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Decision 97-04-090 April 23, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's own Motion into Competition for Local Exchange Service.	R.95-04-043 (Filed April 26, 1995
Order Instituting Investigation on the Commission's Own Motion into Competition for Local Exchange Service.	I.95-04-044 (Filed April 26, 1995)

ORIGINAL

ORDER GRANTING A LIMITED REHEARING OF DECISION 96-03-020 AND MODIFYING DECISION 96-03-020

I. HISTORY

In our 1993 Report to the Governor entitled Enhancing California's Competitive Strength: A Strategy for Telecommunications Infrastructure, (the Infrastructure Report) we found the best way to encourage fast-paced innovation and change was to promote a competitive telecommunications market. (See D.89-10-031, slip opinion at 157, in this case we set forth the New Regulatory Framework to establish incentive based regulation, the precursor to the Infrastructure Report.

In 1994,the California Legislature passed AB 3720 (Costa, Chapter 934, Stats. 1994) and AB 3606 (Moore, Chapter 1260, Stats. 1994) both of which expressed the Legislature's intent that we open telecommunications markets up to competition by January 1, 1997. Public Utilities Code section 709.5 added to the code by AB 3606 requires that we "ensure that competition in the telecommunications markets is fair and recognizes that we state's universal service policy is observed... " as the incumbent Local Telephone Companies (LECs) open their networks to competition. In section 709.5, the Legislature acknowledged that the mere removal of legal impediments to entry would not permit competition in telecommunications markets to become a reality when it recognized that open entry must involve the close coordination of our Open Access and Network Architecture Development Investigation and Rulemaking (OANAD); Local Exchange Competition Investigation and Rulemaking, Universal Service Investigation and Rulemaking and Consumer Protections and Regulatory Streamlining Investigation and Rulemaking. Finally, the Legislature in AB 3643 (Polanco, Chapter 278, Stats. 1994) directed us to ensure that the goals of universal service are met as competition develops.

Specifically, we identified the four major areas of regulatory focus relating to competition. These areas of concern were: (1) Open Access and Network Architecture Development (OANAD). This proceeding is setting up the rules to allow a competitor to have access to unbundled elements of an incumbents LEC's network to provide telecommunications service. (2) Local Exchange Competition Rulemaking. This proceeding deals with interconnection and resale as well as other issues. Interconnection is the ability to connect a new network to the existing network allowing customers to be able to talk to each other when they have different providers. Resale of services is the ability to buy an incumbent LEC's retail services at wholesale rates and to resell them to end users. In our OANAD and Local Exchange Competition Rulemakings we created overlapping rights governing entry into the local exchange market relating to interconnection, unbundled access and resale. Included in the local exchange proceeding is a review of whether the incumbent LECs deserve to be compensated for the negative impacts on their franchise brought by competition. (3) The Universal Service Rulemaking. This proceeding dealt with how to keep rates affordable in high cost, deaf and disabled and low income communities. We issued a final order in the Universal Service proceeding in the fall of 1996 (D.96-10-066). This order is now in the process of being implemented. However, at the federal level the Federal Communications Commission (FCC) is expected to come out with a companion Universal Service order for the interstate jurisdiction that could have a significant impact on the California decision. (4) Consumer Protections and Regulatory Streamlining. This proceeding is currently setting up rules to protect consumers and to streamline the regulatory process. Since the instant case deals with the local competition rulemaking and investigation, only the history of that proceeding will be recited below in depth.

The first major opening of markets in California occurred in September of 1994 in the Implementation Rate Design Phase of I.87-11-033 (D.94-09-065) (IRD). In this case we opened competition in intraLATA toll markets effective January 1, 1995. On November 4, 1994, Commissioners Shumway and Conlon issued an Assigned Commissioners' Ruling which began the process of opening up the local exchange markets by asking the parties to comment on the procedures we should follow to achieve both ours and the Legislature's goal of opening local exchange markets to competition by January 1, 1997. Consequentially, in D.94-12-053, we adopted a preliminary procedural plan to open the local exchange markets up to competition.

A. Local Competition Rulemaking

In accordance with the plan adopted in D.94-12-053, we formally instituted a joint rulemaking and investigation proceeding on April 26, 1995 to further develop rules for local exchange competition. Parties submitted written comments on the proposed rules, and we convened a full panel hearing to hear oral statements addressing the merits of the proposed rules. Based on these comments, we issued D.95-07-054 adopting the interim competition rules applicable to the service territories of Pacific Bell (Pacific) and GTE California (GTEC). This Decision directed companies that wanted to be Competitive Local Exchange Carriers (CLCs) to file petitions for Certificate of Public Convenience and Necessity (CPCN) authority by September 1, 1995 to enable us to act upon and approve them in time to allow local exchange competition by facilities-based CLCs to begin on January 1, 1996, and for bundled resale-based competition to begin on March 1, 1996. This date was later changed to March 31, 1996. Also, we ordered hearings to be held on a number of issues prior to the start of local exchange competition.

On August 18, 1995 the assigned Administrative Law Judge (ALJ) adopted a procedural schedule establishing three phases for the proceeding. Phase I was designated to cover issues relating to the institution of facilities-based competition effective January 1, 1996. On December 20, 1995, in D.95-12-056 we adopted interim rules governing interconnection and related matters in Phase I. In D.95-12-057, we concurrently approved an initial group of CLC petitions to authorize those companies to engage in facilities-based competition. Phase II was designated to cover hearing issues relating to the institution of bundled resale competition, as well as LEC/CLC retail pricing flexibility, NXX rating area consistency, and implementation costs. We are currently considering the schedule for addressing the remaining local competition issues in Phase III of this proceeding.

