information in the record with regard to how the analyses were performed or the assumptions underlying them. We are also concerned that the way ORA has adapted the Lazard Freres and Salomon Brothers analyses may not provide an allocation of cost savings between the two merging companies that recognizes the more efficient operations of Pacific. That is, ORA's estimates of economic benefits subject to § 854 would require the Applicants to share benefits likely to occur in SBC companies other than Pacific. We believe our obligation under § 854 is to pass through only those benefits that can be reasonably attributed to Pacific's operations.

Rather than rely on stock market prices or studies, we shall rely on the analysis of Mr. Nelson which has its foundations in operational and budgetary information as augmented by Dr. Cicchetti. Mr. Nelson analyzed the following three general areas by which cost-reductions could be achieved by Pacific: (1) elimination of duplication, (2) through economies of scale, and (3) implementing shared best practices.[24] Mr. Nelson then applied the savings from these to Pacific's 1996 budget. Mr. Nelson's experience in cost-reduction assignments give him relatively greater

[24] Exhibit 36, Nelson, pages 3 and 4.

advantage to assess merger-related savings at Pacific. His analysis provides us the most reasonable foundation for estimating economic benefits for many types of costs because Nelson considered specific operational budgets for Pacific and was available to explain the foundations of his approach.[29]

Although he did not recommend the inclusion of certain cost savings, he did provide estimates of them, including savings on capital costs, which we incorporate. We therefore use Nelson's analysis as the base for estimating most cost categories.

We therefore calculate the economic benefits of the merger based on his baseline estimates that include Category I and Category II services, but excluding savings associated with Category III services and best practices, as explained above. To that we add a proportioned savings from capital expenditures based on a allocation factor of 83% for Category I and II services. For all of these categories of savings, we extrapolate estimates out to 5.6 years. Incorporating these assumptions into the calculation, we forecast economic benefits associated with Pacific's Category I and Category II services and associated savings from capital expenditure to be $495 million. This number is the net present value for cumulative cost savings. Table 1 presents a breakdown of this amount.

The adopted forecasted estimate of economic benefits is based on a study by Applicants' which we believe reflects the fundamental philosophy we have advocated for telecommunications market. [30] We have adjusted Nelson's estimate of

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[29] TURN's witness Murray presents a method for calculating cost savings essentially based on Applicants' cost savings analysis and then adjusts the Applicants' estimates to account for her proposed definition of "long run" benefits which unreasonably span 20 years. Murray also averages the results of Nelson and Cicchetti's results even though she contends both studies understate cost savings. Murray also recommends using Cicchetti's implementation cost estimates.

[30] For example, Nelson estimates no savings associated with advertising expenses because Nelson presumed this to be an area for which expenses will increase as a result of competitive entry.

implementation costs with Cicchetti's implementation cost for consistency. In addition, we have applied a discount rate of 10% to Nelson's estimates to determine the annualized rate reduction. (See Table 1.)

5. Benefits Allocation

Applicants propose that benefits will be passed through to ratepayers by way of competitive pricing. Nelson's estimate assumes one half of benefits associated with regulated operations may be passed along to ratepayers.

TURN proposes that the Commission allocate 100% of benefits associated with the regulated operations to ratepayers on the basis that it recommends the Commission permit Applicants to retain benefits associated with nonregulated operations.

ORA proposes or presumes a 50% split of benefits between shareholders and ratepayers.

Section 854 requires that we allocate "no less than 50 percent" of economic benefits of the merger to ratepayers. We interpret this to mean that ratepayers must receive at least 50% of the economic benefits of the merger and that the Commission has the discretion to allocate the remaining 50% between ratepayers and shareholders as specific circumstances warrant. In D.96-04-053, in which we approved the merger of GTE California, Inc. (GTEC) and Contel, we allocated half of the benefits to ratepayers, finding that "a 50-50 sharing of the forecasted economic savings is equitable" partly on the basis that other benefits would accrue to ratepayers as competition and incentive regulation evolve. Here, as there, many qualitative benefits may accrue to ratepayers which we do not or cannot quantify here. We therefore find that a 50% sharing between ratepayers and shareholders is reasonable.

We will direct Pacific to refund $248 million to ratepayers over five years. We will require Pacific to effectuate the reduction by adjusting its rates for a period of five years by a total net-present-value of $213 million (the yearly amounts described in Table 1, determined at a 10% discount rate); and by implementing its

Community Partnership Commitment which (as we discuss in more detail later) will require a funding that totals $34 million in net-present value.

Pacific shall file an advice letter no later than October 1, of each year beginning with the year in which the merger will be consummated, to adjust the rates for basic monopoly and non-flexibly priced Category II services by the amount described in Table 1.

B. *Effect on Competition*

1. Overview

Section 854(b)(3) requires the Commission to find that Applicants' proposal does "not adversely affect competition." In making this finding, the Commission is required to request an Advisory Opinion from the Attorney General regarding whether competition will be adversely affected and what mitigation measures could be adopted to avoid this result. Complying with the statute, we requested and received an Advisory Opinion from the Attorney General on December 31, 1996, a week after the parties' filed opening briefs.[31]

The Advisory Opinion concluded that the merger will not adversely affect competition within California telecommunications markets (specifically, the markets for telephone and wireless services.) This opinion is guided by the Merger Guidelines and relevant federal antitrust laws and concludes that Telesis and SBC are neither actual nor potential competitors in any relevant California market

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[31] In *Re SCEcorp*, 40 CPUC2d 159, the Attorney General's opinion was issued before the conclusion of the evidentiary hearings. The Commission took official notice of the Opinion as a "legal opinion based upon specified assumptions" and allowed briefing regarding how the facts developed in the evidentiary record may or may not be at odds with those assumptions. (*Id.* at 289, n. 16.) In this case, the parties had an opportunity to reply to the Attorney General's Advisory Opinion in their reply briefs. In *Re GTE Corporation*, the Commission stated that such opinions are not controlling, but are entitled to "great weight." (*Re GTE Corporation*, 54 CPUC2d at 286; see also *id* at 325, n. 27.)

for telecommunications services.[32] The Advisory Opinion also concludes that the merger by itself will not enhance anticompetitive cross-subsidization opportunities.

However, in order to promote competition in the markets served by Applicants, the Attorney General recommends that the Commission maintain a stable system of price cap regulation on certain services which Applicants provide. Particularly, the opinion urges the Commission to carefully scrutinize requested adjustments to the NRF formula, especially when the cause of unexpected cost increases is unclear. The Advisory Opinion did not address intervenors' broader claims that the proposed merger would have an adverse effect on competition under § 854(b)(3) even if the merger does not technically violate the federal antitrust laws. Prior to the end of the evidentiary hearings, on November 5, 1996, the United States Department of Justice terminated its investigation of the proposed merger pursuant to the terms of the Hart-Scott-Rodino Act, concluding that "the merger did not violate the antitrust laws." (See Exhibit 198.)

Applicants believe that their proposal does not adversely affect competition within the meaning of § 854(b)(3). Intervenors AT&T, MCI, and UCAN believe that the merger will adversely affect competition by eliminating SBC as a probable competitor in future markets for local exchange, intraLocal Access Transport Area (intraLATA) and exchange access services. These intervenors base their conclusion on the grounds that SBC: (1) has the experience, assets, and reputation to compete in out-of-region local service markets and (2) would, absent the acquisition of Telesis, have been likely to enter the market either on its own or in combination with another entity.

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[32] Applicants and the Attorney General follow the analytical framework set forth in the Merger Guidelines adopted by the United States Department of Justice, the Federal Trade Commission, and state attorneys general, as well as the legal and economic principles reflected in case law interpreting the Clayton Act. (See United States Department of Justice Merger Guidelines, 1984 (Exhibit 163); 1992 DOJ/FTC Merger Guidelines, 4 Trade Reg. Rep. (CCH) ¶ 13,104 (1992); National Association of Attorneys General (NAAG) Horizontal Merger Guidelines, 4 Trade Reg. Rep. (CCH) ¶ 13,406 (1993); 1984 DOJ/Merger Guidelines, 4 Trade Reg. Rep. (CCH) ¶ 13,103 (1984).)

Intervenors point to, among other things: (1) the factors that inspired SBC to pursue this merger; (2) SBC's experience in California markets, such as a passive 3% interest in a California cellular service provider, its pursuit of the purchase of a cellular license in San Diego, and an abandoned joint venture with Cox Cable; and (3) its "know-how" as a local services supplier. Additionally, these intervenors believe that the merger will adversely affect competition for broader reasons not based on the federal antitrust laws.

As a measure to mitigate what it terms the merger's anticompetitive potential, UCAN proposes to create a "Consumer Telecommunications Network" to monitor and track the competitive process in telecommunications and to provide testimony before the Legislature and other agencies. Although ORA does not believe that the proposed merger will diminish competition within the narrow confines of the Merger Guidelines, it believes that the merger presents certain adverse effects under § 854(b)(3) which need mitigation as more fully discussed below. ADP alleges that SBC has a history of anticompetitive behavior in the provision of access to subscriber listing information to independent directory publishers, and requests safeguards to assure that an SBC-controlled Pacific does not repeat the allegedly anticompetitive conduct of SBC in the provision of subscriber listing information in California. TURN did not address § 854(b)(3) in detail, but states that its silence "should not be seen as indifference toward these matters." (TURN Opening Brief at p. 2.)

2. Interpretation of "Adverse Effects on Competition"

In *Re SCEcorp*, we set forth analytical precedents and tools for interpreting whether a party's proposal "adversely affects competition" within the meaning of § 854(b)(3).[33] We stated that the more familiar merger analysis is whether "the effect of such acquisition may be substantially to lessen competition or tend to create a monopoly" under Section 7 of the Clayton Act. (*Id.*, 40 CPUC2d at 182.) We

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[33] The outcome of a § 854 analysis is dependent on the specific facts of the case. Thus, our determination could be different if we were presented with different facts, i.e., if the proposed merger was between two contiguous RBOCs.

held that precedent developed under Section 7 of the Clayton Act provides a framework for analyzing competitive effects under § 854(b)(3), and, for the most part, analyzed that merger, as well as subsequent proposals, under the federal antitrust laws. (*Id.*, 40 CPUC2d at 183. See also *Re AT&T*, D.94-04-042, 54 CPUC2d 43; *Re GTE Corporation*, D.94-04-083, 54 CPUC2d 268.)

However, we need not find a technical violation of the Clayton Act in order to deny a merger under § 854. More specifically, we may disapprove a transaction whose impacts are harmful, but less than "substantial" under the Clayton Act. (*Id.*, 40 CPUC2d at 182.) In analyzing a proposal under § 854, the Commission is not limited to a determination that the proposal violates standards set forth in relevant antitrust statutes. We may also rely, as appropriate, on the body of common law regarding competition which predates 1989, when the effect on competition standard for utilities meeting the specified threshold was codified in § 854. (*Id.*, 40 CPUC2d at 183.)

3. Scope of this Analysis

Before discussing the parties' specific contentions regarding § 854(b)(3), it is necessary to define the scope of our analysis. For example, the Attorney General was primarily guided in his analysis by the Merger Guidelines and federal antitrust laws (federal antitrust laws). Intervenors such as ORA, AT&T, MCI and UCAN offer broader concerns about the effect of the proposed merger on competition. As stated above, we do not believe an analysis under § 854(b)(3) should be constrained by the federal antitrust laws. We accordingly address intervenors' broader concerns when raised in a specific context, as well as their federal antitrust concerns.

Several intervenors, such as AT&T and ORA, make much of the fact that: (1) this is the first telecommunications merger that this Commission has been asked to consider since passage of the Telecommunications Act of 1996; (2) the merger would occur in the context of the Commission's legislative mandate to open all telecommunications markets to competition by 1997; and (3) the merger will strengthen a company that already has a 100% share of the residential local telephone market and a

near-100% share of the business local telephone market. (ORA Reply Brief at p. 49.) The scope of our analysis is to examine whether, or under what conditions, this Commission should permit this merger to occur. We are not engaged here in a broader inquiry into the appropriate framework for regulating local exchange, intraLATA, or interLocal Access Transport Area (interLATA) markets, or into when Telesis or SBC should be able to offer interLATA service.

Thus, whatever market power Pacific possesses in the various relevant markets discussed below, our inquiry focuses on specific evidence as to whether this merger increases or otherwise enhances that market power. Several of intervenors' arguments regarding alleged barriers to entry, as more fully discussed below, would exist with or without the merger. We, and certain federal regulators, are examining these arguments in the appropriate proceedings to determine ways to promote robust competition in all telecommunications markets, a goal to which we are strongly committed. However, we do not find, in the absence of specific evidence, that a merger in itself adversely affects competition simply by making a large and strong company larger and stronger.[34] We need to examine Applicants' and intervenors'

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[34] Several intervenors, such as AT&T and ORA, make general allegations that the proposed merger will strengthen an already strong company, and that in and of itself is anticompetitive. This argument is similar to the entrenchment theory of anticompetitive harm, which contends that certain acquisitions involving an already dominant firm can give the firm

> "important advantages that will 'entrench' its dominance and make it less likely that the firm's market position will be undermined in the future. Since the mid-1970's, however, entrenchment has been skeptically received by the courts and by the FTC, particularly when the theory is premised only on the 'deep pocket' of one of the merging firms to entrench the other firm in its market." (Scher, *Antitrust Advisor*, Fourth Ed. (1995) at § 3.34.)

> "Entrenchment has been rejected as an anti-competitive harm when it is alleged to result from improved efficiency or technological capabilities of the dominant firm as a result of its integration with the acquiring firm. These effects are generally deemed to be pro-competitive consequences of the merger." (*Id.*)

We therefore do not accept this entrenchment theory here based on general allegations.

specific claims in the context of the relevant product and geographic market, as demonstrated by the evidence.

4. Relevant Markets

a) Background

Since the Commission starts its § 854(b)(3) analysis with guidance from the federal antitrust laws, it is necessary to understand what relevant markets might be affected by the proposed merger.

The goal of analyzing the competitive effects of a merger is to protect consumers by preventing transactions likely to result in increased prices or reduced output. Mergers can harm consumers when they cause structural changes to the marketplace that increase a firm's ability to exercise market power, which is defined as the ability to affect prices or reduce output of the industry.

Consistent with the United States Department of Justice and Federal Trade Commission Merger Guidelines, a traditional economic merger analysis begins by first considering the impact of a proposed merger on market structure as a threshold indication of the likelihood that the merger may adversely affect competitive performance. If markets are not concentrated, or if a merger does not substantially increase market concentration in relevant markets, the merger is unlikely to cause competitive harm. Where a merger raises competitive concerns, the analysis then turns to more specific assessments regarding the ability of consumers to substitute other products or services, the pricing behavior of firms in the markets, and the difficulty of entry. Finally, if these other considerations do not eliminate the likelihood of anti-competitive effects, the analysis considers any likely efficiency gains that may counterbalance any anti-competitive effects from the merger.

Traditionally, the competitive effects of a proposed merger are analyzed by identifying the relevant product markets affected by the merger. Definition of the product market considers products or services that are reasonably interchangeable, so that pricing decisions by one firm are influenced by the range of alternative suppliers available to the purchaser. The geographic scope of the market, the

area in which the sellers compete and in which buyers can practicably turn for supply, should then be identified.

The Attorney General explains that in some merger cases, it is appropriate to limit a merger analysis to current product markets instead of speculating on which product markets firms may offer in the future. To avoid speculation, the Attorney General limited the product markets considered in its Advisory Opinion to the range of local, intraLATA toll, access, information and other competitive services *currently* offered by both of the merging parties and sold by Pacific in California.

b) Telesis and SBC Telephone Services

Until 1984, telecommunications services in the United States were provided by monopolies, which were subject to traditional economic regulation at both the state and federal levels. This arrangement ended with the divestiture of American Telephone and Telegraph Company. Divestiture was effected by an antitrust consent decree between the United States Department of Justice and AT&T (the Modified Final Judgment (MFJ)). (See *United States v. American Tel. & Tel. Co.*, 552 F.Supp. 131 (D.D.C. 1982).) The MFJ, among other things, divested AT&T of its local telephone operations, and divided the territorial United States into 163 separate geographic areas, referred to in the MFJ as "exchanges" and in the industry as LATAs. The LATAs were then divided among the RBOCs. Simultaneous with this divestiture, state and federal regulators began initiatives to open the door to competition in telecommunications services, and to ensure equal access.

The Attorney General notes that the proposed merger would create the largest supplier of local services in the United States and the sixth largest telecommunications firm in the world. (If the NYNEX and Bell Atlantic merger is approved, that merger will create the largest local telephone company in the United States.) Both Telesis and SBC, through their RBOCs, currently generate most of their revenues from local, access, and intraLATA services. SBC is also a major supplier of cellular services.

Pacific serves approximately 75% of California's residents. SBC provides local telephone services through Southwestern Bell in Texas, Arkansas, Oklahoma, Kansas, and Missouri. SBC is headquartered in Texas, and states in its application that it has no operations in California. SBC does an insignificant amount of business in California, such as owning a passive three percent interest in a California cellular services provider. SBC also offers wireless services under the Cellular One brand name in 27 markets, including Chicago, Boston, Baltimore, and Washington D.C. SBC has cable television operations in Arlington, Virginia and Montgomery County, Maryland. SBC is also licensed to provide Personal Communications Services (PCS) in Little Rock, Tulsa, and Memphis.

The parties' discussions of competitive concerns do not clearly set out all the relevant product and geographic markets used in their analysis, but instead, weave references, which are often vague and general, to these markets throughout their testimony and briefs. As stated above, the Attorney General limits the product markets considered in the Advisory Opinion to "the range of local, intraLATA toll, access, information and other competitive services *currently* offered by both of the merging parties and sold by Pacific in California." Unlike the Attorney General, some intervenors broaden their relevant market inquiries to areas such as interLATA service, which SBC and Telesis do not presently offer. UCAN describes the relevant product market as "a significant supply of regulated and non-regulated telecommunications products and services." (UCAN Opening Brief at p. 28, n. 14.) The following list includes a breakdown of markets which parties and the Attorney General raise in their discussion.

c) Product Markets

Local Exchange Services

Local exchange carriers such as Pacific provide the wires or the "local loops" that physically connect users to each other and to long distance, or interexchange carriers. Local exchange carriers also provide the local switching facilities that direct calls to a local party or the long distance carrier, depending on the number

dialed. Two forms of local exchange service, flat rate and measured rate service, are available to the residential customer. Basic access service for businesses is provided on a measured rate basis. (See *Re Alternative Regulatory Frameworks for Local Exchange Carriers*, D.94-09-065, 56 CPUC2d 117, 154.) In California, local telephone exchanges were until recently exclusive franchises. However, the Telecommunications Act of 1996 and recent state statutes and Commission rulings (see, e.g., D.95-07-054) have removed these restrictions and have established requirements to open local markets to competition.

