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Decision 97-08-060 August 1, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of AT&T Communications of California, Inc. to be designated a non-dominant interexchange carrier.	Application 94-05-042 (Filed May 18, 1994)

ORIGINAL

William A. Ettinger, Attorney at Law, for AT&T Communications of California, Inc., applicant.
Thomas Long, Attorney at Law, for The Utility Reform Network, intervenor.
Janice Grau, Attorney at Law, for the Office of Ratepayer Advocates.[1]

[1] The Division of Ratepayer Advocates (DRA) entered an appearance in this proceeding. By Executive Director memorandum dated September 10, 1996, all functions of DRA were transferred to the Office of Ratepayer Advocates (ORA).

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FINAL OPINION

By this application, AT&T Communications of California, Inc. (AT&T) requests a change in its regulatory designation from "dominant" to "non-dominant" carrier of interexchange services.

I. Background

Following the antitrust consent decree breaking up the American Telephone & Telegraph Co., the Commission in Decision (D.) 84-06-113 adopted a two-tiered framework for regulation of interexchange service companies. We designated AT&T, which at the time had roughly 95 percent of the intrastate interLATA market, a "dominant" interexchange carrier (IEC). As such, we made it subject to traditional rate base/return regulation. In contrast, we designated AT&T's competitors "nondominant" interexchange carriers (NDIECs), with less stringent regulatory controls.[2] The dominant/non-dominant framework rests on the concept that dominant carriers have the market power either to "extract monopoly profits or to price predatorily, while [non-dominant carriers have] the power to do neither." (15 CPUC 2d 423, 467 (1984).) Even then, however, we recognized the emergence of competition in the interexchange market, and noted that "[a]fter equal access allows competitors to provide equivalent service, we will entertain AT&T's application for more flexible regulation." (*Id.* at 473.)

Over the years, we have relaxed the regulatory requirements on AT&T, such as by granting it pricing flexibility and removing requirements that AT&T use local exchange company (LEC) billing services. However, the Commission has continued to impose more regulatory controls over AT&T than its competitors. Rulemaking (R.) 92-08-008 proposed more stringent regulation on AT&T than its competitors with

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[2] As NDIECs, AT&T's competitors had the "freedom to set and change their rates as their self-interests indicate, subject only to such conditions as are necessary to protect their customers from exploitation." (15 CPUC 2d 423, 473 (1984).) The current regulatory framework for NDIECs is set out in D.90-08-032, D.91-10-041, D.91-12-013 and D.92-06-034.

regard to affiliated transactions. R.93-04-003 proposed more stringent open access and network architecture development rules on AT&T than its competitors.

On May 18, 1994, AT&T filed this application requesting that the Commission designate it a NDIEC and impose upon it the same regulatory requirements as all other NDIECs. It asks that the Commission retain the "Observation Approach" and the Monitoring Plan established by D.88-12-091, modified by D.93-02-010, which the Commission adopted as part of a program permitting AT&T pricing flexibility. AT&T asserts that it no longer has market power as defined by the Commission in D.87-07-017 and which would require it to be subject to more regulatory oversight than its competitors.

II. Procedural History

On April 10, 1996, in an interim opinion,[3] the Commission rejected AT&T's and the ORA's joint motion to adopt the settlement[4] filed in this proceeding on September 27, 1995. We denied the settlement because it raised several troubling issues of policy and law. Moreover, the proposal did not resolve the issues raised by the application, but deferred their consideration to a later date.

Following a May 1996 prehearing conference which set out the contested issues, this matter went to evidentiary hearings on September 11-12, 1996. AT&T, ORA and The Utility Rate Network (TURN) participated in the hearings. AT&T presented

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[3] D.96-04-058.