In February of 1996 the United States Congress passed the Telecommunications Act of 1996, which put forth a framework to open all local telecommunications markets to competition. (Pub. L.No. 104-104, 110 Stat.56, codified at and amended the Communications Act of 1934, 47 U.S.C. section 151, et seq. (1996).) In the Act, Congress removed the barriers to competitive entry by requiring the incumbent LECs to open their network to competition. (47 U.S.C. sections 251, 253(a).) In California over 70 firms have been approved to provide local telephone services. The Act, like California law and our decisions, recognized that the removal of legal impediments to competition was not enough to make competition a reality. Instead Congress recognized that competitors would need to interconnect with the incumbent LEC's network, be able to buy at wholesale prices incumbent LEC services to resell to end users and be able to buy unbundled access to the incumbent LEC's network. (47 U.S.C. section 251(c)(2)-(4).) Thus the Act sets forth a specific set of incumbent LEC duties such as the function, features and services that an incumbent LEC must make available to CLCs, as well as the mutual duties of the carriers to each other. (See 47 U.S.C. sections 251(b) and 251(c).) Congress also emphasized that it would like to have the telecommunications competitors negotiate with each other to resolve the broad range of technical and pricing issues associated with interconnection and access to a local carrier's facilities and services. (47 U.S.C. section 252.) If the negotiations fail, carriers can request that state commissions arbitrate disputes. Final negotiated or arbitrated agreements must be approved by the state commission. Agreements reached through negotiations are not subject to the standards set out in sections 251(b) and 251(c) of the Act nor are they subject to the pricing standards in 47 U.S.C. section 252(d). Beginning in September of 1996, we have successfully arbitrated and/or approved a number of agreements interconnecting carriers with Pacific Bell (Pacific) and GTE of California (GTEC).

The various California proceedings discussed above are developing the rules by which competition will begin to fully operate in California in the near future in accordance with both state and federal law.

On March 13, 1996 we issued D.96-03-020 which set forth the Phase II rules by which resale of the services of Pacific and GTEC could begin on March 31, 1996. We ordered Pacific and GTEC to offer various services for resale. Also we adopted wholesale rates for these services that reflect avoided retail costs consistent with federal law. (47 U.S.C. 252(d)(3).) Adopted wholesale rates generally reflect a 17% discount for Pacific and a 12% reduction for GTE, respectively, below current retail rates (with certain exceptions). The interim rules adopted in D.96-03-020 also include incumbent LEC and CLC retail pricing flexibility policies, rating area consistency, and recovery of the costs of implementing local exchange competition.

In D.96-03-020, the rules were found to be interim and designed to be modified, as we pass various milestones in the OANAD and Universal Service cases. Further, we noted that the measures it adopted were based on the best information available at the time. In the interests of maintaining California's leadership in creating a competitive telecommunications market, we initiated resale competition in D.96-03-020 even though the pathway toward a fully competitive market requires additional work. Accordingly, throughout this decision, we laid out remaining tasks to be completed in this as well as other proceedings in order to make a fully competitive market a reality. (Id., slip opinion at 3.)

Finally, we found that the transition will be lengthy to a fully competitive market "the incumbent LECs will likely not lose their market power overnight." (Id., slip opinion at 3.) As a result, we determined, in recognition of the LECs market dominance, that during the initial transition to a competitive marketplace, "the interim rules must retain certain restrictions on the LECs". (Id., slip opinion at 3.) We note that we intend "to continue monitoring the progress of competition on an ongoing basis and will consider modifying regulations for either the LECs or the CLCs when justified to allow the forces of competition to work." (Id., slip opinion at 3.)

On August 8, 1996 the FCC released its order on local competition, First Report and Order, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, et al., FCC 96-325, 61 Fed.Reg. 45475 (Aug. 19, 1996). In this order the FCC contends that sections 251, 252 and 253 of the 1996 Act require it to establish rules to govern interstate and intrastate prices for unbundled elements, interconnection, resale, collocation, and transport termination. Along with a number of other parties, we have challenged this FCC contention of jurisdiction over these intrastate areas. See Iowa

Utilities Board, et al v. Federal Communications Commission, Nos. 96-3321, et al. The case has been briefed and argued. The FCC also issued the Second Report and Order and Memorandum Opinion and Order Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, et al., FCC 96-333, 61 Fed. Reg. 47283 (September 6, 1996). This order has been appealed by us and deals with the FCC's authority to establish national dialing parity policies and related cost recovery standards for intrastate telephone service. See the People of the State of California v. Federal Communications Commission, Nos. 96-3519, et al. This case has been briefed but not yet argued. A decision in both of these cases should be issued in the near future.

On September 20, 1996, we issued a decision that dealt with the requests of Pacific and GTEC under the Takings Clause of the United States Constitution that they be compensated for the impacts of local entry resulting from our local exchange competition rules. The companies asserted that under the new competitive rules they can not earn a fair rate of return. We found that the carriers' quantitative evidence was too speculative at that time. Therefore, we allowed Pacific and GTEC to file at a later date to show whether our adopted new regulatory program "embodied in the roadmap proceedings combined with the NRF-established depreciation methods will deprive them of the opportunity to earn a fair return." (D.96-09-089, slip opinion at 3.)

It is within the context of this historical backdrop that we will consider the complaints raised by parties in the applications for rehearing of D.96-03-020.