IntraLATA

IntraLATA toll services (sometimes referred to as intraLATA) are calls other than local exchange that originate and terminate within a single LATA. The Attorney General notes that intraLATA toll services are a major source of revenue for both Telesis and SBC, stating that the 1995 SBC Annual report and the 1996 Telesis Proxy Statement reported that those companies generated $840 million and $1,232 million, respectively.

We opened the LATAs to competition in *Re Alternative Regulatory Frameworks for Local Exchange Carriers*, 56 CPUC2d at 147. We did so for five reasons: (1) technological developments no longer make intraLATA toll services a natural monopoly, and barriers to entry were low; (2) competition already exists in this market; (3) the disparity between interLATA and intraLATA toll rates is illogical and impossible to defend on economic grounds; (4) opening LATAs to competition will stimulate new services and technologies from which California customers should benefit; and (5) an orderly introduction of intraLATA competition, as opposed to the then-operational de facto process, will allow the Commission to require the new competitors to bear a fair share of the costs of maintaining universal service and pursuing other public policy goals. We note that the other RBOCs have sought Commission approval to offer inter or intraLATA service in California, one has sought approval to offer local exchange services on a resale basis, and one has announced its

intent to use an acquired cable company's system to provide local exchange service in, among other places, California.[35]

InterLATA

InterLATA services are telecommunications between a point in one LATA and a point located in another LATA or outside of a LATA. This is generally referred to as the long-distance market. The MFJ prohibited the RBOCs from providing these services.

The Telecommunications Act of 1996 envisions that the RBOCs will be able to compete in long distance service. Currently, the RBOCs are permitted to enter the long-distance market for calls originating outside their in-region states. The RBOCs are permitted to enter the long-distance market for calls originating in their service areas after obtaining approval from the Federal Communications Commission (FCC), which cannot approve the application unless the RBOC has satisfied a 14-point competitive checklist, which is designed to demonstrate that the RBOC has opened its networks to facilities-based competition for local service. (See 47 U.S.C. §§ 271-272.) Telesis and SBC currently do not provide in-region long distance services. We understand that Pacific expects to seek Commission approval of its checklist in upcoming months.

Access Services

Local exchange carriers generally provide access to interexchange carriers for making available their facilities in the placement, transport and termination of toll calls. The local exchange carriers' access charge fees represent a substantial portion of the revenues generated by both Telesis and SBC. The Attorney

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[35] See, e.g., D.96-10-014 (re Application of Ameritech Communications International, Inc. to resell interLATA and intraLATA; D.96-09-004, re Application of NYNEX Long Distance Company to resell interLATA and intraLATA services; D.97-02-011, re Application of Bell Atlantic Communications, Inc. to resell interLATA and intraLATA services; A.97-01-034, Application of Bell South Long Distance to resell interLATA and intraLATA services; A.97-02-010, Application of Ameritech Communications International to offer local

Footnote continued on next page

General states that in 1995, Telesis generated $2,447 million, or 27 percent of its overall revenues for providing network access services. SBC earned $3,067, or 24% of its overall revenue, for providing these services during 1995.

Wireless Services

Telesis does not currently offer wireless services. In 1994, it divested its cellular operations which now do business as Airtouch Communications Corporation. (See D.93-11-011, 51 CPUC2d 728, modified and rehearing denied in D.94-03-036, 53 CPUC2d 344.) However, Telesis owns valuable Personal Communication Services licenses for Major Trading Areas in Northern and Southern California. SBC describes itself as one of the leading cellular companies in the United States, but does not have wireless properties in California. SBC does own a passive 3% interest in a California cellular provider.

Bundled Products

Bundled products, which is sometimes referred to in this proceeding as "one stop shopping," is a customer marketing tool, whereby a provider would offer, among other things, local exchange, intraLATA, interLATA, and wireless services to its customers. SBC states that its market research indicates that this bundle, at a minimum, should include landline and wireless local and long distance services, and that SBC's management is focused upon meeting its customers' demands for bundled communications services. As yet, SBC and Pacific do not offer a combination of these services which includes in-region long distance service, since they cannot yet offer long-distance service. Pacific provides Internet service and may combine this service with other services it offers.

d) Geographic Market

The parties generally limit their discussions of the geographic market to California or a portion thereof, although intervenors vaguely

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telecommunications services; and U.S. West's announced acquisition of Continental Cablevision, Exhibit 30 at p. 20.).

refer to "at least some California telecommunications markets" at times, without further specifying which markets those might be. (See, e.g., AT&T Reply Brief at p. 9; Brenner, Transcript, Vol. 25, at p. 3450, lines 3-17.) AT&T's and MCI's arguments that the proposed merger will foreclose competition as a result of access price discrimination and nonprice discrimination appear to mix many geographic as well as product markets. We will discuss this issue more fully below.

5. Does the Proposed Merger Eliminate an Actual Competitor?

Federal merger analysis would first determine whether the proposed merger increases market concentration by eliminating an actual competitor in any market. No party disputes that the level of market concentration in any market is not increased, since SBC and Telesis do not compete with each other in any line of business.

6. Does the Proposed Merger Eliminate an Actual Potential Competitor?

An actual potential competitor is a firm that does not currently compete in the relevant market but would enter sometime in the near future, either independently or in combination with another entity. This combination is called a toehold acquisition. If, in lieu of entering the market independently or through toehold acquisition, the actual potential entrant merges with a significant incumbent firm, its incentives to enter the market independently disappear and the market would lose the amount of new competition that the potential competitor would have generated. (See *Antitrust Advisor*, Fourth Edition, 1995, § 3.29 (Shepard's/McGraw-Hill).)[36]

The United States Supreme Court has reserved judgment on whether loss of actual potential competition without proof of other anticompetitive effects is sufficient grounds on which to reject a merger under § 7 of the Clayton Act.

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[36] UCAN also discusses the criteria for a related antitrust doctrine, the "perceived potential entrant" doctrine. (UCAN Opening Brief at p. 29.) However, UCAN abandons this doctrine by failing to apply it. No other party makes this argument, which we reject.

(See *United States v. Marine Bancorporation*, 418 U.S. 602, 625, 639 (1974); *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 537-538 (1973).) In *Falstaff Brewing Corp.*, the Court stated that it has "not squarely faced the question if for no other reason than because there has been no necessity to consider it." (*Id.*, 410 U.S. at 537-538.) However, lower courts, the United States Department of Justice, and the Federal Trade Commission have applied the potential competition doctrine.

To prove a loss of actual potential competition, one must establish that: (1) the relevant market is concentrated; (2) but for the merger, the acquiring firm would likely have entered[3] the market in the near future either on its own or by toehold acquisition; (3) there must be few other potential entrants with comparable advantages; and (4) such market entry would carry substantial likelihood of ultimately producing deconcentration of the market or other significant procompetitive effects. (See *Mercantile Texas Corp. v. Board of Governors, Etc.*, 638 F.2d 1255, 1266-1270 (5th Cir. 1981); *Tenneco, Inc. v. Federal Trade Commission*, 689 F.2d 346, 352 (2nd Cir. 1982).)

Intervenors such as AT&T , MCI, and UCAN urge this Commission to apply the actual potential competitor doctrine more broadly than interpreted under the federal antitrust laws, since the Commission's scope of review under § 854(b)(3) is broader than the antitrust laws. We decline their invitation to broaden the federally-required elements with respect to application of the actual potential competitor doctrine, where a body of established case law currently exists to guide us. Moreover, inherent in the actual potential competitor doctrine is some degree of speculation, that is, a determination of what a company was likely to have done absent the proposed merger. We therefore believe the standards adopted by the federal courts with respect to this doctrine are appropriate to guide our determination.

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[3] Courts are split on the exact standard of proof which must be met in establishing that the acquiring firm was likely to enter if not for the merger. We discuss this issue in more detail below.

Finally, AT&T and UCAN argue that we established a different standard of proof in *Re SCEcorp*, 40 CPUC2d at 183, where we recognized that the word "affect" in § 854(b)(2) is broad enough to reach incipient injury. We disagree. In the cited passage of *Re SCEcorp*, we, in effect, recognized the actual potential competitor doctrine. We stated:

> "[E]ven if the merging firms are not now in competition in a particular market, if there is evidence showing that one is a potential competitor of the other, the elimination of the potential competitor constitutes an adverse effect on competition within the parameters of § 854(b)(3)." (Citing *inter alia*, the Attorney General's Advisory Opinion in that case at pp. 13-14.) (*Id.*)

That Advisory Opinion merely cited two federal cases (*Falstaff Brewing Corp., supra*, and *United States v. El Paso Natural Gas Co.*, 376 U.S. 651 (1964).) These cases do not establish a lesser standard of proof under the actual potential competitive doctrine. Moreover, in *Re SCEcorp*, the parties to the proposed transaction were actual competitors. Therefore, we did not apply the actual potential competitor doctrine to the facts of that case.

a) *Is the Relevant Market Noncompetitive?*

The relevant markets for purpose of this analysis are the local exchange and intraLATA markets in California, or a portion thereof, since those are the markets that are primarily focused on by Applicants and intervenors. It is not disputed that there is not robust competition in these markets at this time, even though rules have recently been established to open the California local exchange markets to competitors, and the Commission has generally held that some competition exists in the toll markets. (See D.95-12-052, slip op. at 48-49.)

Applicants also state that SBC would not have entered the long distance market or any other market in California in the near future without the proposed merger. Intervenors focus on the local exchange and intraLATA markets for their actual potential competitor arguments. They do not make independent arguments that SBC would have been an actual potential competitor in other markets in California

except to the extent that entry in such markets would flow from SBC's entry into the California local exchange markets.[38]

b) Would SBC Likely Have Entered the California Local Exchange or IntraLATA Markets In the Near Future Absent the Proposed Merger?

Courts are split as to the standard of proof which must be met in establishing that the acquiring firm was likely to enter a market for the merger. The Fourth Circuit requires "clear proof" that the acquiring firm would have, in fact, entered. (*FTC v. Atlantic Richfield Co.*, 549 F.2d 289, 294-295 (4th Cir. 1977).) The Second Circuit requires a less strict standard, namely that the acquiring firm "would likely" have entered. (*Tenneco, Inc.*, 689 F.2d at 352.) The Fifth Circuit concurs, finding the Fourth Circuit standard too strict, and requiring "reasonable probability of entry." (*Mercantile Texas Corp.*, 638 F.2d at 1268-69.)[39] We are guided by the "would likely" have

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[38] ORA witness Selwyn states, in general terms, that it also may be appropriate to consider the market for bundled products which he calls "one stop shopping", that may encompass the market for a bundle of services, such as local exchange, intraLATA, interLATA toll, international, wireless, Internet, and cable television, and that may encompass a larger geographic scope than the confines of a single state. Selwyn states that in an internal communication with its employees, Pacific itself identified only two potential competitors of the merged company in this regard (AT&T/McCaw and Sprint). UCAN makes a similar general argument. However, neither ORA, UCAN, nor other parties clarified or otherwise clearly pursued this issue further. The issue is vague as presented, and relies on much speculation, such as when the Applicants might enter the long distance market, and the market for bundled products. The geographic market is also not defined.

[39] "'Reasonable probability' alone, however, does not adequately describe a finding that will prevent federal agencies and district courts from mistaking possibilities for sufficient probabilities. A probability signifies that an event has a better than fifty percent chance of occurring. A 'reasonable' probability presumably represents an even greater likelihood of the event's occurrence. Unfortunately, the threshold between a probability and a 'reasonable' probability is difficult to discern, much less articulate. Any other description of probability (e.g., a 'strong' probability or a 'serious' probability) is equally likely to founder in ambiguity. We adopt the 'reasonable' probability standard, but attempt to mitigate its ambiguity by specifying subsidiary findings that must be compared before the ultimate finding of a reasonable probability is made." (*Mercantile Texas Corp.*, 638 F.2d at 1268-1269.)

entered and "reasonable probability of entry" standard, as we agree that the Fourth Circuit standard is too strict, especially under § 854(b)(3).

The Second Circuit has held that entry by the acquiring firm must occur in the "near" future, with "near" defined in terms of the entry barriers and lead time necessary for entry in the particular industry. (*BOC International Ltd. v. Federal Trade Commission*, 557 F.2d 24, 29 (2nd Cir. 1977.) The court emphasized that it was not requiring any exact, precisely calibrated assessment of time of entry. However, it required proof of a reasonable probability (not a remote possibility) of entry in the near future. (*Id.*)

SBC does not now engage in local exchange services or intraLATA services in California. AT&T's, MCI's and UCAN's theory that the proposed merger will somehow lessen competition is predicated on the claim that but for the merger, a reasonable probability exists that SBC would, in the near term, become an entrant in these markets and compete, either through original entry or through a toehold acquisition.

We do not believe the record establishes a reasonable probability that SBC would have entered all or a portion of the California local exchange or intraLATA market on its own in the near future absent the merger. The record established that SBC's investment strategy focuses SBC's investments in telecommunications markets in which SBC already has network facilities, customers and brand-name recognition, and that these factors are not present in California. The Attorney General concurs:

> "Internal documents do not demonstrate any intention by SBC to enter California markets on an independent basis or toehold basis. In fact, those documents indicate that entry into California would conflict with established SBC investment strategy. That strategy limits SBC investment to telecommunications markets in which SBC already has network facilities, customers, and brand name recognition. None of those factors are present in California. SBC would also have no clearly identifiable competitive advantage within this

> market. In fact, AT&T, which uses a similar investment strategy, does not even list SBC among the likely potential suppliers of local exchange service in California." (Attorney General Advisory Opinion at p. 21.)[40]

According to its witness Kahan, SBC's corporate strategy is to allocate its resources to enter new geographic or product areas only where it has some combination of the following existing assets: existing facilities (either wired or wireless), an existing customer base and brand-name recognition. This strategy is based in the current and perceived future state of competition in telecommunication services – that customers will want to buy a package of services, and that a competitive firm must provide a package of services, such as wired (including Internet services), wireless and long distance, to effectively compete with other full service providers. This corporate strategy is one SBC developed in the course of operating its company, and was not suddenly formulated after the announcement of the proposed merger.

Applicants' witness Gilbert testified that, pursuant to SBC's corporate strategy, SBC is considering providing local exchange service in competition with Ameritech in the Chicago area, where SBC has a significant cellular presence, and in competition with Bell Atlantic in the Washington/Baltimore area, where SBC has both a significant cellular presence and two cable television systems. This is consistent with SBC's corporate strategy. In each of those areas, SBC has network facilities, including an infrastructure of customer support personnel, many existing customers, and brand-name recognition. Because SBC does not have such facilities, customers, or

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[40] AT&T criticizes the Advisory Opinion because it relies on extra record material, including testimony of witnesses in other proceedings which counsel in this proceeding did not have the opportunity to cross examine. We note that it is preferable for our purposes if, as here, when the Attorney General submits his Advisory Opinion after the evidentiary hearings are completed, that the opinion be based, to the extent possible, in the record in this case. We also note that the Attorney General reviewed testimony filed in this case, as well as the transcripts of witnesses who testified on the competitive effects of this transaction, and that the specific analysis of whether SBC is an actual potential competitor cites almost entirely to record material as well as federal case law. (Attorney General Advisory Opinion at pp. 2, 20-21.)

brand-name recognition in California, it has no particular comparative advantage in California and no plans to enter there.

The record also establishes a reasonable probability that SBC would expand into certain immediately adjacent areas where its existing infrastructure could be reasonably extended. These areas would include portions of Arkansas, Kansas, Missouri, Oklahoma and Texas which SBC does not currently serve, but do not include any part of California. SBC demonstrated that it is filing applications for authority to provide out-of-region competitive wired local service only in states where it has a market presence and customers through its existing cellular operations. SBC's marketing of its landline long distance service is focused in its five-state region and where it has wireless properties.

AT&T, MCI and UCAN argue that the fact that the merger is being proposed is evidence that it is reasonably probable that SBC would have entered the California markets absent the merger. Intervenors explain that they do not assert that every time a company proposes to acquire another, that alone demonstrates a reasonable probability that companies would have been competitors absent the merger. Intervenors assert that the factors that inspired SBC to pursue this acquisition are the same factors that would have made it interested in competing in California absent the merger. Intervenors point to SBC's enthusiasm about California as a telecommunications market, as well as SBC's stated synergies with Pacific.

We do not believe that the fact that the proposed merger is taking place should be a persuasive factor in determining whether SBC is an actual potential competitor. That analytical approach necessarily would lead to the conclusion that every proposed merger partner would be an actual potential competitor. The Attorney General's Advisory Opinion concurs with this result.

AT&T, MCI, and UCAN also believe that the record establishes that SBC has "extensive first hand experience" in the California market that sets it apart from the other out of region RBOCs and establishes SBC's interest in the California market absent the merger. AT&T and MCI point out that SBC owns a minority interest in Bay Area Cellular Telephone Company , sells millions of dollars in

telephone equipment in California to businesses and consumers, and had owned paging services in California.

We do not agree that this evidence demonstrates extensive experience in California markets. The evidence consists of a passive 3% SBC ownership interest in a California cellular services provider, sales of unregulated SBC telecommunications equipment by third parties, and the provision of paging services by a former subsidiary which SBC sold in 1993.

We similarly are not convinced by intervenors' arguments that SBC's pursuit of the purchase of a cellular license in San Diego, and its abandoned joint venture with Cox Cable, which has some properties in California, demonstrate that SBC has shown significant interest in this state so we can hold that there is a reasonable probability that SBC would have entered into the California local exchange markets independently as an actual potential competitor in the near term. For instance, in the recent PCS auction, which occurred after 1994, SBC purchased three licenses (for Tulsa, Little Rock and Memphis), which is consistent with its business strategy. SBC did not bid for PCS authorizations in California. Before applying to this Commission for approval of this merger, SBC has not applied in California to provide local exchange or intraLATA services.