On April 12, 1996 GTEC filed an application for rehearing asserting that we erred in ordering GTE to file tariffs containing rates for resale, we imposed onerous restrictions on the incumbent LECs' pricing flexibility, took their property in violation of the Fifth Amendment of the United States Constitution and allowed facilities based CLCs to establish their own rating areas before mitigation measures are implemented. On April 18, 1996 Pacific filed an application for rehearing asserting that we failed to provide adequate notice and hearing, failed to regularly pursue our authority, set rates at an unreasonable level, confiscated Pacific's property without due process and in violation of the Fifth Amendment of the United States Constitution, deprived Pacific of its equal protection under the law and violated section 709.5 of the Public Utilities Code. AT&T Communications of California Inc.(AT&TC), MCI Telecommunications Corp. (MCI) and the California Association of Long Distance Telephone Companies (CalTel) also on April 18, 1996 filed an application for rehearing asserting that D.96-03-020 violated the Telecommunications Act because it did not require the resale of all LEC services at wholesale rates, restricted Centrex/CentraNet services to be resold only as business systems to single businesses and not as a network infrastructure toll aggregation tool and adopted resale discounts which were too low to achieve resale competition. Responses were filed to the applications for rehearing by the Division of Ratepayer Advocates (DRA) (now known as Office of Ratepayer Advocates (ORA)), Pacific, GTEC, and AT&TC, MCI, Caltel, the California Telecommunications Coalition, California Cable Association, Sprint Communications Company, Teleport Communications Group and Time Warner AxS of California.

The applications for rehearing raise issues that fall into four categories: allegations that we have violated the Federal Telecommunications Act and California law, complaints that our decision was procedurally defective, assertions that our actions deprive Pacific and GTEC of their constitutional rights in that Pacific and GTEC are not receiving just compensation for resale of their services to competing carriers and that this underpayment accordingly amounts to a "taking" of their property in violation of the Fifth Amendment guarantee against the taking of property without just compensation. Pacific also asserts that its right to equal protection under the law has been violated.

II. FEDERAL AND STATE LAW

A. Resale of All Services

AT&TC, MCI and CalTel's initial complaint is that D.96-03-020 violates the Federal Act because it fails to require the resale of all incumbent LEC services at wholesale rates. While D.96-03-020 did not require the resale of all LEC services, it did find that the issue of which services are available for resale should be addressed in Phase III of the Local Competition Proceeding. (Id., slip opinion at 12.) We took this position because we did not have a complete enough record to immediately order the incumbent LECs to offer a broader range of services for resale beyond those authorized in the decision. (D.96-03-020, slip opinion at 20.) (See March 28, 1996 Ruling of Administrative Law Judge Pulsifer requesting Comments on several Phase III Resale Issues, including the definition of a resale service consistent with the Federal Act (Id., slip opinion at 12).) We realizes it must authorize all incumbent LEC retail telecommunications services for resale but it also must first evaluate the claims of incumbent LECs regarding the need for various resale restrictions and set the terms of resale. By providing a procedural plan for subsequently authorizing the resale of all incumbent LEC telecommunications services, D.96-03-020 is consistent with the Federal Act and there is no legal error.

B. Preemption of Resale Rates

In contrast to its competitors, GTEC asserts that under the Federal Act we may not set resale rates. GTEC claims that the Federal Act requires states to permit incumbent LECs to negotiate the terms and conditions of resale and permits state regulators to intervene in this process only after the negotiations either have led to an agreement or have failed and a party has invoked arbitration.

GTEC's position evidences a serious misunderstanding of the Act. State commissions have broad authority to implement local exchange competition consistent with state and federal law. (See 47 U.S.C. 261(c).) D.96-03-020's adoption of resale rates for incumbent LEC services was clearly consistent with its duties under the Act. (47 U.S. section 251(d)(3).) While the Act encourages negotiations, state commissions are able to set wholesale rates for incumbent LEC services separate from negotiations between the incumbent LECs and CLCs. Section 252(a) of the Federal Act make it clear that incumbent LECs and the CLCs can negotiate any reasonable, nondiscriminatory rate for resale services. (47 U.S.C. 251 (c)(4).) As of this date GTEC has completed a number of negotiated agreements which in some cases have departed from our prior decisions. Therefore, GTEC has not been constrained in negotiation because of our decision in the instant case.

GTEC continues to misinterpret the Act when it argues that the Federal Act (47 U.S.C. section 253(a)) has preempted any action by us that in any way regulates GTEC's ability to offer service in California. GTEC's argument is without merit. Section 253(a) concerns state regulations that "prohibit or have the effect of prohibiting" the provision of service. We are not prohibiting GTEC from offering any services by its pricing policies in the instant case. The Act recognizes that there is a difference from prohibiting the offering of a service and putting some reasonable regulatory control over the service offerings of incumbent LECs who maintain significant market power. (See the Joint Committee Report on 47 U.S.C. section 253 which found that "[e]xisting State laws or regulations that reasonably condition telecommunications activities of a monopoly utility and are designed to protect captive utility ratepayers from the potenial harm caused by such activities are not preempted under this section.")

C. Centrex/Centranet

Next AT&TC, MCI and CalTel claim that we violated the Federal Act by allowing Centrex/CentraNet services to "be resold only as a business system to single businesses and not as a network infrastructure, toll aggregation tool...". (D.96-03-020, slip opinion at 25; AT&TC, MCI and CalTel's application for rehearing at 3-5.) Petitioners assert that the Federal Act permits only a narrow class of resale restrictions. (See 47 U.S.C. section 251(c)(4).) However, we legitimately justified our action by concluding that such a limitation at least on an interim basis would prevent use of Centrex as a "toll aggregation tool that undermines the federal law on presubscription timing." (D.96-03-020, slip opinion at 25.) We recognized that an augmented record was needed regarding the justification for Centrex and CentraNet resale restrictions and said that in Phase III, we would examine the rationale for Centrex resale restrictions and the potentially broader uses of Centrex and CentraNet services for resale. Therefore, this issue of appropriate Centrex and CentraNet resale restrictions is currently before us in Phase III of the instant proceeding. We have committed no legal error and thus, there is no reason to grant a rehearing of Centrex/CentraNet resale restrictions.

D. Section 709

Next Pacific and GTEC contend that we violated Public Utilities Code sections 709.5(a) and 709(e). (Pacific's application for rehearing at 35; GTEC application for rehearing at 21.) These sections require us to "take steps to ensure that competition in telecommunications markets is fair..." and that we promote competition "in a way that encourages greater efficiency." In the instant decision we have met the requirements by opening up the markets to competition in a fair and even handed manner.

III. PROCEDURAL DEFECTS

A. Due Process Rights

Pacific along with AT&TC, MCI and CalTel all complain that our resale discounts are, for different reasons, not based on the record. (Pacific's application for rehearing at 18; AT&TC, MCI and CalTel's application for rehearing at 8.) First, Pacific asserts that its due process rights were violated because they were given no notice, and consequently no opportunity to put on evidence, that we planned to apply discounts to the resale of many services that are not "basic" services. In D.95-07-054 we gave notice that we anticipated adopting "subsequent rules governing the provision of local exchange service" by March 1, 1996. (See Id., Slip opinion at 47, Ordering Paragraph 4.) Local exchange service included services other than basic exchange access lines. Furthermore in the instant case there were a number of instances when witnesses discussed applying discounts to services beyond basic exchange service. Specificially, AT&T/MCI witness Dr. Selwyn testified that his avoided cost analysis applied to all incumbent LEC services. (Tr. Vol. 16 at 2816, Exh. 45, pg. 5.) Also LDDS WorldCom's (LDDS) witness Dr. Gillan stated that local loops, switching, call termination and switched-based vertical features should be available for resale at the incumbent LECs' total service long run incremental cost of providing service. (EX. 33, pg.4 of Comments of LDDS, fn. 6.) Thus, Pacific was given notice that we were going to look at authorizing resale of services beyond basic exchange service in D.95-07-054. In the instant case, evidence was presented dealing with these issues. In addition to evidentiary hearings, parties also filed written comments in Phase II regarding the resale of a range of incumbent LEC services. Therefore, Pacific had adequate notice that we were considering authorizing the resale of all local exchange services at wholesale prices, and had the opportunity to be heard on this issue.

B. Lack of Evidence - Residential Services

Next, AT&TC, MCI and CalTel assert that the "Commission's decision, particularly as it applies to the nominal discounts adopted for residential service, is not based on the evidence in the record as required by the Commission's Rules of Practice and Procedure." (AT&TC, MCI and CalTel's application for rehearing, pg. 8.) Pacific also asserts that there is no record for the residential service discount which was adopted. (Pacific's application for rehearing, pg. 18.) In D.96-03-020, we adopted lower discounts for residential services (10% and 7%) for Pacific and GTEC respectively in comparison to other services (17% and 12%). A review of the record indicates that the parties are correct that there is not a sufficient record to support the adopted discounts for residential service. (See Commissioners Duque and Neeper's Dissent, slip opinion at 1.)

Instead the record supports the use of avoided cost wholesale discounts of 12% for GTEC and 17% for Pacific for residential services. These interim discounts adopted in D.96-03-020 are appropriate for residential services because the average discount rates of 17% and 12% were developed from the accounting data presented in evidence reflecting the entire range of the regulated incumbent LEC operations, including residential services. Further, these discounts reflected the average avoided cost of retailing all incumbent LEC retail services. Therefore, the record supports the position that all of the incumbent LEC retail telecommunications services authorized for resale should be priced using a uniform discount based upon company-wide average avoided costs.

While the individual avoided costs of specific services making up the average may vary either above or below the average, the record in this case clearly supports the conclusion of law that use of an average avoided cost discount provides an acceptable interim measure for CLC wholesale discounts pending development of more precise discounts for residential, as well as other services in the OANAD proceeding. The incumbent LECs in their arguments complain that we have set the resale rates at discounted wholesale prices and not at retail prices. The incumbent LECs believe wholesale residential service should have no discount applied because residential service is priced below its costs, thus, resulting in zero avoided costs embedded in the retail rate. This claim is challenged by other parties. We disagree, it is the avoided cost of the service, not the avoided revenue which is the relevant determinant of a wholesale discount in comformance with the Act. (See D.96-10-066 where we adopted a universal service program which recognizes that incumbent LECs have implicit subsidies in their rates and replaces them with explicit subsidies-known as the California High Cost Fund.)

However, whether or not the claim is true that residential services are priced below cost, the costs of providing the service do not change. Therefore, there are still retail costs which can be avoided by the incumbent LECs in offering residential service on a discounted wholesale basis. In applying these avoided costs, the 12% and 17%, to residential services, we are complying with the legal mandate established under the Act that all services offered for resale must be discounted based on avoided retailing costs. (47 U.S.C. sections 251(c)(4), 252(d)(3).) Therefore, Pacific and GTEC's arguments fail.

Instead, in this order we grant rehearing on the issue of the proper discounts for residential service. No further proceedings are necessary, as the existing evidentiary record, the application for rehearing, and briefs in response to it provide an adequate basis for the order on rehearing. Based on the record and the arguments above we order 12% and 17% discounts for GTEC and Pacific respectively for residential service.

C. Sections 451 and 728 - Essential Facilities Doctrine

Next, Pacific claims that we have violated Public Utilities Code sections 451 and 728 and the essential facilities doctrine. (Pacific's application for rehearing at 25, 26.) These code sections require that rates be set at fair and reasonable levels. The essential facilities doctrine is an antitrust concept that requires facilities to be sold to competitors at reasonable rates. (See Southern Pacific Communications Co. v. AT&T, (D.C. Cir. 1984) 740 F.2d 980, 1009; United States v. Terminal Railroad Association, (1912) 224 U.S. 383, 411; Rogers Radio Comm. Services, Inc. v. FCC, (D.C. Cir 1985) 751 F.2d 408, 414, 415.) The standard we must follow is that rates be set at just and reasonable levels. However, current law does not require we set a rate for a particular service so it recovers all costs associated with providing that "product or commodity". (See Giles Lowery Stockyards v. Depart. of Agriculture (5th Cir. 1977) 565 F.2d 321, 327.)