We likewise reject intervenors' argument that SBC's assets such as "know how" as a supplier of local service, billing expertise, identification of the "Bell" name, and the ability to negotiate with Pacific to obtain successful terms to provide local service (many of which items other RBOCs also possess) are sufficient to make it reasonably probable that SBC would have entered these California markets in the near future on its own. Although this evidence might demonstrate capacity to compete, it does not demonstrate SBC's interest in a particular market. In this case, SBC established that entry in the California market independent of the merger is contrary to the established SBC business strategy. Moreover, the record established that SBC, like many businesses, has limited resources and has to prioritize its investments, and is not able to invest in every lucrative telecommunications market.

We reach a similar conclusion on the issue of whether SBC would have become an actual potential competitor by toehold acquisition. Intervenors argue that all of the qualities discussed above make it reasonably probable that SBC would have entered the California markets by combination with another entity (sometimes called toehold acquisition), primarily as a wireless provider. This in turn would have given it a toehold to have entered at least some part of Pacific's local exchange territory as a facilities-based provider. Intervenors assert that this argument is consistent with SBC's investment philosophy stated above, where it only expands in markets in which it has a presence, or toehold.

The thesis of AT&T's and MCI's witness, Brenner, appears to be that there is a possibility or some probability that SBC would have entered at least some portion of the California market as a supplier for local telephone services absent the merger through toehold acquisition, possibly either a competitive access provider or a wireless provider. However, Brenner could not be more specific, nor could he identify the particular markets in any more definite fashion than "possibilities" or "some probability."[41]

Our concern here is that the standard is the reasonable probability, not the possibility, that SBC would become an actual potential competitor through toehold acquisition in the near term. The evidence on the record does not establish this type of market entry to a reasonable probability. Intervenors' argument that California could become a high priority for SBC if SBC acquired other assets, such

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[41] Brenner stated:

> "I've not attempted to identify which geographic areas or which markets they would or would not enter. But it's important to my analysis that there are multiple possibilities. So there is some probability, I believe, that they would, but for the merger, enter Market A, there's some probability they'd enter Market B, some problem built [sic] they'd enter Market C, and so on.
>
> "I don't know which of those they in fact would enter, but the probability is much higher that they will—they would, but for the merger, enter at least one of those and make a competitive difference than would be the case if we were looking at only a single market." (Transcript, Vol. 25, at p. 3450, lines 3-17.)

as cellular or PCS properties in the state, is speculation driven by further speculation of possible entry and can be used to explain why any region in the country could become a high investment priority.

Intervenors point to several pages of Applicants' internal plans which discuss RBOCs as a class of possible competitors. We take official notice of the fact that, after the close of the record, many of the other RBOCs have now applied for authority to offer interLATA or intraLATA services in California. One RBOC, Ameritech, has applied for authority to provide local exchange services as a reseller. U.S. West recently announced on agreement to acquire Continental Cablevision and, in so doing, stated its plans to use the Continental system to provide local exchange service in, among other places, California. (See Exhibit 30 at p. 20.) While this new officially noticed evidence and record evidence makes the question a closer call, it does not change our ultimate conclusion here. At best, it can only demonstrate that SBC should be considered an actual potential competitor on the basis of its status as an RBOC, and not for SBC's unique attributes.

The inclusion of all the other RBOCs, as well as other similarly situated companies, as actual potential competitors would not make SBC's absence from the pool economically or legally significant. (See part 3 below.) For example, in Exhibit 40, an internal Pacific document refers to competitors as: (a) facilities based carriers (TCG, TCI, Cox, MFS, Time Warner); (b) interexchange carriers (AT&T, MCI, Sprint); (c) local exchange carriers (GTEC, Contel, RBOCs); (d) resellers (Furst Group, Midcom); and (e) Value Added Service Providers (Compuserve) and "many more to come!" We also note that AT&T's and MCI's internal business planning documents, as opposed to their sponsored testimony in this case, do not specifically identify SBC as an actual potential competitor in the California local exchange markets, or a portion thereof. While we do not rely on this fact, we note that these internal plans are at odds with these intervenors' testimony in this case.

To be clear, we do not hold here that there is no possibility that SBC could become an actual potential competitor of Pacific in the local exchange or intraLATA markets either independently or through combination with another entity

under any conceivable set of circumstances. But we apply the standard of a reasonable probability, not a possibility. We do not believe the record demonstrates a reasonable probability that such entry will occur.

Finally, intervenors' arguments assume that SBC would be providing facilities- based local exchange services in at least some market in California. The record does not support this assumption. AT&T admits in its brief that Pacific intends to compete against GTEC on a resale (not facilities) basis because facilities-based entry would delay entry for several years. Given the fact that SBC does not possess facilities within hundreds of miles of California, and given Pacific's intentions with respect to GTEC's service area, we do not agree that, even assuming there is a reasonable probability that SBC were found to be an actual potential competitor of Pacific for at least some local exchange services in some markets, there is a reasonable probability that it would do so as a facilities-based carrier in the near future. Given this finding, we do not need to address intervenors' arguments that resale-based competition is not as effective as facilities-based competition in the local exchange markets.

c) *Are There Few Other Potential Entrants With Comparable Advantages?*

Assuming the record demonstrated that, but for the merger, there is a reasonable probability that SBC would have entered all or some California markets as a provider for local exchange or intraLATA services, that would not be the end of the inquiry. Courts have recognized that even if the acquiring firm would have entered independently or in combination with another entity without the merger, the presence of many other firms which are equally ready and willing to enter makes the issue moot. The theory is that elimination of one potential entrant under those circumstances would not be significant. (*Mercantile Texas Corp.*, 638 F.2d at 1267.)

There is some uncertainty as to how many other potential entrants are necessary. The Department of Justice Merger Guidelines provide that a challenge is unlikely if "the entry advantage ascribed to the acquiring firm (or another advantage of comparable importance) is also possessed by three or more firms."

(United States Department of Justice 1984 Merger Guidelines, Section 4.133, Exhibit 163.) The guidelines further provide that the likelihood of a challenge increases as the number of similarly situated firms drops below three and "as the extent of the entry advantage over nonadvantaged firms increases." (*Id.*) A leading antitrust treatise concludes that "three similarly well-qualified potential entrants should be presumptively sufficient to obviate concern for the elimination of potential competition," and "six entrants remove[] any plausible basis for attacking a merger eliminating a potential entrant." 5 Philip Areeda & Donald F. Turner, ANTITRUST LAW ¶ 1123 at 123-124 (1980).

Intervenors argue that since competition is nascent in local telephone service, the entry of other firms may not be sufficient in both quantity and type for the markets to become effectively competitive. AT&T and MCI argue that the merger does not have to eliminate entry to harm competition; competition will be harmed if the proposed merger reduces the extent of entry enough to reduce the extent to which competition develops. However, elimination of one actual competitor does not automatically impose an adverse affect on competition.

The record establishes that there are many potential competitors who are at least as capable as SBC of competing against Pacific in the California local exchange and intraLATA business (especially since the record does not demonstrate a reasonable probability that SBC would have been a facilities-based provider). AT&T and MCI state that it is important to determine whether and to what extent new entrants are simply reselling Pacific's local service and to what extent they are producing services using their own facilities in order to evaluate how much and what type of competitive pressure Pacific faces at a given point in time. This argument, however, is premised on the fact that SBC would likely have been a facilities-based potential competitor absent the merger. Even Brenner, AT&T's and MCI's witness, acknowledged that AT&T, MCI, Sprint, GTEC, MFS, TCG, Teleport, ICG, Brooks Fiber, TCI and Airtouch have network facilities in California, although acknowledging that the extent to which their existing network facilities are suited to providing local telephone service varies. However, we believe this "list" can be compared with SBC,

since we do not find a reasonable probability that SBC would have been a facilities-based carrier absent the merger.[12] We note that the Attorney General has reached a similar conclusion:

> "Moreover, AT&T, MCI, Sprint, Metropolitan Fiber Systems, Brooks Fiber, TCG, ICG and other major firms now compete with Telesis in markets where entry is viable and they are all planning to aggressively expand the range of that competition." (Attorney General Advisory Opinion at pp. 18-19.)

Also, assuming SBC is found to be a potential competitor, and is found to be so on the basis that it is a RBOC, then all the other RBOCs should be included on this list as well. Under these circumstances, even assuming that SBC were determined to be an actual potential competitor (which we do not find here), we do not believe that its removal as a competitor would be significant.

Cross-subsidization Issues

The Attorney General addressed cross-subsidization issues. The Advisory Opinion defines cross-subsidization as occurring when a firm with a common capital facility uses revenues from one service to finance a portion of the cost of producing a second service. The Advisory Opinion explains that cross-subsidies can be anticompetitive under cost based regulation if a firm with market power uses them to drive rivals out of a market. For example, a firm can price a competitive service below cost to the extent it is allowed to treat the cost of providing that service as a recoverable expense of the regulated sector. Suppliers which sell only the competitive service may be unable to match this cross-subsidized price and may, therefore, be forced to leave the market. The Advisory Opinion explains that the practice does not have adverse competitive effects unless the firm can reasonably expect to prevent future competitive reentry while it recoups profits lost during the predation stage.

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[12] Many other companies have also applied to the Commission for authority to provide local exchange services on a resale basis.

The Advisory Opinion states that local exchange carriers could not profitably use cross-subsidies to monopolize long distance markets since, even if a local exchange carrier could temporarily force AT&T and other suppliers to exit certain long distance markets, the company could not recoup its investment because the well-financed long distance carriers could easily reenter these markets as soon as prices rose again above production cost. However, the Attorney General notes that there may be other services which can be anticompetitively cross-subsidized, since telecommunications services are highly interdependent and the networks that provide them are almost infinitely complex.

The Advisory Opinion notes that, in theory, price cap regulation eliminates incentives to cross-subsidize competitive services, if the Commission appropriately maintains price cap regulation. The Advisory Opinion therefore recommends that the Commission maintain a stable system of price cap regulation. The Advisory Opinion urges that we carefully scrutinize requested adjustments to the NRF formula, especially where the cause of unexpected cost increases is unclear. In addition, the Advisory Opinion suggests that we separately treat regulated and unregulated services.

In our next NRF review, we intend to carefully scrutinize requested adjustments to the formula with an eye to preventing potential cross-subsidization issues raised by the Advisory Opinion.

On another issue, Dr. Selwyn points out that SBC has in recent years invested less in its telephone infrastructure, on a per-access line basis than other RBOCs, and that this investment is well below Pacific's investment level. Selwyn points to what he describes as a premium SBC plans to pay Pacific's shareholders if this merger is consummated, and states that SBC will have a strong incentive to recoup this premium by allowing California's local telephone networks to become outdated. Selwyn recommends that we impose as a condition of this merger a requirement that the merged company maintain the same level of annual investment over the next 10 years, and require the merged company to submit monitoring reports to ensure its compliance. Applicants oppose Selwyn's premium thesis, and oppose this condition as

anticompetitive if directed only at them and not to other similarly situated companies, and also as micromanagement.

The need for Pacific to maintain an adequate level of investment in its California infrastructure has been a matter of keen concern to us for many years. In D.93-11-011, 51 CPUC2d 728, when we authorized the spin-off of Telesis' wireless subsidiaries, we recognized Selwyn's testimony that Telesis had made no net capital investment in Pacific since 1987. In fact, since 1987 Pacific has disinvested some $1.17 billion.

On the other hand, we stated that:

> "[w]e do not expect there to be a perfect annual correlation between the authorized rate of depreciation and the level of investment. We also note that the cost of telecommunications technology is dropping, and therefore historical depreciation rates are not a perfect guide as to the proper amount to spend on new investment. Further, as technology constantly evolves and becomes more affordable, investment strategies that spend less over time and accomplish more may benefit ratepayers. We should not gauge the cost-effectiveness of investment by the absolute level of dollars spent." (51 CPUC2d at 750.)

On the other hand, we also admonished Pacific that if Pacific:

> "incurs future increases in costs, such as the cost of increased investment, the principles of NRF preclude future rate increases unless PacBell's rate of return falls below the lower benchmark. Therefore, even if future PacBell capital expenditures are expected to exceed currently authorized rates of depreciation, we expect Telesis, consistent with our NRF framework, to invest sufficient funds in PacBell rather than requesting an increase in the NRF revenue requirement and disrupting the NRF compact." (*Id.*)

We advise SBC similarly. We will not gauge the cost-effectiveness of investment by the absolute level of dollars spent nor will we mandate a

specific spending level. However, the level of annual infrastructure expenditures is a factor which we will continue to monitor,[13] and is an issue which we may choose to investigate at a future date, either upon our own motion or upon the request of an interested party, if the circumstances warrant such a review.

And just as we advised Telesis in D.93-11-011, we similarly advise SBC that even if future Pacific capital expenditures may exceed currently authorized rates of depreciation, we expect SBC to invest sufficient funds in Pacific without requesting an increase in the NRF revenue requirement or otherwise disrupting the NRF compact.

7. Does the Proposed Merger Foreclose Local Competition As a Result of Access Pricing Discrimination?

AT&T and MCI argue that approval of the merger will result in reduced local competition due to the fact that it will increase the magnitude of an alleged artificial advantage that Pacific will enjoy if it is allowed to offer interLATA service to in-region customers while switched access charges remain above cost. UCAN also supports this position. This argument mixes many product and geographic markets such as the local exchange market, the long-distance market, and an anticipated market for one-stop shopping. These intervenors take several steps to reach this conclusion. First, AT&T and MCI argue that interexchange carriers will see a different and higher cost as a purchaser of switched access than Telesis' interexchange service will see as a consumer of switched access that it produces itself, so long as Telesis continues to charge prices for switched access substantially above the cost of producing the service.

In AT&T's and MCI's view, the access price advantage will allow Pacific to obtain a larger share of the interLATA, in-region market than it would if all

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[13] For example, the Commission currently receives 12 reports filed by Pacific to monitor compliance with our goal of encouraging technological advance expressed in the NRF decision, D.89-10-031, 33 CPUC2d 43, 197-198. These reports include reviews of Bellcore activities, Research and Development and capital expenditures, new technology deployment, and strategic plans for technology transition. Furthermore, given the link between network

Footnote continued on next page

competitors faced the same market conditions; what is more, this advantage will be compounded if the proposed merger is approved. This is so because the new merged firm would, in effect, acquire SBC switched access from itself. It would gain what these intervenors call an artificial advantage from its use of SBC switched access, because it would perceive a lower cost for this access service than would interexchange carriers that still purchase the access from SBC. Thus, AT&T and MCI argue that the merger would extend and increase the overall magnitude of the artificial advantage.

AT&T and MCI argue that this advantage in the long-distance market will be leveraged back into the local market as a result of consumers' strong preference for firms able to provide a bundled package of services that they call "one-stop shopping." They believe that customers attracted to Telesis' interexchange service as a result of its artificial advantage would be less likely to shift from Pacific local service to a competitor's local service than if the artificial advantage had not attracted them to Telesis' interexchange service. Because new entrants in the local market will have a harder time attracting customers, AT&T and MCI conclude there will be a reduction in the amount of facilities-based competition necessary to put significant competitive pressure on the incumbent.

We do not view this argument as merger-related, but rather, as a problem AT&T and MCI have with RBOCs being able to offer interLATA service before access charges are reformed. However, Pacific and SBC have not yet been authorized to offer certain interLATA service, and cannot do so until they obtain approval from, among other agencies, the FCC. These intervenors should pursue this argument with federal and state regulators in the appropriate forum.

Even if this artificial advantage were to exist (an issue which we do not address one way or the other), the record here did not establish that the merger will increase the artificial advantage to the degree that it would have an adverse effect on

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innovation and service quality, the Commission's service quality requirements, monitoring efforts, and investigations would involve reviews of infrastructure investment.

competition. Although Brenner did state that this artificial advantage will increase, he was not able to quantify the existing alleged advantage or the extent to which the merger would increase it. Nor are we convinced that the merger may cause some firms to stay out of the local exchange service business for this reason. No party testified that the proposed merger would cause it to change its plans as a result of what AT&T and MCI call the artificial advantage. AT&T's and MCI's plans are not deterred in this regard. The record contains statements by two competitive access providers that the merger will not change their plans to compete. We, therefore, decline to deny or condition the proposed merger on these grounds.

8. Will the Proposed Merger Increase Non-Price Discrimination?

AT&T and MCI also argue that if Telesis is allowed into the long-distance market before effective local competition develops, Telesis will have an incentive to engage in discrimination in the way it provisions access services to its competitors. AT&T and MCI argue that the merger will increase Telesis' incentive to discriminate against competing long-distance carriers in two ways: (1) by directly lowering the quality of access service for competitors, making their offerings less attractive to consumers; and (2) by forcing competitors to order increased network capacity, hire more staff, or make other moves to offset the effects of discrimination, thereby raising their costs and the prices of their services.

Although we take these allegations seriously, we do not view them as related to the merger. They are concerns that these intervenors would have even if the merger were not occurring. AT&T and MCI have recently filed complaints against Pacific at this Commission dealing with some of these same allegations. The Commission will deal with those issues in the appropriate forum as they arise. We therefore decline to deny or condition the proposed merger on these grounds.

9. SBC's Alleged Anticompetitive Behavior

General Allegations

AT&T, UCAN, ORA, and ADP urge the Commission to consider concerns regarding SBC's attitude toward competition in its home territories, and state

that SBC's past conduct is a good indicator of how SBC would conduct itself in the future. These parties point to such things as: (1) SBC's lobbying efforts to pass the Texas Regulatory Reform Act of 1995 (known as PURA95), which they state is widely regarded as one of the most anticompetitive statutes in the country; (2) SBC's filed comments in the FCC's Notice of Proposed Rulemaking on Local Competition Issues in CC Docket 96-98; and (3) other state regulatory commissions' criticisms of Southwestern Bell's procedures for recordkeeping and allocating costs associated with affiliate transactions.

We address these issues in Section (c)(7) below dealing with the effects on regulatory jurisdiction and effectiveness. However, we note here that most of the items above involve SBC's lobbying, regulatory, or legislative activities, which we decline to condition here.

The Directory Publishers Litigation

The ADP also alleges that SBC engaged in anticompetitive conduct with respect to directory publishing and advertising rates. ADP points to a federal case in which the jury found that SBC and its affiliate Southwestern Bell Yellow Pages, Inc. engaged in anticompetitive conduct. Plaintiffs and SBC eventually reached a settlement in the case and the Fifth Circuit opinion was vacated on a joint motion by plaintiffs and SBC. There is much debate in this proceeding about the effect of the vacated judgment on the jury verdict. But even if the Applicants are correct that the vacated judgment has no legal effect, we can still consider this case as evidence of a jury's evaluation of SBC's prior conduct.

As a mitigation measure, ADP recommends we implement a series of mitigation measures to protect the directory publishing market from anticompetitive behavior. Applicants state that this is unnecessary, as the conduct complained of by the ADP and their proposed mitigation measures are addressed by the 1996 Telecommunications Act and are currently the subject of an FCC rulemaking proceeding to interpret the provisions of the Act related to directory publishing.

We decline to adopt specific mitigation measures dealing with directory publishing in this proceeding, because these issues are being addressed both

by the FCC and by our Commission in a different forum. We note that this Commission has issued rules relating to subscriber directory listing and access to directory listing information. (See, e.g., D.96-02-072 and D.97-01-042.) It appears that the majority of the issues raised by ADP are addressed in D.97-01-042. However, we put Applicants on notice that we expect them to abide by existing and upcoming rules in this area, and that we will seriously consider and review any allegations that they have failed to comply.

10. Will the Proposed Merger Reduce the Ability of Regulators to Collect Benchmarking Information?

AT&T and MCI argue that an additional harmful effect of the proposed acquisition is the diminution of available benchmarking information to this Commission. They argue that the elimination of SBC as a free-standing RBOC would reduce the amount of independent information available to the Commission to benchmark Pacific's behavior. These intervenors state that benchmarking information can help the Commission, for example, to evaluate claims made by the incumbent local exchange carrier that it is not technically feasible to unbundle certain network elements or to allow particular points of interconnection. Comparisons also can help detect and prove discriminatory behavior by the incumbent local exchange carrier. AT&T states that the loss of benchmarking information would be exacerbated here by the threat that, if the Commission approves the merger, SBC would likely continue to align itself with other providers, citing to Exhibit 34, a First Boston account speculating on future possible RBOC mergers. AT&T also notes that SBC, in its petition to vacate the Modified Final Judgment, has recognized that this benchmarking information plays an important role.

Applicants argue that this is a regulation and not a competition issue. They point out that in *Re Regulation of Cellular Radiotelephone Utilities*, D.90-06-025, 36 CPUC2d 464, 493-494, we indicated that we would not apply benchmarking to the cellular industry, and Applicants, by analogy, point to benchmarking's lack of use here.

In *Re Regulation of Cellular Radiotelephone Utilities*, we did not adopt the Division of Ratepayer Advocates' (predecessor to ORA) recommendation to set

rates based on benchmarking, but rather, stated that we would rely on the market. That case is not analogous here, where there is not robust competition in some markets to which intervenors refer. However, we do not believe that the absence of an independent SBC would have an effect on benchmarking such that it would create an adverse effect on competition on which to condition or deny the merger.

Applicants state that because SBC, like Pacific and all other RBOCs, will continue to be regulated in numerous states, this Commission will not have any less information available for benchmarking purposes. They also state that Commission will retain the authority to obtain the information necessary to regulate Pacific.

Applicants recognize that we retain the authority to obtain necessary information to regulate Pacific. We place Applicants on notice that they should supply such necessary information, and should not attempt to shield themselves, inter alia, with a holding company or other corporate structure, when this Commission requests necessary information to regulate Pacific.

Other Mitigation Measures

Based on the above discussion, we do not adopt the mitigation measures with respect to § 854(b)(3) proposed by the parties unless otherwise stated above. Although these mitigation measures may be appropriate in a different context and a different proceeding, we do not believe it is appropriate to adopt them here, in light of the record developed on competitive issues which is discussed above.

We mention two recommended mitigation measures more specifically. We decline to condition this merger upon Pacific's and SBC's satisfaction of the competitive checklist which is necessary before Applicants can provide certain interLATA services. As stated above, the problems intervenors raise when Applicants' participation in the long distance market is combined with their market position in the local exchange market are problems which would exist with or without the merger, and are being addressed in the appropriate forums.

We also do not adopt UCAN's proposal that we establish a new organization called the Consumer Telecommunications Network. The stated purpose of this organization would be to monitor the state of telecommunications competition, the

long-term effects of public policy and decisionmaking on competition, as well as to provide testimony to appropriate legislatures and agencies. In other words, the organization would combine investigation, monitoring, and advocacy functions. UCAN notes that Applicants support a scaled down version of this proposal in the Community Partnership Commitment. We discuss the Community Partnership Commitment below, and do not repeat that discussion here.

C. Other Effects of the Proposed Merger

Section 854(c) requires that the Commission consider several criteria and "find, on balance, that the merger, acquisition, or control proposal is in the public interest." Unlike the requirements of § 854(b), § 854(c) does not require a finding that each criterion be met on its own terms. Rather, it directs us to weigh the effects of the merger to determine whether the merger is "on balance" in the public interest. We address each of the relevant criteria below.

1. Financial Condition of Resulting Utility

Section 854(c)(l) requires the Commission to consider whether the merger will "(m)aintain or improve the financial condition of the resulting public utility doing business in the state."

Applicants observe that the merger will improve Telesis' financial position because of SBC's very strong financial position, SBC's marketing expertise, and the economies of scope and scale anticipated by the merger.

With regards to the requirement that the financial condition be maintained or improved, as noted above, no party offered evidence that the financial condition of Pacific would be compromised by the merger. The record supports a finding that the merger is almost certain to improve the financial condition of Telesis and Pacific as its subsidiary. We believe that the Applicants have met their burden with regard to demonstrating that the merger will maintain, and in fact, improve the financial condition of Telesis and Pacific, and consequently its customers.

2. Service Quality

Section 854(c)(2) requires that the Commission consider whether the proposed merger will "(m)aintain or improve the quality of service to public utility ratepayers in the state."

Applicants assert Pacific's service quality will be maintained following the merger. They observe that SBC has earned high marks from customers in this area. They point to the California Commitments letter which proposes a general commitment to service quality and to the Community Partnership Commitment which would commit funding to over 100 community and public interest groups in their efforts to improve service to underserved communities.

ORA comments that in some respects SBC's quality of service is superior to Pacific's. ORA observes SBC has a policy of crediting customers $25 if installation or repairs are not timely. ORA believes customers express less satisfaction with Pacific's service than in the past and is disappointed that Pacific expresses no intention of improving its service to SBC's levels.

ORA also believes Pacific is not in compliance with GO 133-B which requires that Pacific representatives answer 80% of business office calls and trouble report service incoming calls within 20 seconds. Pacific's records indicate these performance indicators fell below standards for 1993, 1994 and 1995. ORA observes that the existing standards were developed during a period before Pacific began using recorded menus and that Pacific has ignored the GO 133B standards since the time it began using those menus. To provide better incentives for Pacific to improve its performance with the use of the recorded menu, ORA recommends the Commission adopt additional standards. If Pacific continues to use the recorded menus, ORA recommends a rule requiring that 90% of customer calls to report trouble should be answered within 60 seconds from the time the customer finishes dialing the last digit, or within 55 seconds if the call is to the business office. If these standards are not met, ORA recommends Pacific be penalized based on the number of calls that were not answered in accordance with the standards. Specifically, ORA recommends a penalty of $4.3

million which it calculates by multiplying rate increase awards by the percentage of times Pacific failed to meet the standards between 1993 and 1995.

ORA believes that § 854 requires assurances regarding customer service as a part of this proceeding and the Commission should not delay implementation of new standards on the basis that Pacific would be the only company to which they might apply.[44]

TURN recommends the Commission conduct an independent audit to evaluate service quality trends for the initial five year period following the merger.

UCAN argues that the merged company is likely to permit service quality to decline to the lower benchmarks of the two companies. UCAN refers to Pacific's existing problems with ISDN service, ORA's analysis of Pacific's performance under GO 133B, and various service reports to argue that Applicants do not appear to consider service quality a high priority, especially in markets where competition is either lacking or weak.

UCAN believes many of SBC's existing service practices should be unacceptable to the Commission. For example, UCAN observes that SBC's reference to its success in marketing Caller ID, and the service's provisioning without per line blocking, indicates SBC's disregard for the privacy concerns this Commission and California consumers have expressed. UCAN also observes that SBC has offered business customers demographic information about SBC customers and has required landlords to provide it with personal information about tenants, practices which are contrary to Commission policy and the interests of California consumers and which may be unlawful. UCAN also opposes SBC's practice of bundling "vertical" services and aggressively marketing them to residential customers who it believes are unlikely to want or need most of the services.

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[44] ORA would apply the new standards to Pacific only because if they are adopted in this proceeding, other utilities would not have an opportunity to be heard on the matter.

In order to protect consumers, UCAN recommends the creation of an independent nonprofit organization to provide a forum for alternative dispute resolution. The organization would handle consumer complaints regarding billing, slamming and other potentially unlawful or unethical activities. UCAN also recommends the imposition of fines for systematic consumer service breakdowns.

Applicants reply to ORA concerns regarding new standards by arguing that the Commission should not address such matters in this proceeding. They maintain that, unless new standards are applied to all utilities concurrently, the standards will be anticompetitive.

Discussion

We expect that the quality of Pacific's regulated services will not decline as a result of the merger. Specifically, we will require Applicants to maintain the quality of service using existing reportable standards and statistics for a period of no less than five years or until the Commission changes the standards.

We expect and have confidence that Applicants' will fulfill their promises with regard to service quality. With respect to UCAN's allegations that SBC's policies and practices may be contrary to Commission policy, if the merger is consummated, SBC would be expected to abide by our policies just as we would expect of Telesis absent the merger.

In the interim, we cannot overlook the undisputed evidence that Pacific is and has been out of compliance with GO 133B, apparently for some time. GO 133B requires that Pacific representatives answer 80% of incoming calls within 20 seconds. ORA observes that Pacific failed to meet this standard for trouble report answering time almost 50% of the time for the period 1993 through the first six months of 1996. Pacific's failed to meet the requirements for business office answering time more than 80% of the time in the first half of 1996 and about 40% of the time in 1995. The statistics are even worse for ethnic market groups, among them, customers who speak Chinese, Spanish, and Tagalog. Pacific failed to meet the standards 91% of the time for these groups in 1995 and 83% of the time during the first half of 1996. Finally, ORA reports that medium sized companies have been in compliance with the GO 133B

standards, suggesting they are not unreasonable. As ORA observes, Pacific's failure to comply with GO 133B continues in spite of rate increases totaling $13 million a year plus $4 million in one-time awards to improve its business office answering time (see Resolution T-15442).

We are concerned by Pacific's failure to meet trouble report service answering time standards following our adoption of a settlement in D.94-06-011 under which Pacific, as a settling party, agreed to improve its trouble report service answering time in order to avoid the imposition of a penalty mechanism. In D.94-06-011, we found that "...Pacific will also be adjusting its procedures to improve its quality of service..." (see page 118, D.94-06-011). Since that time, in fact, Pacific's service quality has declined.

In this proceeding ORA demonstrates that Pacific has failed to comply with Commission rules. Yet neither Pacific nor SBC has presented evidence or argument to contradict ORA's analysis or stated an intention to remedy Pacific's violations. If Pacific believes the GO standards fail to recognize the benefits or limitations of the technology it is using, it should petition the Commission for changes to the rules rather than ignore them.

With regard to ORA's recommendations regarding modifications to existing standards, we comment that ORA presented an impressive analysis of issues relating to Pacific's service quality which may be useful in other contexts. ORA does not convince us, however, that its proposals are reasonable conditions of the merger or that this proceeding is the appropriate forum to revise existing standards even if some rule revisions may ultimately be in order. For this reason, we decline to impose penalties or sanctions on Pacific based on the limited review of the record on quality of service in this case. Simply stated, neither the Commission nor other parties have had adequate opportunity to review the proposed standards because of the many issues raised in this proceeding.

Accordingly, we limit our action regarding allegations of violation of service quality standard within this proceeding to the requirement that Pacific comply with GO 133B standards or face penalties in accordance with our rules. We put Pacific on notice of our intent to enforce our rules. Although we are within our

authority to impose penalties on Pacific here, we will provide Pacific 90 days to demonstrate two months of compliance with existing GO 133B standards and a plan to accomplish ongoing compliance or face penalties consistent with the law. If, after 90 days, Pacific remains in violation of GO 133B standards, we will at that time consider appropriate penalties. This inquiry and our notice to penalize Pacific for non-compliance with Commission rules will go forward notwithstanding the status of the Applicants' proposal to merge.

We decline UCAN's offer to establish and fund a nonprofit organization to handle consumer complaints. This Commission is obligated to handle such complaints and has the staff to redress consumer complaints. Moreover, we would not create an independent organization with redundant authority to review potential violations of Commission rules and the law and which has no accountability.

3. Quality of Management of the Merged Company

Section 854(c)(3) requires the Commission to consider whether the proposed merger will "(m)aintain or improve the quality of management of the resulting utility doing business in the state."

Applicants state that SBC is committed to retaining Pacific management discretion. They observe that SBC will continue its commitment to permitting local managers to make business decisions where appropriate after general business goals and principles are established at SBC headquarters. Applicants state that no management changes are contemplated as a result of the merger and refer to management training programs already offered by SBC to demonstrate its commitment to high quality management.

ORA argues that Applicants have failed to give the Commission any information which would allow the Commission to find that the merger will not adversely affect the quality of Pacific's management. Accordingly, ORA recommends the Commission require Pacific to file an advice letter following the merger which would set forth the companies' plan for integrating the organizational units. ORA also

recommends the Commission require Pacific to present its plans for management development and training in a subsequent workshop.

Discussion

ORA suggests we tighten our oversight of Pacific's management structure after the merger. We are not sure what purpose would be served by requiring Pacific to file advice letters or attend workshops on matters relating to quality of Pacific's management. ORA has offered no evidence to suggest that the merged company will compromise the management of Pacific. On the other hand, we have the direct testimony of Applicants' witness, David Dorman, that the management of Pacific will not be diminished but rather, will be strengthened by the addition of SBC's management expertise, noting the possibility of staff reduction at the Telesis holding company level to avoid duplication with SBC holding company activities.

We have never dictated personnel practices as a general matter and consider micromanagement of the industry at this time antithetical to the evolution of the market. We provide California utilities and their shareholders with the discretion to develop and implement their own methods for assuring high quality management. We intervene in those processes only if we perceive problems which are potentially unlawful or which might have harmful effects on labor practices, utility rates or services. We see no reason to depart from this practice in this instance.

4. Effects on Public Utility Employees

Section 854(c)(4) requires the Commission to consider whether the proposed merger will "(b)e fair and reasonable to affected public utility employees, including both union and nonunion employees."

Applicants believe that the merger will improve employee opportunities by making their employer financially stronger. They state that SBC contemplates no overall reduction in Pacific's workforce as a result of the merger and that, where job reductions do occur, efforts will be made to place affected employees in new businesses operating in California. Applicants will continue Pacific's commitment to a diverse workforce and observe that the unions support the merger.

ORA believes Applicants have failed to provide any evidence which would permit the Commission to make any findings regarding the effects of the merger on Pacific employees. ORA observes that Applicants refused to provide any plans regarding future job reductions, stating that they have no plans prior to the merger.

ORA believes Applicants commitment to 1,000 new jobs in California is too vague to be relied upon, observing that the jobs may simply be transfers of other SBC employees to California. TURN makes similar comments. ORA recommends the Commission order SBC to provide the Commission with an "enforceable business plan" regarding jobs and job placements. It also recommends the Commission require submittal of statistics demonstrating the maintenance or improvement of diversity in Pacific's workforce.

ORA is particularly concerned with the future disposition of Pacific's pension fund surplus which exceeds $3.7 billion. ORA recommends the Commission require SBC to file a proposal for treatment of the pension fund and obtain Commission approval prior to any changes to the funds or their use.

Discussion

As with our discussion regarding management quality, we can identify from the record here no specific labor problems which may result from the merger. We are not predisposed to enforce utility business plans, which would represent a departure from our policy to create incentives for utility managers to assume the risk of their operations rather than rely on our constant oversight.

We comment in a subsequent section on the Applicants' stated commitment to creating 1,000 new jobs.

5. Effects on Public Utility Shareholders

Section 854(c)(5) requires the Commission to consider whether the proposed merger will "(b)e fair and reasonable to the majority of all affected public utility shareholders."

Applicants observe that 97 percent of shareholders and the Telesis Board favor the merger. They point to the report of Salomon Brothers, Telesis' investment advisor, which found that the merger is fair to Telesis' shareholders from a financial point of view.

Discussion

No party argues that the proposed merger will be unfair or unreasonable to existing or future shareholders. To the contrary, the record strongly supports a finding that the majority of the benefits expected from the proposed merger will accrue to shareholders by reducing market risk, increasing financial strength and combining the geographic and product markets of the two utilities. The increase in Telesis' stock price immediately following the announcement of the merger also supports an expectation that the merger will improve shareholder earnings.

6. Effects on State and Local Economies and Communities Served by the Merged Company

Section 854(c)(6) requires the Commission to consider whether the proposed merger will "(b)e beneficial on an overall basis to state and local economies, and to the communities in the area served by the resulting public utility."

Applicants believe the merger will fulfill this requirement in several ways. Generally, they believe the merger will strengthen Pacific and thereby increase California jobs and result in a broader array of services to California customers at lower prices.

Applicants present a document they refer to as the "California Commitments letter" from the president of SBC to the president of Telesis. The letter states SBC's promise to increase jobs and locate four new headquarters in California. Finally, Applicants refer to the Community Partnership Commitment, an agreement under which Pacific will give up to $81.7 million to local community groups for a variety of public purposes. We address each of these matters below.

a) *Benefits Associated with More Competitive Markets*

Applicants claim state and local economies will benefit from the merger as result of SBC's success in wireless telecommunications markets. They argue SBC's related expertise will assure optimal development of Telesis' investment in California PCS licenses. Similarly, Applicants believe the merger will create economies of scale in the companies' combined efforts to market vertical services. They refer to several such services already offered by SBC, but not Pacific, to demonstrate SBC's commitment to innovation.