In the instant case, we noted that since the incumbent LECs could charge rates based on avoided retail costs and would avoid these costs at the wholesale level, the net effect on the incumbent LECs of applying these discounts to residential retail rates should be zero. Under this scheme, the incumbent LECs should be indifferent to the sale of these services whether the services are sold at the retail or wholesale level. For wholesale customers the incumbent LECs earn lower revenues but also have lower costs. The bottomline net revenue is the same for retail and wholesale services. Further, if the incumbent LECs' retail rates are below cost as they assert (a contention disputed by other parties and before us in the OANAD proceeding), they are not worse off on a net earning basis because wholesale rates are based on current tariffed rates.

GTEC and Pacific also ignore the fact that we have recognized and addressed the issue of residential service priced below cost in our Universal Service proceeding. D.96-10-066 established a mechanism called the California High Cost Fund-B which recognizes that implicit subsidies exist and replaces them with explicit subsidies. The California High Cost Fund operates by identifying high cost areas within the serving areas of California's large LECs. Carriers of Last Resort, including GTEC and Pacific, are eligible for the difference between the cost to serve these areas and the combination of their residential flat basic rates and the Federal End User Common Line Charge in high cost areas. An adjustment is also made for Federal Carrier Common Line Charge revenue. In this proceeding we have addressed Pacific and GTEC's concerns about below cost pricing of residential service.

Given this history, the incumbent LECs' current complaint that the rates we set for basic service in prior rate cases were confiscatory, amounts to a backdoor full scale challenge to the universal service proceeding and the entire rate design set in prior cases. The opportunity to challenge these decisions has passed, and this case is not an appropriate venue to raise this issue. Instead if the incumbent LECs feel that the current rate design should be changed to reflect new conditions, the appropriate vehicles are a petition for modification of our prior rate design and/or universal service decisions or an application to raise rates.

In sum, contrary to Pacific's argument, the Code allows for some rates to be set below cost if other revenues are sufficient to give a utility the opportunity to earn a fair return. Similarily, our decision on resale competition is consistent with the essential service doctrine. In United States v. Terminal Railroad, supra, 224 U.S. at 411, the Court required access to essential facilities to be given to competitors "upon such just and reasonable terms and regulations as will, in respect of use, character and cost of service, place every such company upon as nearly an equal plane as may be with respect to expenses and charges as that occupied by the proprietary companies." Accordingly, our order in this case is fully consistent with antitrust principles and sections 451 and 728 of the Public Utilities Code.

The real issue that the incumbent LECS are complaining about is that we set the resale rates at wholesale prices and not at retail prices. However, under the Federal Act we are compelled to set wholesale rates at avoided retail costs. (47 U.S.C. sections 251(c)(4), 252(d)(3).)

D. Resale Discounts

Next, AT&TC, MCI and CalTel (AT&TC, MCI and CalTel's application for rehearing at 8) assert that the resale discounts are too low to achieve vibrant resale competition. While the record contains certain evidence supporting the higher discounts, it also contains other evidence supporting the discounts that were adopted. Therefore, we have made a decision based on a weighing of the record evidence in this case which is consistent with the just and reasonable rate requirement in sections 451 and 728 of the Public Utilities Code. It should also be pointed out that the rates in the instant decision are interim and will change as competition gets underway and a more permanent rate structure is developed in OANAD.

E. Avoided Costs

Finally, Pacific in its application complains that in several ways we miscalculated the final discounts adopted as "avoided cost" (Pacific's application for rehearing at 10-16) and also failed to order a "true up" of Pacific's losses from resale at a later time. (Pacific's application for rehearing at 23.) In these discussions Pacific is rearguing positions it took in the proceeding. In the instant case we considered these arguments and rejected them on the merits.

F. Implementation Costs

Pacific asserts that it should have been given an opportunity to recover all resale implementation costs, including those incurred prior to January 1, 1996, the date when competition was first allowed for the facilities based competitors. (Pacific's application for rehearing at 22.) We found that "[m]erely because a LEC is expected to incur additional costs as part of providing service, there is no automatic entitlement that it be made whole for such costs on a dollar-for-dollar basis. In a competitive market, firms are not guaranteed recovery of specific costs on a dollar-for-dollar basis. Instead, competitive firms must recover their costs through the normal course of business by competing for greater sales or by being more efficient." (Id., slip opinion at 90.) The Decision goes on to say that we will allow Pacific and GTEC an opportunity to recover "reasonably incurred costs to implement competitive local exchange service....[and] it is not unreasonable that end-users pay for such costs." (Id., slip opinion at 90.) We then found that the incumbent LECs could establish a memorandum account to record actual implementation costs incurred on and after January 1, 1996, the date when local exchange competition was officially instituted. (Id., slip opinion at 112, Ordering Paragraph 22.) We warned that "[t]he LECs will have to demonstrate that the costs they seek to recover provide benefits to the public interest and are consistent with our general policy for establishing end-user surcharges." (Id., slip opinion at 91.) We went on to say that "[t]he authorization to track recorded costs should not be construed as an assurance that recorded costs will automatically be subject to recovery through a surcharge." (Id.) Finally, we required the incumbent LECs to submit their recorded costs to us on January 1, 1997. (Id.)

In D.96-03-020 we allowing the incumbent LECs to have an opportunity to recover implementation costs from the date when facilities based competition was first authorized. We permitted accruals in the memo accounts to begin January 1, 1996, the date when facilities based competition was first authorized by us. Thus, the incumbent LECs have been provided a reasonable opportunity to seek to recover their implementation costs concurrent with our order instituting local exchange competition. The incumbent LECs decision to invest in competition related expenses before the January 1, 1996 date was a business decision and not an activity ordered by us. Accordingly, there is no basis for rehearing on this issue.