Finally, Applicants argue that the merger will promote economies of scale in marketing and operations which will permit the combined firm to make financial investments necessary to enter and compete more efficiently in the long-distance business. Applicants believe their combined efforts will, in all of these markets, result in lower prices and increased availability of innovative services, thereby benefiting state and local economies.

Discussion

The proposed merger will benefit California and its local economies and the communities in the area served by the affected utilities through the following: (1) by locating four major operating subsidiaries in California, (2) by implementing their commitments in the California Covenants which demonstrate the commitment of the Applicants to continue to invest in California, and (3) by committing to maintain diversity in the work force.

We recognize that this merger is driven by Applicants' desire to reposition themselves to take advantage of the growth potential in the telecommunications industry. By locating the proposed four operating headquarters in California, Applicants will bring a growing industry and innovative services to the communities in which they will operate and generally to the California economy.

We are, overall, persuaded that the proposed merger of Telesis with SBC will benefit local and state economies and the communities served by Telesis.

b) *The California Commitments*

On April 1, 1996, the President of SBC signed a letter to the president of Telesis, which Applicants present here as evidence that SBC intends to pursue actions that would benefit the state and local economies of California.

The California Commitments, as Applicants call them, commit the merged companies to create 1,000 new jobs in California at Telesis companies. Applicants argue that the jobs will increase the incomes of California residents by $50 million a year, plus an additional $100 million a year in "multiplier effects."[45]

The California Commitments letter also plans that Pacific will maintain its headquarters in California and the combined company will locate four new headquarters in California: the long distance company, the international services company, an Internet company and an integrated administrative and support services company; sustain appropriate commitments to the wireless, and other leading initiatives, to continue, to the extent practicable, to purchase supplies and services from vendors in California and Nevada. Applicants refer these lines of business as the "heart and soul" of combined companies which will strengthen California's economic position and pledge that they will meet this commitment within two years of the closing of the merger .

Applicants promise in their California Commitments letter to maintain and improve the quality of service to utility customers in California, to expand service to ethnic markets, and to expand communications links with key international markets. They also commit to continue workforce diversity and to invest in Pacific's infrastructure.

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[45] "Multiplier effects" is a term of economic theory which refers to the effects that some type of economic activity has on related parts of the economy. That is, an economic transaction may have indirect but positive effects by spurring incremental economic activity. Here, the new jobs would in principle create new income for those hired, which would be used to purchase goods and services or make investments which would not otherwise occur. These ancillary effects would represent or spur economic growth.

Other parties are not so optimistic that the California Commitments will produce the community contributions Applicants promise. ORA refers to Applicants testimony on related topics as "fanciful," complaining that Applicants appear to reject any meaningful enforcement of their promises and back away from clarifying the non-specific elements of the letter.

UCAN comments that the commitment to new jobs is offered without any evidence that the jobs would be offered to California residents or that, in fact, the jobs would be offered to existing employees of Telesis whose existing position was to be eliminated by the merger. UCAN comments that the California Commitments are generally unenforceable and ambiguous.

Discussion

The California Commitments letter is a statement of intentions from SBC to the company it proposes to own. It is offered as evidence of the Applicants' commitment to California's economy and consumers. These commitments are demonstrative of Applicants intent and they are laudable goals.

Among the many commitments Applicants make, the one promising to create 1,000 new jobs has, perhaps inordinately, received the most attention. The prospect of 1,000 new jobs is definitely appealing and more tangible than other major commitments made by Applicants. Applicants have also, in part, relied upon it in promoting public acceptance of the merger proposal. However, this particular promise has been unduly subjected to considerable interpretation.

In the California Commitment Letter, the Chairman of the Board and Chief Executive Officer of SBC, Mr. Edward E. Whitacre Jr., with acknowledgment from the Chairman of the Board and Chief Executive Officer of Telesis, Mr. Philip Quigley, is clear in what Applicants promised. The letter states that the 1,000 jobs are "over what would otherwise have been the case under previous plans if this merger had not occurred." (See Exhibit A of Joint Application of Telesis and SBC) Applicants have further identified the benchmark for establishing and measuring the 1,000 jobs commitment, including implementation and the types of jobs that will be created. (See Exhibit 103, Carr, page 1,2.) We are persuaded by Applicants efforts to

assure us that their jobs commitments are real. But we also keep in mind that in a competitive market, Applicants need the flexibility to investigate and invest in technologies in response to market demand and their strategies to prevail in that market. We wish to see this promise fulfilled and expect that Applicants will realize them. No party questioned the sincerity of the Applicants' plan to locate four headquarters in California, nor does the record include any evidence of potentially detrimental effects of having four offices headquartered in California. We have reviewed the business plans of the Applicants and are convinced that the effects will be beneficial. While there may be debate over the quantification of the benefit, we believe such a determination is unnecessary. The applicable PU Code (PU Code § 854(c)(6)) requires a finding that the merger will be beneficial on an overall basis to state and local economies; the statute does not require quantification of the benefit.

We fully support the Applicants in their efforts to place headquarters in California. The accompanying positive benefit of the new jobs on the economic development for the state and local economies is significant. The offices that will be located in California are the headquarters for high technology, emerging industries. As such, jobs to be created will not be temporary jobs such as a one-time construction of a building, but rather we expect the jobs will be permanent with secondary effects. Additionally, the business functions of those entities (Internet, long distance, and international services) are highly competitive which will help maintain California's economic position in the increasingly competitive telecommunications industry.

Furthermore, we recognize while the gain of a net 1,000 new jobs and its secondary multiplier effects are desirable merger benefits to California's economy, the California Covenants contain other long term and notable commitments that will have potentially greater impact on the over all economy. We note that these other commitments Applicants make in the letter deserve recognition, because, when implemented, they will advance the economic and social interests of Californians in more significant ways. SBC's commitment to invest in the California economy; to continue the charitable contributions and community support that Telesis has provided

to Californians; to establish four more operations; and to continue workforce diversity are important elements that have favorably influenced our considerations of this merger. We fully support the commitments made by the Applicants and trust that they will keep the promise they made to Californians.

c) *The Community Partnership Commitment*

The Community Partnership Commitment is an agreement with about 100 community and nonprofit organizations under which Pacific promises to fund over $50 million in consumer education efforts plus an additional $32 million for other activities over a ten year period. Applicants observe that the Community Partnership Commitment will provide valuable contributions to underserved communities in California, a more valuable economic benefit than small monthly rebates for Pacific's customers.

Greenlining Institute and Public Advocates urge the Commission to adopt the Community Partnership Commitment. Public Advocates observes that over 80 percent of new households in California are comprised of minority populations, many of whose first language is not English. Public Advocates also refers to the three million low income households who subscribe to lifeline telephone service in advocating for the funding mechanisms in the Community Partnership Commitment which would help educate such customers about the resources available to them. Public Advocates argues that the Community Partnership Commitment would fulfill the requirements of § 854 with regard to allocating economic benefits to ratepayers. Greenlining Institute makes similar points, adding that small refunds to customers are meaningless compared to the "leveraged effect" of a consumer fund under which communities most in need would be targeted.

Finally, Greenlining believes that the Community Partnership Commitment fulfills § 854 because it presumes the expenditure of $82 million will stimulate economic activity amounting to over $13 billion in benefits. These benefits include the economic effects of linking more customers to the network, educating and protecting customers, and increasing minority contracting.

ORA finds little to recommend in the Community Partnership Commitment. It observes that the agreement relieves Pacific of any financial obligation to the signatories if the Commission finds that the merger is contingent upon additional or different financial obligations to satisfy the requirements of § 854(b). ORA believes § 854(b) does not permit Applicants to discharge their obligations to ratepayers by funding special interest group activities. ORA also argues that even the "trickle down" theory of economics would not support a finding that the Community Partnership Commitment will create any significant benefits for state or local economies. The real benefit of the Community Partnership Commitment, according to ORA, would go to the groups who receive the awards.

TURN and UCAN believe the Community Partnership Commitment to fund universal service objectives is conceptually appealing but that its provisions fall short. They believe the Community Partnership Commitment's requirement that funds may not be used to advocate positions that are adverse to any signatory's interests is a restraint on free speech. TURN describes as "cynical" that portion of the Community Partnership Commitment which relieves Pacific from its obligations if the Commission finds that § 854 requires different or additional financial obligations than those set forth in the Community Partnership Commitment, arguing that many of its signatories are likely to be unaware of the estimates of merger benefits presented in this proceeding.

UCAN presents an elaborate critique of specific elements of the Community Partnership Commitment, arguing, among other things, that the governance of the funding is discriminatory, that the funding level is wholly inadequate to fulfill the document's purposes, that the agreement inappropriately requires grantees to use only Pacific products and services, and that Applicants have failed to provide a consistent proposal for how the agreement should be treated in this proceeding.

In lieu of the Community Partnership Commitment, TURN recommends the Commission direct that $50 million of the adopted ratepayers' share of the forecasted economic benefits be allocated to ratepayers from underserved

communities. UCAN proposes that Telesis increase its corporate giving from $8.7 million in 1995 by 12% for three years following the merger.

UCAN supports the observations of Greenlining Institute and Public Advocates generally with regard to the need to protect certain disadvantaged populations, but recommends an alternative to the Community Partnership Commitment. It proposes the creation and funding of an organization it calls the "Technology Applications Trust." The purpose of the trust would be to develop programs to help underserved communities use emerging services and technology. It recommends a funding level of $200 million over a seven year period and the administration of the trust by a committee of community group representatives.

Discussion

The Community Partnership Commitment anticipates numerous activities to support customer service, underserved markets and local communities, among them:

- An increase in corporate giving of $1 million annually over the 1996 budget for three years;
- The continuation of multilingual customer services;
- A contribution of $100,000 per year for seven years toward the formation of a Universal Service task force to develop methods to promote universal service by working with community groups;
- The formation of the Community Technology Fund to promote access to advanced telecommunications services in underserved communities and funding over ten years up to $50 million;
- The formation of a "Think Tank" to research interests of underserved communities and the general public in the evolving competitive environment, with funding by Pacific up to $200,000 a year for five years;
- A "challenge" grant under which Pacific will contribute up to an additional $3 million annually for nine years after the merger in amounts equal to

those offered by other telecommunications providers;

- A commitment to continue to employ, promote and contract with minorities, women and people with disabilities;
- A commitment to maintain headquarters for Pacific in California and to expand its employment base by at least 1,000 jobs.

The Community Partnership Commitment is an agreement between Pacific and certain nonprofit organizations, some of whom are parties to this proceeding. It is not, however, a settlement in the usual sense. That is, the signatories did not follow Rule 51 which governs the submission and review of settlements and most of the Community Partnership Commitment's signatories are not parties to this proceeding. Moreover, Applicants state that they do not present the agreement for the Commission's approval.

Although the Applicants do not seek our approval of the agreement here, the Community Partnership Commitment's provisions become void by the terms of the agreement if the Commission orders economic benefits to be allocated any way other than as the agreement sets forth. However, we have herein determined implicitly that the Community Partnership Commitment would not by itself fulfill the requirements of § 854.

Notwithstanding the above, we acknowledge that the objectives of the Community Partnership Commitment (CPC) are desirable and commendable ideas. The elements of the CPC demonstrate a plan of action that seeks long term solutions to increase access to telecommunications services for the under-served communities of California. For example, the CPC would establish a Community Technology Fund that promotes access to advanced telecommunications services in under-served communities and fund it over ten years by up to $10 million per year over ten years; it would contribute $200,000 per year to promote universal service among community groups to achieve a 98% penetration in low-income, minority and limited English-speaking communities within the next seven years; it would encourage the

formation of a "Think Tank" to research the interests of communities in the evolving competitive telecommunications market; and among other things, it commits Applicants to promote and contract with minorities, women and people with disabilities. We consider the benefits that will accrue as a result of these commitments important to all ratepayers specifically and California in general since it encourages economic development. The benefits of the CPC will go beyond benefits arising from a simple refund to ratepayers.

Finally, to conform the CPC with our general philosophy regarding such funds, we will approve the CPC with two clarifications. First, it is our understanding that the CPC will be available to any of the community-based organizations that wish to apply for funding. We encourage the entity that will implement the CPC to consider all requests that further the goals of the CPC including customer education and reaching underserved communities to meet 98% penetration rate.

Second, we fully expect that the CPC will, in the time periods forecasted, distribute funds equal to or greater than the funding level committed. However, if not distributed at the end of seven years from the effective date of the CPC, the surplus funds, if any, shall be distributed to entities/funds that promote our universal service goals for underserved communities throughout the state.

The objectives of the CPC are consistent with our overall goals to ensure California's under-served communities have access to the evolving telecommunications services. In this sense, we agree in part with Applicants' argument that benefits can be passed on to ratepayers through the CPC; however, as we determine in this decision, the shareable economic benefits under § 854 exceeds the economic benefits amount that will accrue to ratepayers through the CPC. For all the above reasons, we will require Applicants to abide by the spirit and terms of the CPC, and account for its funding a part of ratepayers' benefit. Accordingly, we shall adjust the ratepayers portion of shareable economic benefit that is to be refunded through surcredits by $34 million (the net-present-value of $50 million.)

7. Effects on Regulatory Jurisdiction and Effectiveness

Section 854(c)(7) requires the Commission to consider whether the proposed merger will "(p)reserve the jurisdiction of the Commission and the capacity of the Commission to effectively regulate and audit public utility operations in the state."

Applicants argue the merger will not diminish the jurisdiction or capacity of the Commission to regulate Pacific in any way. They also believe the Commission may alter its regulatory framework in the future should such action ever be required to preserve jurisdiction. The merger application states the merger will not change accounting practices, availability of books and records to the Commission or the status of utility assets. Applicants state their belief that the other California utilities whose headquarters are located out-of-state are no more difficult to regulate than those located in California.

ORA does not agree with Applicants' claim that SBC has a reputation as a "good corporate citizen." ORA argues that the agencies who regulate SBC and its affiliates provided information that is not so favorable to them. ORA observes that SBC has consistently fought regulatory and legislative initiatives to promote competition in the markets of SBC and its affiliates. In making its case, ORA refers to SBC's local exchange affiliate's successful efforts to prevent ICG from providing telephone service to the City of San Antonio. In 1993, a federal jury found SBC guilty of antitrust violations in directory publishing markets.

ORA also argues that SBC and its affiliates have engaged in unethical business practices. In this regard, ORA observes that SWBT representatives, including a vice president, had attempted to bribe a regulatory official in Oklahoma and that SBC failed to address the matter when it became aware of the matter.

Finally, ORA argues that SBC and its affiliates have consistently opposed regulatory efforts to allocate Yellow Pages revenues to ratepayers and it created a separate subsidiary of its Yellow Pages operations in Oklahoma without prior regulatory approval.

ORA proposes a number of mitigation measures to promote effective regulation in California following the merger. Among them, ORA proposes a

moratorium on Applicants' ability to propose legislation which would reduce regulation in California including law governing Yellow Pages revenues. ORA is also concerned that a more complex corporate structure will impede its ability to audit Pacific's records, especially with regard to affiliated transactions.

In response to ORA's concerns about allegations and findings in other jurisdictions, Applicants argue that this Commission does not have a role in evaluating the results of federal investigations and completed judicial processes. They argue that ORA's reference to Commission findings with regard to improper accounting practices were the recommendations of Commission staff, not the findings of the Commission itself. Disagreements between regulators and regulated firms are, according to Applicants, common in the normal course of regulatory activities and SBC's positions were presented in good faith.

Applicants state their intention to comply with all rules and laws regarding affiliate company relationships and to maintain the bookkeeping and accounting practices of Pacific. Applicants observe that with regard to the alleged bribery in Oklahoma, SBC cooperated with the FBI and US Attorney's Office from the time it learned of their investigation.

Discussion

We do not believe that the Commission's ability to effectively regulate Pacific will be impaired if the merger is consummated. For example, GTEC's parent company is located in Connecticut; AT&T's parent company is located in New Jersey. We do not find that the out of state locations of the parents of these two companies have measurably diminished or constrained our ability to regulate GTEC or AT&T. Similarly, we do not believe Pacific's situation will be any different. Pacific, as a California service provider will continue to be subject to all applicable rules and policies regardless of where its parent company is located. The fact that the parent company's headquarters is not located in this state does not change our ability to regulate the subsidiary. The location of a utility's headquarters in another state, and the parent company's business interests in many states, will undoubtedly affect the utility's loyalty to state policy and the local community. Likewise, the corporate philosophy of SBC, as

in the case of AT&T and GTE, will surely make a difference in the way the subsidiary, in this case Pacific, conducts its business here and with the state legislature. And we expect that philosophy will be in conformance with our policies, rules and regulations.

We put SBC and Pacific on notice that we expect full compliance with prevailing law, policies and practices in this state if the merger is effectuated. We will expect SBC and Pacific to comply fully with our rules and policies regarding affiliate transactions pursuant to our Significant Utility/Affiliate Transactions Reporting requirements. Where cost allocation methods between Pacific and SBC or its other affiliates differ, SBC shall follow those guidelines and rules that apply to Pacific for transactions that involve Pacific.

Because the applicants did not have information on post merger organization structure and affiliate transactions at the time testimony was filed and hearings were held for this case, we will require Pacific to provide to the Commission's Telecommunications Division within 90 days of the effective date of this decision, information on the expected affiliate transactions which are anticipated to occur between the various entities in the post merger organization. In the same filing, Pacific shall review and identify each existing affiliate transaction rule where changes are warranted, provide comments on the applicability of the respective rule to the post merger organization, and propose, if necessary, specific modifications to the respective rules to comply with this Commission's affiliate transaction rules and procedures, as ordered by the Commission in D.92-07-072 (Pacific Bell Information Systems decision), in the post merger organization environment.

We decline to impose any restraints on the lobbying, regulatory or legislative activities of SBC, Telesis, Pacific or any other utility in the state in response to ORA's allegations. Such a restraint would be almost surely unlawful and would be in any case very bad public policy. We consider it our duty to encourage participation in the processes of government and will continue to do so even where the position or lawful activity of a party is distasteful to us. Similarly, we decline to condition the approval of the merger on Pacific's agreement to modify its positions or requests for

rate increases in other proceedings, preferring instead to address those matters on the merits in appropriate proceedings.