G. Rating Centers

In their applications, Pacific and GTEC contend that we erred in allowing the facilities based CLCs to establish their own rate centers for rating and pricing calls. (Pacific's application for rehearing at 24 and GTEC application for rehearing at 31.) In the instant case, we attempted to balance the CLCs' desire to establish their own rating centers and the incumbent LECs' interests in preventing confusion and misrating. In the instant decision, we conclude that CLCs can, but are not required to, open a separate NXX code in each rate center in which they offer service. (Id., slip opinion at 79.) However, CACD (now the Telecommunications Division) is required to develop a program to mitigate the customer confusion and misrating problems that may arise from inconsistent rating areas. (Id., slip opinion at 80.) Clearly, we attempted to assist in the transition by requiring workshops to implement "steps and timetable for implementing a customer awareness program regarding new procedures for determining how calls will be rated as CLCs establish NXX rating areas which differ from those of the LECs." (D.96-03-020, slip opinion at 111, OP 18(d).) Phase III is a forum to further address the issue raised herein. No legal error was committed us on this issue.

IV. ECONOMIC TAKING

Pacific and GTEC's economic taking argument asserts that we have erred in ordering Pacific and GTEC to resell services at wholesale prices minus avoided costs. Pacific and GTEC are alleging a violation of the takings provisions of both the California and federal constitutions. Since the law is similar under both constitutions, no distinction is made in the discussion. (Pacific's application for rehearing at 28; GTEC application for rehearing at 13.)

The Takings Clause of the Fifth Amendment of the United States Constitution provides that "private property" may not "be taken for public use, without just compensation." In Yee v. Escondido, (1992) 503 U.S. 519, 522, the Court refers to "regulatory takings" as those cases in which the government does not actually take property for its own use. Rather, it regulates property in a way that creates the "functional equivalent" of an "ouster." In Duquesne Light Co. v. Barasch, (1989) 488 U.S. 299, 307, the U.S. Supreme Court recognized that regulated utilities have an unusual "partly public, partly private status" that "creates its own set of questions under the Takings Clause of the Fifth Amendment."

Duquesne analyzes utility-related taking issues by focusing on whether rates properly compensate utilities for the property they have dedicated to public use. (Duquesne, supra, 488 U.S. at 307, 310.) The Court has interpreted this to mean that an unlawful taking or confiscation occurs if a regulation or rate is unjust and unreasonable. More specifically, a rate order violates the just compensation requirement only if the "net effect" or "end result" is confiscatory. Whether a regulation or rate is just and reasonable depends on a balancing of the interests of the regulated entity providing the services and the interests of the consumers of such services. (Federal Power Com. v. Hope Nat. Gas Co., (1943) 320 U.S. 591, 603; see also 20th Century Ins. Co. v. Garamendi, (1994) 8 Cal.4th 216, 293, cert.

denied, 115 S.Ct. 1106 (1995).) "'The "just and reasonable" principle does not require "that the cost of each company be ascertained and its rates fixed with respect to its own costs. [Citation ommitted] It is permissible for an agency to use average costs rather than the costs of individual [utilities].'" (Id., citing Giles Lowery Stockyards v. Depart. of Agriculture, supra, 565 F.2d at 327. See also Permian Basin Area Rate Cases, (1968) 390 U.S. 747, 818-819.) "[A] regulated industry is not entitled, as a matter of right, to realize a particular rate of return, and the interests of the consuming public are also to be considered in establishing rates." (Giles Lowery Stockyards v. Depart. of Agriculture, supra, 565 F2d at p. 324.) "That a particular rate may not cover the cost of a particular good or service does not work confiscation in and of itself." (20th Century Ins. Co. v. Garamendi, supra, 8 Cal.4th at 293.) Further, a regulated entity neither has a constitutional right to a profit nor a constitutional right against a loss. (Id. at 294.) "The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid." (Federal Power Com. v. Hope Nat. Gas Co., supra, 320 U.S. at 601.) It is well settled that, within reasonable bounds, companies operating in regulated industries have no vested interest in any particular regime. (Duquesne, supra, 488 U.S. at 316.) When regulation has only a "minor diminution" in value, an applicant's claim of "taking" is without merit. (Penn Central Transportation Co. v. New York City, (1977) 430 U.S. 104, 124.) "[T]he only circumstances under which there is a possiblity of a taking of investors' property by virtue of rate regulation is when a [firm suffers]...deep financial hardship" because of the regulatory scheme imposed by the state. (20th Century Ins. v. Garamendi, supra, 8 Cal.4th at 296.)

Moreover, unlike physical taking cases, in economic taking cases such as the instant case, "[l]oss of future profits--unaccompanied by any physical property restrictions -- provides a slender reed upon which to rest a takings claim....Further, because of its very uncertainty, the interest in anticipated gains has traditionally been viewed as less compelling than other property-related interests." (Andrus v. Allard, (1979) 444 U.S. 51, 66.)

Further, "[t]here is . . . no constitutional right of freedom from competition. . . . Freedom from competition is not a compensable property right under the provisions of the California Constitution, article I, section 19." (Peerless Stages, Inc. v. Santa Cruz Met. Transit Dist., (1977) 67 Cal.App.3d 343, 347; See Re Natural Gas Procurement and Reliability Issues, D.92-02-042, slip opinion at 36-37.)

"The loss of, or the failure to obtain, patronage due to competition does not justify the imposition of charges that are exorbitant and unjust to the public. The clause of the Constitution here invoked does not protect public utilities against such business hazards. [Citations omitted.]" (Public Serv. Com. of Montana v. Great Northern Util. Co., (1933) 289 U.S. 130, 135.) More importantly, the law on taking "has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces." (Market Street R. Co. v. Railroad Com. of Cal., (1945) 324 U.S. 548, 567.)