Ordering paragraph 5 of D.93-11-011 ordered Telesis and Pacific to participate in audit for the purpose of determining whether the separation transaction complies with the terms disclosed by Telesis, the conditions imposed by D.93-11-011, and the Commission's affiliate transaction rules. The audit has been completed and filed with the Commission; however, hearings have not yet been conducted on the audit results which include reference to pension funds. Therefore, we will direct SBC, Telesis, and its subsidiaries to agree to be bound by the Commission's final order on the results of the audit of the separation transaction.

Finally, we note that Applicants have asked us to approve an indirect change in control of Pacific from a wholly-owned subsidiary of Telesis to a second-tier subsidiary of the combined company that will result from Telesis' planned merger with SBC.

Pacific would remain a subsidiary of Telesis, which would become a wholly-owned subsidiary of SBC. Also, Applicants represent that no utility property would be sold, assigned or otherwise transferred as a result of the merger or any of the transactions described in the application. Applicants state that the transaction does not involve a purchase of assets, and all utility property currently owned by Pacific would remain with Pacific following the merger of its parent.

We clarify here that we approve, with the conditions stated herein, Applicants' request for approval of an indirect change in control of Pacific from a wholly-owned subsidiary of Telesis to a second tier subsidiary of the combined company that will result from Telesis' planned merger with SBC, with Pacific remaining the subsidiary of Telesis. We do not grant any other forms of approval. For instance, we do not approve any other structural changes with respect to Pacific.

8. Mitigating Measures

Section 854 (c) (8) requires the Commission to "[p]rovide mitigation measures to prevent significant adverse consequences which may result." from the

merger. As we discussed above in considering each of the remaining seven criteria under Section 854 (c), we find that the merger will not result in any significant adverse consequences; therefore we will not adopt the mitigation measures recommended by the parties as explained in each of the sections. However, to ensure the continuity of our regulatory oversight of the merged company, we will require the following conditions:

1. We shall direct Applicants to agree to be bound by the Commission's disposition of the audit ordered in Application 93-11-011.

2. In as much as the conclusions we reach in this case are based strictly on the record before us, if circumstances change such that SBC proposes to acquire, merge, or otherwise control another RBOC our view may be different. For this reason, we shall require Applicants, for five years after the effective date of this decision, to inform the Commission of such a transaction by filing a notice in this proceeding, served on all parties of record. The notice shall explain the changed circumstances and how the changed circumstances should affect the analysis and conditions we impose in this decision.

3. Pacific shall within 90 days from the effective date of this decision review and identify each existing affiliate transaction rule where changes are warranted, provide comments on the applicability of the respective rule to the post merger organization, and propose, if necessary, specific modifications to the respective rules to comply with this Commission's affiliate transaction rules and procedures, as ordered by the Commission in D.92-07-072 (Pacific Bell Information Systems decision), in the post merger organization environment.

9. Comments on the Alternate Decision

The joint Alternate Order of Commissioners Neeper and Bilas and Alternate Pages of Commissioner Conlon were issued for comment on March 17, 1997, in accordance with PU Code § 311 of our Rules of Practice and Procedure. On March 14, 1997, the full Commission heard oral argument. The following parties filed timely comments and/or reply comments on the Alternate Order and Alternate Pages: ORA, TURN, GTEC, AT&T, Greenlining, Applicants, Public Advocates, Inc., and UCAN.

We have reviewed the comments and reply comments of the parties, and we have, where appropriate, made changes to this decision.

Together with its comments,[46] UCAN filed a protest alleging that the publication and dissemination of the alternates were faulty. We find the protest has no merit since both alternates were served on March 17, 1997, pursuant to Rule 77.6(e). This is 14 days before the Commission meeting at which the ALJ's proposed decision is scheduled to be considered, i.e., March 31, 1997. Moreover, our rules with respect to comments to alternates generally provide for a short comment period. As stated above, UCAN filed comments to the alternates which we consider. UCAN did not state in its protest either: (1) what, if any, particular issues it was unable to address, or (2) which issues raised in UCAN's comments it would have addressed more fully, if it had more time.

10. Conclusion

Section 854 requires that we determine whether the merger would "on balance" be in the public interest considering the several criteria discussed above. We conclude that the required elements of this section are contained in the application. We have found that over all the merger will benefit shareholders, the financial condition and management quality of Telesis and Pacific, and consequently the California economy. We find that the merger will not harm management quality or the quality of service. We find no evidence that utility employees will be treated unfairly or unreasonably from the merger.

We believe the California economy will benefit as a result of the commitment Applicants make to, among other things, (1) invest in California; add at least 1000 jobs due to the merger; maintain the headquarters of Pacific in California;

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[46] UCAN titled its comments as "reply" comments, but they appear to be initial comments as they largely address the alternates as opposed to other parties' comments to the alternates. We grant UCAN permission to file these comments since accepting them will not prejudice any party.

(3) locate the headquarters of several subsidiaries in California. We take these commitments seriously and expect that Applicants will keep them.

We have required Pacific to reduce the rates of certain of its services to pass on the economic benefits of this merger as required by § 854. With this requirement, we believe the public interest will be served if the merger is consummated. On balance, we find the proposed merger meets all the requirements of § 854, and is in the interests of the public.

We therefore will grant the application as set forth in the ordering paragraphs of this decision.

III. Findings of Fact

1. On April 26, 1996, Applicants filed a joint application with this Commission pursuant to Public Utilities Code § 854.

2. Applicants propose to merge their companies such that Telesis would become a subsidiary of SBC and Pacific would continue to be a subsidiary of Telesis.

3. Applicants state the intent of the merger is to improve their respective competitive positions by taking advantage of economies of scope and scale and taking advantage of the complementary strengths and skills of each company.

4. The Commission held 23 days of evidentiary hearings on the application from October 24 to November 26, 1996.

5. The California Attorney General filed his Advisory Opinion pursuant to § 854(b)(3) on December 31, 1996.

6. The Commission held seven public participation hearings throughout the state in September, October, and December 1996. The Commission held these hearings in Eureka, Fresno, Pasadena, Riverside, Sacramento, San Diego, and San Francisco.

7. The Commission examines merger, acquisition, or control activities on a case-by-case basis to determine the applicability of § 854.

8. Applicants concede that §§ 854(a)and (c) apply to this transaction, but challenge the applicability of § 854(b).

9. Although the proposed merger transaction is technically structured as a merger between SBC and Telesis, the practical result of the proposed transaction, if it is consummated, will involve Pacific, which represents 90% or more of Telesis' assets and is key to the merger.

10. We focus on substance rather than form in determining whether Pacific is a party within the meaning of § 854.

11. It would elevate form over substance to conclude that the Legislature was more concerned with competition if the utility was a party to the transaction absent the holding company structure but was less concerned about competition when a holding company was involved.

12. The parties propose a variety of methods for estimating economic benefits associated with the merger which produce a range of recommended estimates of $366 million to $3.7 billion.

13. The merger is likely to create savings in capital costs. Such costs are tangible even if they result from purchases which have not yet been made.

14. Savings from "Best practices" can be achieved by Pacific through reengineering efforts.

15. Defining "long term" in this proceeding as 5.6 years permits reasonable forecasts of economic benefits of the merger and recognizes the rapid pace of change in the telecommunications market.

16. Analyses of the economic benefits of the merger using stock market prices may fail to incorporate all information relevant to the merged companies' profitability. The record demonstrates that the stock market did not have and does not have all information which may be relevant to the effects of the merger which is available to Applicants, intervenors and regulators.

17. Applicants presented an analysis of economic benefits based on budgetary and operational information which emphasizes effects on Pacific and which was sponsored by the Pacific employee who conducted the analysis.

18. The Lazard Freres and Salomon Brothers analyses upon which ORA relied for its estimates of economic benefits were used by the boards of the two Applicants during their due diligence review.

19. The record does not provide adequate information about how the Lazard Freres and Salomon Brothers analyses were performed, the assumptions underlying them or their intended use.

20. The Attorney General's Advisory Opinion concluded that the merger will not adversely affect competition within California telecommunications markets (specifically, the markets for telephone and wireless services.) The Advisory Opinion also concluded that the merger by itself will not enhance anti-competitive cross-subsidization opportunities. However, in order to promote competition in the markets served by Applicants, the Attorney General recommends that the Commission maintain a stable system of price cap regulation on certain services which Applicants provide. Particularly, the Opinion urges the Commission to carefully scrutinize requested adjustments to the NRF formula, especially when the cause of unexpected cost increases is not clear.

21. Prior to the end of the evidentiary hearings, on November 5, 1996, the United States Department of Justice terminated its investigation of the proposed merger pursuant to the terms of the Hart-Scott-Rodino Act, concluding that "the merger did not violate the antitrust laws."

22. In *Re SCEcorp*, we set forth analytical precedents and tools for interpreting whether a party's proposal "adversely affects competition" within the meaning of § 854(b)(3). We held that precedent developed under Section 7 of the Clayton Act provides a framework for analyzing competitive effects under § 854(b)(3), and, for the most part, analyzed that merger, as well as subsequent proposals, under the federal antitrust laws.

23. The goal of analyzing the competitive effects of a merger is to protect consumers by preventing transactions likely to result in increased prices or reduced output. Mergers can harm consumers when they cause structural changes to the marketplace

that increase a firm's ability to exercise market power which is defined as the ability to affect prices or reduce output of the industry.

24. Traditionally, the competitive effects of a proposed merger are analyzed by identifying the relevant product markets affected by the merger. The geographic scope of the market, the area in which the sellers compete and in which buyers can practicably turn for supply, should be identified.

25. The Attorney General notes that the proposed merger would create the largest supplier of local services in the United States and the sixth largest telecommunications firm in the world.

26. Both Telesis and SBC, through their RBOCs, currently generate most of their revenues from local, access, and intraLATA services. SBC is also a major supplier of cellular services.

27. Pacific serves approximately 75% of California's residents.

28. SBC provides local telephone services through Southwestern Bell in Texas, Arkansas, Oklahoma, Kansas, and Missouri. SBC is headquartered in Texas, and states in its application that it has no operations in California. SBC does an insignificant amount of business in California, such as owning a passive 3% interest in a California cellular services provider. SBC also offers wireless services under the Cellular One brand-name in 27 markets, including Chicago, Boston, Baltimore, and Washington D.C. SBC has cable television operations in Arlington, Virginia, and Montgomery County, Maryland. SBC is also licensed to provide Personal Communications Services in Little Rock, Tulsa, and Memphis.

29. The parties' discussions of competitive concerns do not clearly set out all the relevant product and geographic markets used in their analysis, but instead weave references, which are often vague and general, to these markets throughout their testimony and briefs.

30. The following product markets were identified by the Attorney General and the parties: local exchange services; intraLATA; interLATA; access services; wireless services; and bundled products.

31. The parties generally limit their discussions of the geographic market to California or a portion thereof, although intervenors vaguely refer to "at least some California telecommunications markets" at times, without further specifying which markets those might be.

32. No party disputes that the level of market concentration in any market is not increased, since SBC and Telesis do not compete with each other in any line of business.

33. An actual potential competitor is a firm that does not currently compete in the relevant market but would enter sometime in the near future, either independently or in combination with another entity. This combination is called a toehold acquisition. If, in lieu of entering the market independently or through toehold acquisition, the actual potential entrant merges with a significant incumbent firm, its incentives to enter the market independently disappear and the market would lose the amount of new competition that the potential competitor would have generated.

34. The relevant markets for purposes of the actual potential competitor analysis are the local exchange and intraLATA markets in California, or a portion thereof. It is not disputed that there is not robust competition in these markets at this time, even though rules have recently been established to open the California local exchange markets to competitors, and the Commission has held that some competition exists in the toll markets.

35. SBC's corporate strategy is to allocate its resources to enter new geographic or product areas only where it has some combination of the following existing assets: existing facilities (either wired or wireless), an existing customer base and brand-name recognition. This corporate strategy is one SBC developed in the course of operating its company, and was not suddenly formulated after the announcement of the proposed merger.

36. The record establishes a reasonable probability that SBC would expand into certain immediate adjacent areas where its existing infrastructure could be reasonably extended. These areas would include portions of Arkansas, Kansas, Missouri, Oklahoma and Texas which SBC does not currently serve, but do not include any part of California. SBC demonstrated that it is filing applications for authority to provide

out-of-region competitive wired local service only in states where it has a market presence and customers through its existing cellular operations. SBC's marketing of its landline long distance service is focused in its five-state region and where it has wireless properties.

37. We do not believe that the fact that the proposed merger is taking place should be a persuasive factor in determining whether SBC is an actual potential competitor. That analytical approach necessarily would lead to the conclusion that every proposed merger partner would be an actual potential competitor.

38. SBC's assets such as "know-how" as a supplier of local service, billing expertise, identification of the "Bell" name, and the ability to negotiate with Pacific to obtain successful terms to provide local service (many of which items other RBOCs also possess), while perhaps demonstrating capacity to compete, does not establish SBC's interest in a particular market.

39. SBC, like many businesses, has limited resources and has to prioritize its investments, and is not able to invest in every lucrative telecommunications market.

40. Intervenors' argument that California could become a high priority for SBC if SBC acquired other assets, such as cellular or PCS properties in the state, is speculation driven by further speculation of possible entry and can be used to explain why any region in the country could become a high investment priority.

41. Elimination of one actual potential competitor does not automatically impose an adverse affect on competition.

42. Assuming arguendo there is a reasonable probability that SBC were found to be an actual potential competitor of Pacific for at least some local exchange services in some markets, the record did not establish that there is a reasonable probability that it would do so as a facilities-based carrier in the near future.

43. The record establishes that there are many potential competitors who are at least as capable as SBC of competing against Pacific in the California local exchange and intraLATA business (especially since the record does not demonstrate a reasonable probability that SBC would have been a facilities-based provider.)

44. The need for Pacific to maintain an adequate level of investment in its California infrastructure has been a matter of keen concern to us for many years.

45. AT&T's and MCI's argument that the approval of the merger will result in reduced local competition due to the fact that it will increase the magnitude of an alleged artificial advantage that Pacific will enjoy if it is allowed to offer interLATA service to in-region customers while switched access charges remain above cost is a problem these intervenors have with RBOCs being able to offer interLATA service before access charges are reformed and is not merger-related.

46. Pacific and SBC have not yet been authorized to offer certain interLATA service, and cannot do so until they obtain approval from, among other agencies, the FCC.

47. Even if this artificial advantage were to exist (an issue we do not address one way or the other), the record here did not establish that the merger will increase the artificial advantage to the degree that it would have an adverse affect on competition.

48. Although we take seriously AT&T's and MCI's allegations that if Telesis is allowed into the long-distance market before effective local competition develops, Telesis will have an incentive to engage in discrimination in the provision of access service, we do not view them as related to the merger. These are concerns that these intervenors would have even if the merger were not occurring.

49. This Commission has issued rules relating to subscriber directory listing and access to directory listing information. The majority of the issues raised by ADP are addressed in D.97-01-042.

50. Applicants recognize that we retain the authority to obtain necessary information to regulate Pacific. We place Applicants on notice that they should supply such necessary information, and should not attempt to shield themselves, inter alia, with a holding company or other corporate structure, when this Commission requests necessary information to regulate Pacific.

51. The merger and the conditions imposed herein upon its approval will create benefits for California ratepayers and the California economy that are in addition to those which are estimated herein pursuant to § 854(b).

52. The merger is likely to improve the financial condition of Telesis and Pacific.

53. Pacific's President testified that the merger is required in part to improve Pacific's shaky financial position.

54. The record does not support ORA's recommendations to revise existing service quality standards as a condition of the merger.

55. Pacific is out of compliance with standards set forth in GO 133B for business office answering times and trouble report answering time.

56. The record does not support the recommendations of ORA with regard to oversight of the merged companies' management practices.

57. The record does not identify any labor problems which should be anticipated as a result of the merger.

58. The record demonstrates that the merger is likely to be beneficial to the shareholders of the merged companies.

59. The California Commitments letter will be beneficial to the state and local economies.

60. Applicants state they do not seek approval of the Community Partnership Commitment.

61. The Community Partnership Commitment becomes void by its terms if the Commission orders economic benefits to be allocated any way other than as the agreement sets forth or at levels that exceed its terms.

62. The Community Partnership Commitment will benefit state and local communities.

63. Restraints on Applicants' lobbying or other governmental activities may be unlawful and would be contrary to Commission policy to encourage participation in regulatory and legislative processes.

64. Applicants will have met their burden to demonstrate the merger would be in the public interest, consistent with § 854(c) if the merger's approval is conditioned upon the mitigation measures set forth herein.

65. Our analysis of this application and the imposition of these conditions is based on the particular fact pattern presented by the parties to this application.

IV. Conclusions of Law

1. Section 854(e) requires that Applicants have the burden of proof by a preponderance of the evidence to demonstrate that the requirements of §§ 854(b) and (c) are met.

2. In order to determine whether § 854(b) applies to this application, we first should examine the actual language of the statute. In examining the statute's language, decisionmakers should give the words of the statute their ordinary, everyday meaning. If the meaning is without ambiguity, doubt, or uncertainty, then the language controls. Only if the meaning of the words are not clear, decisionmakers should take the second step and refer to the legislative history.

3. The plain language of § 854(b) is clear, and applies where a utility of a specified financial size is a party to the proposed transaction.

4. Pacific should be considered a party to this transaction within the meaning of § 854(b). Section 854(b) should therefore apply to this transaction in its entirety.

5. Section 854(b) requires the Commission to allocate certain forecasted economic benefits to ratepayers which accrue as a result of the merger where it has ratemaking authority.

6. Section 854(b) requires that ratepayers be allocated a share of short term and long term economic benefits accruing as a result of the merger.

7. A reasonable estimate of economic benefits accruing as a result of the merger is $495 million because it is based on Applicants' estimates of cost savings, incorporates all relevant types of cost savings and assumes long term benefits, consistent with § 854(b).

8. Section 854(b) does not prohibit the Commission from relying on competition to flow through some of the economic benefits associated with the merger in this case.