The Fifth Amendment does require that the courts focus on the financial health of a carrier's regulated operations as a whole and not just the rates for each service to be compensatory. A confiscatory result could happen when the regulation at issue "threatens the financial integrity of the [regulated carrier] or otherwise impedes [its] ability to attract capital." (Illinois Bell Telephone Co. v. FCC, (D.C. Cir. 1993) 988 F.2d 1254, 1263.)

Finally, the instant case is one in which the applicants are alleging an economic taking relating to monetary investment. Therefore if Pacific and GTEC do not "lose money on [their] over all business, it is hard to think that it could successfully charge that its property was being taken for public use 'without just compensation.'" (Baltimore & Ohio R.R. Co. v. United States, (1953) 345 U.S. 146, 148.) (See Franchise Impacts Decision, D.96-09-089, where we could not find as of September 1996 that "our local competition rules have changed our regulatory structure so drastically as to have violated our obligation to ensure an opportunity to earn a fair return on investment and a fair opportunity to recover invested capital for either GTEC or Pacific." (Id., slip opinion at 71, Conclusion of Law 12.)

In the instant case, we directed the incumbent LECs to resell their services on an interim basis to allow for the opening of competition in the local exchange market. (D.96-03-020, slip opinion at 100, Conclusion of Law 1.) Under established doctrine relating to "takings", the question that we must decide is whether this interim "resale" pricing scheme which we have directed the incumbent LECs and CLCs to use for no more than two years, amounts to a taking of Pacific and GTEC's property in violation of their state and federal constitutional rights.

A. Nature of the Regulation

In conducting this inquiry, we should look to the character of the regulation at issue. The Federal Act and state law remove barriers to competition by requiring the incumbent LECs to open their networks to competition. (AB 3720 (Costa, Chapter 934, Stats 1994; AB 3606 (Moore, Chapter 1260, Stats. 1994); Pub. L.No. 104-104, 110 Stat.56, codified at and amended the Communications Act of 1934, 47 U.S.C. section 151, et seq. (1996).) At this time the incumbent LECs own most of the equipment that connects a telephone to a switch, which routes calls from one telephone to another. Because of this, federal and state law do not require competitors to construct fully redundant networks to enter the telephone business. Instead the law allows competitors to buy from incumbent LECs, services at wholesale prices based upon the incumbent LECs' retail charges, "excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided" by selling at wholesale. (47 U.S.C. sections 251(c)(4), 252(d)(3).)

In the instant case we found our "resale" pricing scheme to be interim in nature. (D.96-03-020, slip opinion at 100, Conclusion of Law 1.) We have set hearings to investigate the proper methodology to use in setting the final prices to be paid by a CLC to buy an incumbent LEC's services "at wholesale rates based on avoided retail costs" and to resell the services to end users. (47 U.S.C. section 251(c)(4).) We hope to have a decision in place by next year on this issue. (See <u>Yee v. Escondido</u>, <u>supra</u>, 503 U.S. at 522; <u>Penn Central Transportation Co. v. New York City</u>, <u>supra</u>, 430 U.S. at 124.)

B. <u>Just and Reasonable</u>

Even acknowledging the interim nature of the regulations, Pacific and GTEC complain that a taking occurs because some of their retail rates are priced below cost and subsidized by other regulated services that face competitive pressures.

By establishing interim rates based on avoided retail costs (the current regulated rate), we were preserving the status quo pending the outcome of the OANAD proceedings. In the instant case, we noted that since the incumbent LECs could charge rates based on avoided retail costs and would "avoid these costs at the wholesale level, the net effect on the [incumbent] LECs of applying these discounts to residential retail rates should be zero". (D.96-03-020, slip opinion at 33.) Under this scheme the incumbent LECs generate the same net revenue on these services whether the services are sold at the retail or wholesale level. For wholesale customers the incumbent LECs earn lower revenues but with lower costs. Therefore, our resale prices do not affect Pacific and GTEC's overall revenues. Further, if the incumbent

LECs' retail rates are below cost as they assert (a contention disputed by other parties and before us in the OANAD proceeding), they are not worse off on a net earnings basis because this is the current regulated rate. (See 20th Century Ins. Co. v. Garamendi, supra, 8 Cal. 4th at 293; Giles Lowery Stockyards v. Depart. of Agriculture, supra, 565 F.2d at 327.)
(p. 32)

As we discussed previously, with our Universal Service Decision (96-10-066) we recently created the California High Cost Fund-B which addresses the concerns raised by Pacific and GTEC about the vulnerability of implicit subsidies. Under this program Pacific is expected to receive over $300 million per year in explicit universal service support. This support will be funded through an end user surcharge on the bills all carriers charge for intrastate services. The source of the subsidy is competitively neutral and will not be subject to competitive pressure. Pacific has recently applied to reduce its toll rates by $298 million and its switched access rates by $7.4 million to remove implicit subsidies embedded in those rates. (Application Number 97-03-004, March 6, 1997.) We have recognized and addressed Pacific and GTEC's legitimate concerns about implicit subsidies.

C. Benefits vs. Harms

As to the degree of impact of the regulation on applicants' monetary investment, it must be kept in mind that without some type of resale in place, local exchange competition cannot even begin in any type of meaningful way. Moreover, during the first and second years of local exchange competition, we have not found that viable local competitors are fully operative. (See Testimony of March 18, 1997 Hearing in Order Instituting Rulemaking and Investigation on the Commission's Own Motion into Competition for Local Exchange Service, R. 95-04-043, I.95-04-044.) Therefore, there is little risk of economic harm to Pacific and GTEC from our interim approach. (See Penn Central Transportation Co. v. New York City, supra, 430 U.S. at 124.)

In this new environment, Pacific and GTEC will have more flexibility to enter new markets, greater control over the rates which they can charge for their services, the ability to reach more customers, and thus earn more profits. Both the Federal Act and California law open these new opportunities for the incumbent LECs to grow their businesses and gain economically. (Illinois Bell Telephone Co. v. FCC, (D.C. Cir. 1993) 988 F.2d 1254, 1263.)