9. The Commission should require Applicants, as a condition of the approval of the proposed merger, to pass on to Pacific's customers the economic benefits associated with the merger and quantified in this decision through five annual rate reductions, and by implementing the Community Partnership Commitment.

10. An equal sharing of economic benefits between ratepayers and shareholders is reasonable in this case and consistent with § 854(b).

11. Section 854(b)(3) requires the Commission to find that Applicants' proposal does not adversely affect competition. In making this finding, the Commission is required to request an Advisory Opinion from the Attorney General regarding whether competition will be adversely affected and what mitigation measures could be adopted to avoid this result.

12. We need not find a technical violation of the Clayton Act in order to deny a merger under § 854. More specifically, we may disapprove a transaction whose impacts are harmful, but less than "substantial" under the Clayton Act.

13. We do not find, in the absence of specific evidence, that a merger in itself adversely affects competition simply by making a large and strong company larger and stronger. We need to examine Applicants' and intervenors' specific claims in the context of the relevant product and geographic market, as demonstrated by the evidence.

14. The proposed merger should not eliminate an actual competitor in any market, since SBC and Telesis do not currently compete with each other in any line of business.

15. To prove loss of actual potential competition, one must establish that: (1) the relevant market is concentrated; (2) but for the merger, the acquiring firm would likely have entered the market in the near future either on its own or by toehold acquisition; (3) there must be few other potential entrants with comparable advantages; and (4) such market entry would carry substantial likelihood of ultimately producing deconcentration of the market or other significant procompetitive effects.

16. We decline intervenors' invitation to broaden the federally-required elements with respect to the application of the actual potential competitor doctrine, where a body of established case law currently exists to guide us. We did not establish a different standard of proof with respect to this doctrine in *Re SCEcorp*.

17. In applying the actual potential competitor doctrine, we are guided by the "would likely" have entered and "reasonable probability of entry" standard, as we agree that the Fourth Circuit standard is too strict, especially under § 854(b).

18. The Second Circuit has held that entry by the acquiring firm must occur in the "near" future, with "near" defined in terms of the entry barriers and lead time necessary.

19. The record does not establish a reasonable probability that SBC would have entered all or a portion of the California local exchange or intraLATA markets on its own or in combination with another entity in the near future absent the merger.

20. Assuming arguendo SBC were an actual potential competitor, the inclusion of all the other RBOCs, as well as other similarly situated companies, as actual potential competitors would not make SBC's absence from the pool economically or legally significant.

21. A leading antitrust treatise concludes that three similarly well-qualified potential entrants should be presumptively sufficient to obviate concern for the elimination of potential competition and six entrants remove any plausible basis for attacking a merger eliminating a potential entrant.

22. In our next NRF review, we should carefully scrutinize requested adjustments to the formula with an eye to preventing potential cross-subsidization issues raised by the Attorney General.

23. We will not gauge the cost-effectiveness of investment by the absolute level of dollars spent nor will we mandate a specific spending level. However, the level of annual infrastructure expenditures is a factor which we will continue to monitor, and is an issue which we may choose to investigate at a future date, either upon our own motion or upon the request of an interested party, if the circumstances warrant such a review.

24. Even if future Pacific capital expenditures may exceed currently authorized rates of depreciation, we expect SBC to invest sufficient funds in Pacific without requesting an increase in the NRF revenue requirement or otherwise disrupting the NRF compact.

25. We should not adopt specific mitigation measures dealing with directory publishing in this proceeding, because these issues are being addressed both by the FCC and by this Commission in a different forum. We put Applicants on notice that we expect them to abide by existing and upcoming rules in this area, and that we will seriously consider and review any allegations that they have failed to comply.

26. The absence of an independent SBC should not have an effect on benchmarking such that it would be an adverse effect on competition on which to condition or deny the merger.

27. The proposed merger should not have an adverse effect on competition within the meaning of § 854.

28. The Commission should require Pacific to demonstrate two months of compliance with GO 133B and present a plan for ongoing compliance within 90 days of the effective date of this order or face penalties.

29. Applicants should implement the Community Partnership Commitment.

30. Pacific should within 90 days from the effective date of this decision review and identify each existing affiliate transaction rule where changes are warranted, provide comments on the applicability of the respective rule to the post merger organization, and propose, if necessary, specific modifications to the respective rules to comply with this Commission's affiliate transaction rules and procedures, as ordered by the Commission in D.92-07-072 (Pacific Bell Information Systems decision), in the post merger organization environment.

ORDER

IT IS ORDERED that:

1. The request of Pacific Telesis Group (Telesis) and SBC Communications, Inc. (SBC) (Applicants) for approval of an indirect change in control of Pacific from a wholly-owned subsidiary of Telesis to a second-tier subsidiary of the combined company that will result from Telesis' planned merger with SBC, with Pacific remaining the subsidiary of Telesis, is granted with the conditions set forth herein:

   a. Pacific Bell (Pacific) shall reduce its rates by the amount described in Table 1 for each of the five years beginning with Pacific's annual advice letter filing to effectuate rate changes on January 1, 1998 by means of Rule 33 adjustment to the surcharges for exchange, toll, and access services;

   b. Pacific shall implement the Community Partnership Commitment.

c. Applicants shall agree to be bound by the Commission's disposition of the audit ordered in Application 93-11-011;

d. Applicants shall notify the Commission in writing that the merger which is the subject of this application has been accomplished. The written notice shall be delivered to the Commission within five business days of the effective date of the merger.

e. If circumstances change such that SBC proposes to acquire, merge, or otherwise control another RBOC within five years after the effective date of this decision, Applicants shall inform the Commission, prior to the transaction being consummated, by filing a notice in this proceeding, served on all parties of record. The notice shall explain the changed circumstances and how the changed circumstances should affect the analysis and conditions we impose in this decision.

f. Pacific shall within 90 days from the effective date of this decision review and identify each existing affiliate transaction rule where changes are warranted, provide comments on the applicability of the respective rule to the post merger organization, and propose, if necessary, specific modifications to the respective rules to comply with this Commission's affiliate transaction rules and procedures, as ordered by the Commission in D.92-07-072 (Pacific Bell Information Systems decision), in the post merger organization environment.

2. Notwithstanding the status of the merger of SBC and Telesis, Pacific shall file annual information consistent with existing reporting requirements to demonstrate the maintenance or improvement of service quality, consistent with Commission rules and General Orders (GOs). Pacific shall maintain or improve its service quality over the five years following the merger.

3. Notwithstanding the status of the merger of SBC and Telesis, Pacific shall within 90 days from the effective date of this decision demonstrate two months of compliance with the provisions of GO 133-B.

4. If Applicants effectuate the merger which is the subject of this order, their failure to comply with each element of Ordering Paragraph 1 shall constitute a violation of a Commission order and subject Applicants to penalties and other lawful sanctions consistent with state law.

5. Pacific shall demonstrate two consecutive months of compliance and present a plan for ongoing compliance with GO 133B requirements for business office answering

time and trouble report answering time, or be subject to penalties. In addition to aggregate statistics, Pacific shall file information in this proceeding about its business office answering time within 90 days from the effective date of this order identifying the results for each of the six language centers. Its filing shall separate the answering time statistics by language.

6. Applicants shall file written notice with the Commission in this proceeding, served on all parties to this proceeding, of their agreement, evidenced by a resolution of their respective boards of directors duly authenticated by a secretary or assistant secretary, to the conditions set forth in this decision. Failure of Applicants to file such notice and failure of Applicants to merge their companies pursuant to this order within 60 days of the effective date of this decision, shall result in the lapse of the authority granted by this decision.

This decision is effective today.

Dated March 31, 1997, at San Francisco, California.

JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
RICHARD A. BILAS
Commissioners

I will file a written dissent.

/s/ P. GREGORY CONLON
President

APPENDIX A
Page 1

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END OF APPENDIX A

APPENDIX B

854. (a) No person or corporation, whether or not organized under the laws of this state, shall merge, acquire, or control either directly or indirectly any public utility organized and doing business in this state without first securing authorization to do so from the commission. The commission may establish by order or rule the definitions of what constitute merger, acquisition, or control activities which are subject to this section. Any merger, acquisition, or control without that prior authorization shall be void and of no effect. No public utility organized and doing business under the laws of this state, and no subsidiary or affiliate of, or corporation holding a controlling interest in a public utility, shall aid or abet any violation of this section.

(b) Before authorizing the merger, acquisition, or control of any electric, gas, or telephone utility organized and doing business in this state, where any of the utilities that are parties to the proposed transaction has gross annual California revenues exceeding five hundred million dollars ($500,000,000), the commission shall find that the proposal does all of the following:

(1) Provides short-term and long-term economic benefits to ratepayers.

(2) Equitably allocates, where the commission has ratemaking authority, the total short-term and long-term forecasted economic benefits, as determined by the commission, of the proposed merger, acquisition, or

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are mandated by either the commission or the Legislature as a result of, or in response to any electric industry restructuring. However, the value of an acquisition or change in control may be used by the commission in determining the costs or benefits attributable to any electric industry restructuring and for allocating those costs or benefits for collection in rates.

(Amended by Stats. 1995, Ch. 622, Sec. 1. Effective January 1, 1996.)

END OF APPENDIX B

Table 1
Page 1

Forecasted Economic Benefits	
	Net Present Value (NPV) (Millions)[1]
Operational Savings in Pacific Bell[2]	$464.78
Cost impact of 3% purchase savings on capital material costs[3]	$30.41
TOTAL BENEFITS	$495.19
Ratepayer Share (50%)	$247.60
Community Contributions[4]	$34.45
Total Ratepayer Rate Reduction	$213.15

Annual Schedule of Rate Reductions (Millions)[5]				
1998	1999	2000	2001	2002
$46.89	$51.58	$56.74	$62.41	$68.65

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1 Calculations use a 10% discount rate and result in a net present value for the beginning of the year, 1997.

2 Based on Exhibit 36. Uses Nelson's original $326 full annual savings and excludes $53 million for savings from best practices. The result is multiplied by an 83% allocation factor to exclude category III savings. The full annual savings of $226.6 million are achieved in 2002, the fifth year of savings. Annual savings are reduced by implementation costs in the first three years consistent with Cicchetti's analysis ($25.2 million for severance and retention, 10% of full annual savings for systems re-engineering, and 5% of full annual savings for training; total costs are allocated evenly over 24 months beginning April, 1997). The NPV of 5.6 years of savings is calculated. The resulting NPV amount is multiplied by an 81% intrastate separations factor.

3 Based on Nelson's table in exhibit 37, Attachment 1. Annual savings are multiplied by an 83% allocation factor to eliminate category III-related savings. The NPV of 5.6 years of savings is calculated. The resulting NPV amount is multiplied by an 81% intrastate separations factor.

4 NPV of applicants' committed contributions to the Community Technology Fund ($5 million/year for 10 years), increased corporate giving ($1 million/year for 3 years), and funding for an under-served community "think tank" ($200,000/year for 5 years) and for a Universal Service Task Force ($100,000/year for 7 years).

5 The amount in each year is equivalent to 1/5 of the 1997 Net Present Value of the total ratepayer rate reduction using a 10% discount rate.

Forecasted Economic Benefits Calculations

Original Nelson Savings without "best practices",without category III/Cicchetti implementation costs, NPV 5.6 years, 10% discount rate.

Year	Years of Saving	Annual Saving	Implement	Net Savings	10%NPV
1997		0.00	22.20	(22.20)	(20.18)
1998	1	53.38	29.59	23.79	19.66
1999	2	146.84	7.40	139.44	104.76
2000	3	200.15		200.15	136.70
2001	4	213.37		213.37	132.48
2002	5	226.59		226.59	127.90
2003	5.6	135.95		135.95	72.48
					573.81
				intrastate	0.81
					464.78

Nelson benefits from capital expendituere savings, Ex.37, attachment 1, adjusted by 83% to eliminate category III savings.

Year	Years of Saving	Total Capital Expenditures	Materials/ National Supplier	3% Savings	Implementation Costs	Net Purchase Reduction	Category I and II allocation	cumulative savings	carrying cost savings	10%NPV
1997						0.00	0.00	0.00	0.00	0.00
1998	1	1810.00	607.80	18.23		18.23	15.13	7.57	1.74	1.44
1999	2	1810.00	607.80	18.23		18.23	15.13	22.70	5.22	3.92
2000	3	1810.00	607.80	18.23		18.23	15.13	37.84	8.70	5.94
2001	4	1810.00	607.80	18.23		18.23	15.13	52.97	12.18	7.56
2002	5	1810.00	607.80	18.23		18.23	15.13	68.10	15.66	8.84
2003	5.6	1086.00	364.68	10.94		10.94	9.08	80.21	18.45	9.83
										37.55
									intrastate	0.81
										30.41

Community Partnership Agreement Calculations

Net Present Value of Community Partnership Agreement., Ex 2, Rebuttal of Dorman, Rebuttal of Carr, and rebuttal of Bar.

			Community Technology Fund	Telesis Foundation	Universal Service Task Force	Consumer Think Tank	Nominal Total	NPV (10%)
1.00	1	1997	5	1	0.10	0.20	6.30	5.73
2.00	2	1998	5	1	0.10	0.20	6.30	5.21
3.00	3	1999	5	1	0.10	0.20	6.30	4.73
4.00	4	2000	5		0.10	0.20	5.30	3.62
5.00	5	2001	5		0.10	0.20	5.30	3.29
6.00	6	2002	5		0.10		5.10	2.88
7.00	7	2003	5		0.10		5.10	2.62
8.00	8	2004	5				5.00	2.33
9.00	9	2005	5				5.00	2.12
10.00	10	2006	5				5.00	1.93
Total							54.70	34.45

END OF TABLE 1

A. 96-04-038
D. 97-03-067

COMMISSIONER JESSIE J. KNIGHT, JR., CONCURRING:

I support the order sponsored by Commissioners Neeper and Bilas, with the disclaimer that at one point I considered writing even a third alternate, allowing the market to flow through the merger benefits one hundred percent.

With that as a precursor, the analysis of Commissioners Neeper and Bilas to estimate merger benefits on a 5.6 year horizon is most reasonable and within the record of the case. However, the pace of convergence in the telecommunications industry may even challenge this estimate. On balance, I consider the 5.6 year horizon more appropriate than the overly lengthy 8 and 10 year estimates in the two other proposals before us today. Recent announcements in the industry strongly support the premise that an estimate of 5.6 years can certainly be classified as "long term" given the relentless pace of innovation, the transformation and globalization of markets, and the convergence of wireless, PCS, and satellite services within the telecommunications industry. For example, just in the short time since the close of the record in this proceeding, technology breakthroughs have been announced in wireless loop technology, new "CDMA" digital services, new "smart" phones and a new paradigm called "local multipoint distribution service," a service which allows telephone, television, and internet access over a new slice of airwaves. Also, recent news reports highlight that new business partnerships are forming, such as the on-going talks between Cable & Wireless and Sprint. In the gestalt, these new services and breaking news events suggest that governmental economic determinations run the risk of inappropriately defining the universe of the industry, thus penalizing industrial development. The Commission should not base billion dollar decisions on a stale record that cannot possibly keep up with changes in the industry.

I also prefer the Neeper/Bilas calculation of merger savings which excludes among other things, savings from competitive services, such as long distance and Yellow Pages. Under the Commission's so-called "new regulatory framework", telecommunications services of the incumbent monopoly utility are separated into three categories based on the various levels of competition. "Category III" represents fully competitive services which are granted correspondingly complete freedom in pricing. In my judgment, it

would be improper to force the merged company to return benefits achieved in these competitive markets to ratepayers of monopoly services. As the Neeper/Bilas order properly notes, any merger savings on Category III services will be passed on to consumers through market forces. As I mentioned earlier, I would prefer a decision that allowed the competitive market to flow through <u>all</u> the benefits of this merger, not just in Category III services. But given the range of opinions expressed in the administrative law judges' proposed decision and the two alternates, it would have been impractical and possibly futile to add yet another choice into the decision mix. Upon reflection, I decided that this would have only splintered the Commission's decision-making ability as a body even further.

In my view, it is sheer conjecture to even <u>begin</u> to calculate merger benefits for this industry through a formula. From my own involvement with mergers and acquisitions, I know that cost-savings estimates are difficult to formulate with certitude in very mature industries, let alone an immature, emerging industry with new technologies that are changing the competitive landscape daily. Consider what the word "convergence" means for telecommunications. The various worlds of the monopoly local telephone companies, wireless technology, computer networks, cable networks, satellite technologies, PCS providers--maybe even energy providers--are all blurring their lines of operation and their influence on outcomes. The Commission should not be called upon under Public Utilities Code Section 854 to engage in the highly speculative endeavor of calculating merger benefits in a restrictive fashion. Section 854 is a statute that bears reexamination in light of the fundamental market changes confronting the industries this Commission regulates. In my personal judgment, California is at a competitive disadvantage with its sister states in that it is the only state, to my knowledge, that has this straight-jacket benefit calculation and sharing requirement. Why should obsolete statutes retard California's economic development, and penalize its changing utility industries in this manner? My business experience convinces me that competition <u>will</u> provide the benefits of this merger to consumers through price decreases, increased product innovation, and overall enhancements to the telecommunications marketplace in California. I should hope that leadership emerges soon to repeal Section 854 entirely. The Neeper/Bilas order complies with the law as it stands now, did a superb job in this application, and since it produces the lower merger "tax," I support it.

Next, I draw attention to a key criticism I have with both the proposed decision originally offered by the administrative law judges and the original alternate 1-b which also drove me to support the Neeper/Bilas order. Both proposals included restrictions on the use of Pacific Bell's net income that are, in my mind, clearly antithetical to the public interest. The original proposed decision conditioned the merger on the agreement that Pacific Bell's net earnings would not be used for any purpose other than investing in

Pacific Bell's infrastructure. Alternate 1-b initially proposed to require Commission approval of dividend pay-outs that exceed net income. When this was amended, this restriction was removed except for the fact that the company is put on notice that their financial filings before the Commission will be monitored for such activity, including loans or advances to its parent company.