Moreover, Pacific and GTEC cannot hide behind their taking arguments to insulate themselves from the economic forces of competition, or to insure recovery of all costs that have been affected by such forces. Neither the California or federal constitutions protect applicants from these forces. Taking does not occur because the regulatory scheme replicates the rates that would be charged in a competitive market. The Fifth Amendment does not shield carriers from losses due to competition. (See Public Service Comm'n of Montana v. Great Northern Utilities Co., (1933) 289 U.S. 130, 135; Market Street R. Co. v. Railroad Com. of Cal., (1945) 324 U.S. 548, 567.) In sum, as shown above, Pacific and GTEC's taking arguments concerning resale of services at wholesale rates are without merit.

V. EQUAL PROTECTION RIGHTS

Pacific next asserts that its equal protection rights have been violated because it, as the incumbent provider of local exchange service, is held to stricter rules and regulations than it potential competitors. (Pacific's application for rehearing at 32.)

The standard for review for equal protection claims to social and economic legislation is the rational basis test. The U.S. Supreme Court has held in New Orleans v. Dukes, (1976) 427 U.S. 297, 303, that:

"Unless a classification trammels fundamental personal rights or is drawn upon inherently suspect distinctions such as race, religion, or alienage, our decisions presume the constitutionality and require only that the classification challenged be rationally related to a legitimate state interest."

The United States Supreme Court also used the rational basis test in Minnesota v. Clover Leaf Creamery Co., (1981) 449 U.S. 456. That case involved Minnesota's ban of the sale of plastic nonreuseable milk containers in order to promote energy conservation. Paperboard nonreuseable milk containers, however, had been grandfathered. Plastic container manufacturers claimed their equal protection rights had been violated. The Court, presented with contradictory evidence as to whether the statute would actually promote conservation, applied the rational basis test and found it irrelevant whether the statute would actually have the effect of promoting conservation. Rather, it was only necessary that the Legislature could rationally have believed that the statute would have this effect. The rational basis test is applied virtually identically in both the California and federal courts. The California Supreme Court has stated, in United States Steel Corp. v. Public Utilities Commission, (1981) 29 Cal.3d 603, 612, that the "most that we require of [the correspondence between the classification and the legislative goal] is that it be rational--i.e. that ... the classification be found to rest upon 'some reasonable differentiation fairly related to the object of regulation'." (Emphasis in original.) (See also Hays v. Wood, (1970) 25 Cal.3d 772, 786-787.)

In the instant matter, we have over the span a almost a century, pursued a regulatory policy towards Pacific and GTEC that has had a rational basis. In the last several years we have moved away from cost of service regulation to incentive based regulation. We have also opened up various telecommunications markets to competition. (See above for detailed description of the Commission's actions in this area.) However, none of these moves has as yet resulted in a fully competitive market. (See Testimony of March 18, 1997 Hearing in Order Instituting Rulemaking and Investigation on the Commission's Own Motion into Competition for Local Exchange Service, R. 95-04-043, I.95-04-044.) Therefore, it is necessary for us to continue to regulate the incumbent LECs in a different manner than their competitors because the incumbent LECs are in a very different position from their competitors at this time. However, we have made a commitment to revisit this issue as conditions change.

Finally, GTEC raises the argument that we have erred when it imposed restictions on the incumbent LECs pricing flexibility. (GTEC's application for rehearing at 24.) While GTEC has many complaints in this area, none of them deal with legal error. Instead GTEC wants us to change our policy based on GTEC's competitive concerns. The issues raised by GTEC have been fully briefed in the instant case, we have considered these arguments and rejected them.

VI. CONCLUSION

AT&TC, MCI, CalTel and Pacific's applications for rehearing is granted in part relating to wholesale discounts for residential service but as to all other issues, the applications for rehearing for all parties are denied because they fail to raise legal error.

We have reviewed all other allegation of the applications for rehearing and believe that there are no other grounds for rehearing as set forth. Having fully considered the issues raised, Pacific, GTEC, AT&TC, MCI and CalTel's applications for rehearing of D.96-03-020 are denied.

VII. FINDING OF FACT

1. The record supports the use of avoided cost wholesale discounts for residential services of 12% for GTEC and 17% for Pacific.

VIII. CONCLUSION OF LAW

1. Rehearing is granted but no further proceedings are necessary, as the existing evidentiary record, the application for rehearing, and any briefs in response to it provide an adequate basis for the order on rehearing.

2. The interim discounts of 12% and 17% for GTEC and Pacific respectively are appropriate for residential service because the average discount rates of 17% and 12% were developed from the accounting data presented in evidence reflecting the entire range of the regulated incumbent LEC operations, including residential services. Thus the use of a uniform discount based upon company-wide average avoided cost is adopted.

ORDER

Therefore, **IT IS HEREBY ORDERED** that:

1. Rehearing is hereby granted for the purpose of using a uniform discount for residential service based upon company-wide average avoided cost.

2. The Ordering Paragraphs 4, 5 and 6 from D.96-03-020 are hereby modified in the following manner: For residential customers, Pacific and GTEC shall establish wholesale tariff rates equal to their current residential 1MR and 1FR retail rates with an adjustment for avoided retailing costs of 17% for Pacific and 12% for GTEC.

3. As to all other issues, the applications for rehearing for all parties are denied.

This order is effective today.

Dated April 23, 1997, at San Francisco, California.

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

I dissent.

/s/ HENRY M. DUQUE
Commissioner

I dissent.

/s/ JOSIAH L. NEEPER
Commissioner

MISSING DECISION #'S

D. 97-03-021

D. 97-03-026

D. 97-03-041

D. 97-04-073

DECISION NO._______________ CASE NO._______________ APP.NO._______________