In contrast to these proposals, I believe in free markets. Today's modern economies rely upon the free flow of capital. Our country is a successful leader and beneficiary of this philosophy. A policy that seeks to prevent capital from leaving the state will only serve to deter those seeking to invest capital in the state. I learned this first hand as a young businessman in Latin America. If capital cannot flow out of an area, it will not flow in. History is filled with examples of similar policies that, while well intentioned, did not work to bring prosperity to lesser developed nations. This is a policy that would truly harm California's economy. California must not turn to anachronistic "third world" policies, if it is to remain a first-rate competitor in today's global economy. Protectionism like this has no place in a free market, and I cannot countenance its adoption by California, a state that is critically dependent on open and free markets across the globe.

I would also like to focus for a moment on two important features of this merger that unfortunately were either largely overlooked or discounted in the debate, not unusual in any merger transaction. These features are research and development and the expanding international business opportunities that can and will benefit California's economy. The seeds of opportunities in these two areas will have a profound domino effect on the competitive landscape. With regard to R&D, the increased financial strength of the merged enterprise should allow it to pursue exciting new products for introduction in California that will not only benefit our consumers, but ensure our state's leadership position in telecommunications innovation.

As for international strength, SBC and Telesis have committed to basing their new headquarters for international operations in California. As an unabashed internationalist, I view this as a commitment that looms large for California. This new headquarters will be well positioned to tackle enhanced global marketing opportunities, will undoubtedly provide job growth to our State, and will contribute other product and pricing advantages to California consumers. California has a natural competitive advantage due to its geographic proximity to Latin America and the Pacific Rim. This is not a throw-away line, nor an advantage to take lightly. The merged company will capitalize on this advantage. How could we as regulators even begin to speculate about the value or size of the future endeavors that may be born from future research or global expansions?

I also cannot overlook the impact of this merger on job creation in California. The commitment of SBC and Telesis to create 1000 jobs in California will have a positive multiplier effect on California's economy, due to interactions between all sectors of the economy. As incomes from the 1000 job increase are spent in other sectors, another round of job creation results. The compound effect can mean a total of over 2000 even newer jobs for the State. Furthermore, price reductions from competition and operating efficiencies from enhanced quality telecommunication services will yield even an additional round of job creation. As firms realize the benefits of price reductions and become more efficient, they increase their spending power. This allows investment in new areas, thereby creating even more jobs.

Finally, I agree with the treatment of the Community Partnership Commitment in the Neeper/Bilas order. The Commission's support for this partnership agreement is imperative. The agreement provides a creative and novel method of flowing merger gains to communities that are often overlooked. The agreement's creation of a Community Technology Fund to promote access to advanced telecommunications services as well as the formation of a Universal Service task force are key components. This agreement will do more to promote economic development and universal access to telecommunications services than a tiny credit on ratepayer bills. The Commission should take serious note that average consumers have voiced this opinion loudly. This agreement does indeed allocate economic benefits to both ratepayers and the citizens of our State. The Commission's explicit acceptance and clarification of the Community Partnership Commitment in the Neeper/Bilas order ensures substantial gains to all Californians and it is appropriate to include these advantages in the Commission's calculation of merger benefits as required by law.

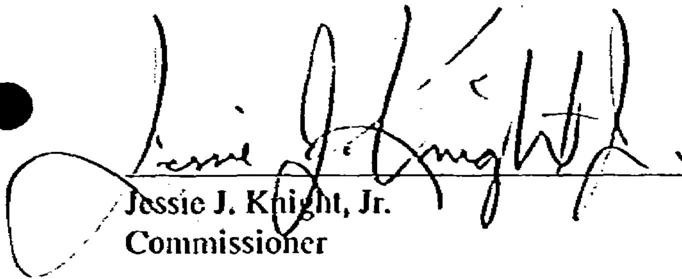
The concept to allow customers to opt to contribute their refund to the Community Partnership fund rather than receive a tiny refund on their bill is certainly creative and has considerable merit. However, it would no doubt be more administratively costly to track the exact amount of an individual customer's refund and ensure its final destination at the Partnership fund. I would prefer that we consider the idea of voluntary ratepayer contributions for charitable purposes for any utility in California in a separate proceeding, and not just for Pacific Bell. Programs like this are already in use elsewhere and I would welcome a utility proposal to implement a similar program here. The idea is not appropriate to apply here narrowly in this merger, particularly if not part of the developed record.

I cannot emphasize enough my faith in the SBC/Pacific Telesis merger and its ability to bring job growth, economic development opportunities, product and service innovation, global opportunities, and ultimately economic leadership to California.

Because of my faith in these ever-emerging business opportunities, I have consistently voted against awarding Pacific Bell any financial support for the effects of competition on its former monopoly "franchise." Obviously, Pacific Bell was very unhappy with my vote on this. I consider their claims a regulatory anachronism because they are based on the old paradigm as the Commission's regulations shift to a brave new world. Pacific Bell, under its newly merged parent company, will have incredible opportunities to balance any monopoly losses against competitive gains in the new world order, with enhanced opportunities to earn. When the Franchise Impact case comes before the Commission again, Pacific Bell will not have to wonder about my vote.

Therefore, with my faith in competition intact, I will vote in support of the Neeper/Bilas order, but I still wish it could have gone farther.

Dated March 31, 1997 in San Francisco, California.



Jessie J. Knight, Jr.
Commissioner

P. GREGORY CONLON, President of the Commission, dissenting

I dissent from the majority opinion in the decision authorizing the merger between SBC Corp. (SBC) and Pacific Telesis (Telesis); however, I do not object to the merger before the Commission in principle. Having been convinced by the record and the proposed decision of the Administrative Law Judges (ALJs) that there were no anti-competitive effects from the merger, I support the management teams of SBC and Telesis in their decision to join forces to better compete in the new telecommunications world. However, I disagree with my colleagues on significant portions of the adopted order.

Thanks to the diligent work of the jointly assigned Commissioner in this docket, Commissioner NEEPER, assigned Administrative Law Judges (ALJs), applicants, intervenors, and staff, the review of the proposed merger, which was announced by Telesis in April 1996, was completed in less than a year. The instant application called for Telesis to be acquired by SBC, another Regional Bell Holding Company (RBHC), even though Telesis three years earlier had indicated that its spin-off of cellular operations into a separate company, today called AirTouch Communications (AirTouch), would not harm its financial condition. Without the cellular business now at AirTouch, and with a downturn in the California economy, Telesis had suffered financially and sought a robust merger partner in SBC, a fully diversified RBHC, to help Telesis' financial situation.

As required by statute, the majority opinion finds that the merger will have salutary effects on Telesis' financial condition and management,

shareholders, employees, and state and local economies. Further, through the Community Partnership Commitment, certain community-based organizations will greatly benefit from the merger. In addition, the majority determines that the merger will not negatively affect Pacific Bell's (Pacific) service quality, and our ability to regulate this utility. However, in my opinion, the majority decision does not fully address the concerns of the general body of ratepayers.

Section 854(b)(2) of the Public Utilities Code sets forth what this Commission must do to ensure that ratepayers also receive the benefits of a merger. Under this statute, we must find that a proposed merger:

> Equitably allocates, where the commission has ratemaking authority, the total short-term and long-term forecasted economic benefits as determined by the commission, of the proposed merger, acquisition, or control, between shareholders and ratepayers. Ratepayers shall receive not less than 50 percent of those benefits.

I conclude that the majority applies this statute inconsistently. On one hand, they employ a narrow reading of the statute to keep from flowing to the general body of ratepayers net savings from Yellow Pages operations. They justify this by noting that the Commission does not have jurisdiction over the rates of Yellow Pages advertising,[1] and ignoring the fact that the Commission today has authority to impute net revenues from Yellow pages operations to set the rates of

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[1] D.97-03-067, mimeo at p. 29.

Pacific. It is precisely these net revenues that will increase as a result of the merger.

On the other hand, the majority opinion argues against reflecting the net savings associated with Category III and long-distance services in their net-benefit analysis based on a broad reading of § 854(b)(2).[2] I believe that the majority disregards the assurance demanded by the statute that ratepayers receive at least 50% of the benefits of a proposed merger. The majority relies on our decisions in the mergers between McCaw Communications and AT&T, and GTE-California and Contel,[3] even though the decision in the former case applied a preexisting statute with language significantly different from the current,[4] and the decision in the latter recognized that competition could only be counted on to pass benefits *in excess* of the minimum 50% required by the statute. The Commission was able to accept the settlement in the AT&T/McCaw case because it could rely on competition as a ratemaking tool to ensure that some undetermined level of benefits were flowed through to ratepayers. However, under the current statute, we no longer have the discretion to determine the ratemaking method for the flow-through of benefits, and must now ensure a minimum level of benefits to the ratepayers.

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[2] I do not include long-distance services in my determination of the net benefits of the proposed merger for a different reason, namely, that it is simply too speculative to include in that calculation services that are not yet being offered by the applicants.
[3] *Id.*, at pp. 27-28.
[4] 54 CPUC2d 43, 50-54, D.94-04-042.

My colleagues further pronounce that *all* ratepayers will benefit from the funding of the Community Partnership Commitment,[5] but leave the funding to come solely from the refund owed to customers of Category I and II services.[6] By not stating why Category III customers should not contribute to the Community Partnership Commitment while fully benefiting from the Commitment, my colleagues seem inconsistent. I note that the Community Partnership Commitment, as originally crafted and funded, would not have run into this problem because it was to be funded at the risk to the applicants' shareholders.

I also cannot agree with the majority's choice of adopting the applicants' view on the proper short- and long-term period over which the net-benefit analysis should be performed. Faced with a variety of recommendations between 6.6 years and 20 years,[7] the majority selects the applicants' unsupported 6.6-year timeline which is based on the notion that Pacific will be no longer price-regulated by that time.[8] There is little basis for this. Indeed, the applicants' own investment advisors for the merger produced estimates of competitive inroads that indicated that the extent of facilities-based choices years beyond the 6.6-year horizon would be minimal. My own recommendation to employ an 8-year horizon composed of a period of 3-year implementation period beginning in 1997 and a 5-year period during which ratepayers would receive the full benefits of the merger,

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although only 1.4 years greater than the majority decision's, was a superior solution, supported by the record, and fair to shareholders *and* ratepayers, in accordance with § 854(b).[9]

After calculating the figures that, in our separate estimations, would ensure that ratepayers would receive 50% of the net savings of the merger, both the majority and I determine that it is proper to credit from those figures the contribution to the Community Partnership Commitment. However, the majority opinion forces the California ratepayer to play the role of silent partner by foregoing refunds that would have accrued to the generic ratepayer in favor of funding the community-based organizations that chose to sign the Community Partnership Commitment. Rather than providing specific protections for the ratepayer, the majority leaves it to the Commitment participants to make funds available "to any community-based organizations that wish to apply for funding."[10] This does not resolve the inherent conflict of interest, for the very same parties that need the money, and signed the Commitment, will be making the decisions on how to disburse the funds allocated to the Commitment. The Commission will never know whether the ratepayers funds have been allocated or spent fairly.

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[9] Although not clearly discernible in the majority opinion, the calculation of the net benefits in the adopted order does not comport with the facts in the instant case. The majority used figures from two completely different analyses provided by applicants. Indeed, the criticism applied to The Utility Reform Network's (TURN) benefit calculation in the ALJs' proposed order, i.e., that TURN selected gross savings and implementation costs inconsistently in an attempt to maximize net savings, applied even more to the benefit calculation in D.97-03-067.
[10] *Id.*, at p. 88.

I contrast our action here with $50 million of ratepayer funds with the set-up adopted for the similarly situated California Teleconnect Fund in Decision 96-10-066, our Universal Service decision. Like the Community Partnership Commitment, the Teleconnect Fund will allocate $5 million a year for community-based organizations. *Unlike* the Community Partnership Commitment, the Teleconnect Fund requires that community-based organizations certify to their carrier of choice that they are providing some specific functions so that we can ensure that "the discounted telecommunications services [sold through the Teleconnect Fund] are being used to directly or indirectly benefit the public at large, and that the discount is not being used simply to reduce the [community-based organizations'] telecommunications expenses."[11] Monies collected from the applicable surcharge are held in a trust currently overseen by the *staff of the Commission*. The staff will also manage the pay out of funds to carriers serving qualifying community-based organizations. At some point in the future, control of the trust will likely be transferred to an entity responsive to the Commission. It appears that the Commission's concerns that led to setting up the certification and governance requirements of the Teleconnect Fund are inexplicably not shared with regards to the California Partnership Commitment.

The majority attempts to address another concern with the Community Partnership Commitment by telling applicants in the dicta of the decision that there is an undefined expectation that if funds from the Commitment

[11] D.96-10-066, mimeo at p. 85.

go unspent, they will be targeted to be used elsewhere for similar goals. Although the majority makes a good-faith effort at resolving the potential of unspent funds going back to the applicants, and thus resulting in less than 50% of the benefits going to the ratepayers, the adopted order fails to place this as a condition on the merger.

I suspect, in addition, that the community-based organizations that signed the Commitment will *not* be the ones informing the Commission of such an outcome. In a masterful stroke, applicants managed to severely curtail any future advocacy on behalf of those segments of California that most need it, particularly when such advocacy might involve actions against Pacific and SBC. As the Commitment states "Grants awarded for the purpose of consumer advocacy may not be used to assert positions which, in the judgment of any signatory to this Commitment [i.e., Pacific], are adverse to such signatory's interests." Hence, in cases involving marketing abuses by applicants, such as those unearthed during the proceeding for Application (A.) 85-01-034,[12] the signatory organizations will hesitate before risking their funding from the Commitment.

Lastly, in a nod to a monopoly market structure, the majority certifies a Community Partnership Commitment that states that, "To the extent that funds are used to acquire services and products from telecommunications providers,

[12] 21 CPUC2nd 182, 188-190. The Commission's investigation into alleged abuses resulted in the Commission ordering Pacific to cease and desist from certain marketing practices. Of particular importance here was the Commission's finding that "Pacific Bell's service representatives have been improperly applying the procedures for administration of the Moore Universal Telephone Service Act."

those services and products will, whenever possible, be acquired from Pacific Bell." In other words, ratepayer funds will be employed in the purchase of the services of the incumbent telecommunications provider, *unless some other industry member decides to join and support the Commitment with its own shareholders' monies.*

Having completed our review of this merger, the challenge in telecommunications now is to ensure that we address any remaining barriers to competition in the local-exchange market. I will not be comfortable with statements by the incumbent monopoly providers that there is competition, nor by entrants that there is not sufficient competition. I invite my colleagues to stay focused, for competition will not occur because we wish it so or because we state that it already exists. Much work is ahead, and I look forward to cooperating with SBC, Pacific, new entrants, consumer interests, and my colleagues to get the work done.

SAN FRANCISCO, CALIFORNIA
MARCH 31, 1997

P. GREGORY CONLON
PRESIDENT OF THE COMMISSION

P. GREGORY CONLON, President of the Commission, dissenting

I dissent from the majority opinion in the decision authorizing the merger between SBC Corp. (SBC) and Pacific Telesis (Telesis); however, I do not object to the merger before the Commission in principle. Having been convinced by the record and the proposed decision of the Administrative Law Judges (ALJs) that there were no anti-competitive effects from the merger, I support the management teams of SBC and Telesis in their decision to join forces to better compete in the new telecommunications world. However, I disagree with my colleagues on significant portions of the adopted order.

Thanks to the diligent work of the jointly assigned Commissioner in this docket, Commissioner NEEPER, assigned Administrative Law Judges (ALJs), applicants, intervenors, and staff, the review of the proposed merger, which was announced by Telesis in April 1996, was completed in less than a year. The instant application called for Telesis to be acquired by SBC, another Regional Bell Holding Company (RBHC), even though Telesis three years earlier had indicated that its spin-off of cellular operations into a separate company, today called AirTouch Communications (AirTouch), would not harm its financial condition. Without the cellular business now at AirTouch, and with a downturn in the California economy, Telesis had suffered financially and sought a robust merger partner in SBC, a fully diversified RBHC, to help Telesis' financial situation.

As required by statute, the majority opinion finds that the merger will have salutary effects on Telesis' financial condition and management,

shareholders, employees, and state and local economies. Further, through the Community Partnership Commitment, certain community-based organizations will greatly benefit from the merger. In addition, the majority determines that the merger will not negatively affect Pacific Bell's (Pacific) service quality, and our ability to regulate this utility. However, in my opinion, the majority decision does not fully address the concerns of the general body of ratepayers.

Section 854(b)(2) of the Public Utilities Code sets forth what this Commission must do to ensure that ratepayers also receive the benefits of a merger. Under this statute, we must find that a proposed merger:

> Equitably allocates, where the commission has ratemaking authority, the total short-term and long-term forecasted economic benefits as determined by the commission, of the proposed merger, acquisition, or control, between shareholders and ratepayers. Ratepayers shall receive not less than 50 percent of those benefits.

I conclude that the majority applies this statute inconsistently. On one hand, they employ a narrow reading of the statute to keep from flowing to the general body of ratepayers net savings from Yellow Pages operations. They justify this by noting that the Commission does not have jurisdiction over the rates of Yellow Pages advertising,[1] and ignoring the fact that the Commission today has authority to impute net revenues from Yellow pages operations to set the rates of

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[1] D.97-03-067, mimeo at p. 29.

Pacific. It is precisely these net revenues that will increase as a result of the merger.

On the other hand, the majority opinion argues against reflecting the net savings associated with Category III and long-distance services in their net-benefit analysis based on a broad reading of § 854(b)(2).[2] I believe that the majority disregards the assurance demanded by the statute that ratepayers receive at least 50% of the benefits of a proposed merger. The majority relies on our decisions in the mergers between McCaw Communications and AT&T, and GTE-California and Contel,[3] even though the decision in the former case applied a preexisting statute with language significantly different from the current,[4] and the decision in the latter recognized that competition could only be counted on to pass benefits *in excess* of the minimum 50% required by the statute. The Commission was able to accept the settlement in the AT&T/McCaw case because it could rely on competition as a ratemaking tool to ensure that some undetermined level of benefits were flowed through to ratepayers. However, under the current statute, we no longer have the discretion to determine the ratemaking method for the flow-through of benefits, and must now ensure a minimum level of benefits to the ratepayers.

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[2] I do not include long-distance services in my determination of the net benefits of the proposed merger for a different reason, namely, that it is simply too speculative to include in that calculation services that are not yet being offered by the applicants.
[3] *Id.*, at pp. 27-28.
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/s/ P. Gregory Conlon
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