[4] The settlement would have required AT&T to:1) remain designated as the dominant interexchange carrier in the California interexchange market for a period of time; 2) continue to provide reports not required of NDIECs, and provide new reports as well as new information to its customers; 3) institute a price protection plan for Universal Lifeline Telephone Service subscribers; and 4) submit testimony in two years so that the Commission could reach a final decision concerning AT&T's non-dominance. In return, the settlement provided that AT&T would not be subject to rate of return regulation, that the company would suspend monthly reporting of rate of return data and report such data annually, and that AT&T would be permitted, as are all NDIECs, to bundle tariffed services with non-tariffed products.

witnesses and testimony. The parties submitted opening briefs on October 18, 1996, and reply briefs on November 1, 1996.[5]

On October 21, 1996, TURN filed a motion to require AT&T to flow through the full benefits of the Implementation Rate Design (IRD) access cost reductions to consumers; to rescind its recent increases to directory assistance and service charges; and to disclose service charges on customer bills. AT&T responded on November 5, 1996. We find that there are no legal grounds for granting the relief requested on the basis of a motion. Moreover, we decline to grant TURN's alternate request that we hold further evidentiary hearings on the basis of statements that focus only on one IEC. Motion denied.

III. Positions of the Parties

A. AT&T

AT&T seeks to be regulated, in all respects, as are NDIECs. Specifically, AT&T requests that the Commission affirm that AT&T is no longer subject to rate of return regulation, that its continuing reporting requirements will be the same as all other NDIECs in California, that hereafter it may bill its customers without unique restrictions, and that AT&T will receive the same treatment as all other NDIECs in future Commission proceedings.

AT&T maintains that the "unrefuted and overwhelming" evidence that it presented demonstrates that the California interexchange market is effectively competitive, and that AT&T does not possess market power. The company asserts that an assessment of AT&T's position within the present California interexchange marketplace, utilizing the eight criteria of the Observation Approach,[6] shows the appropriateness of the requested regulatory adjustment.

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[5] ORA requested corrections to the transcript on November 1, 1996. None of the parties objected to the corrections; therefore, they are accepted.

[6] The eight criteria of the Observation Approach are:1) determination of the relevant market; 2) market share, with an evaluation of trends, rather than static measurements; 3) AT&T and

Footnote continued on next page

AT&T presented evidence that its market share has declined from almost 80% in 1987, to approximately 55% in 1996 (Exhibit (Ex.) 2,[7] attachment 1), notwithstanding more than $1 billion in price reductions (Ex. 2, attachment 27). It compared California Intrastate Annual Growth in minutes of use and revealed that AT&T's competitors have grown at three times the rate of AT&T since 1987 (Ex. 2, attachment 2). Competitors have entered the California market at an average rate of approximately 40 per year (Ex. 2, attachment 7a), and thirteen of the NDIECs are affiliates of local exchange carriers (Ex. 2, attachment 7b). AT&T's competitors had no significant facilities in 1984, but in 1996 they controlled "78.53% of the activated circuit miles serving the California interLATA market." (Ex. 1 at 8.)[8] In addition, the company's competitors control over 80% of the points-of-presence in California, including rural areas of the state. (Ex. 1 at 10, Appendix 11.)

Dr. John W. Mayo's testimony[9] presented the company's economic framework and analysis of the data in terms of the eight-prong Observation Approach. Dr. Mayo testified that the fact that close to 500 interexchange companies today provide service in California suggests that entry into the interexchange market is very easy. Specifically, economic barriers to entry and exit are low. In addition, despite declining prices of incumbent firms, Dr. Mayo stated that these new entrants' unceasing rapid growth rates indicate that barriers to expansion are also very low. He further maintained that these factors strongly show that the type of bottleneck conditions which characterize other segments of the telecommunications industry do not restrain

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NDIEC (originally referred to as other common carriers) earnings; 4) NDIEC facilities ownership, based on actual facilities; 5) ease of market entry and exit; 6) NDIEC size and growth potential; 7) equal access and other technical factors; and 8) service options and customer satisfaction.

[7] Direct Testimony of John Sumpter.

[8] Direct Testimony of Del R. Guynes.

[9] Ex. 12.

either entry or expansion in the state's interexchange market.[10] As a whole, Dr. Mayo asserted, the data signifies a very high elasticity of supply which "imposes significant competitive discipline on the...IECs."[11] Moreover, he suggested that the Telecommunications Act of 1996, with its prescription for LEC interexchange entry both within and outside of the areas in which they currently operate, will undoubtedly increase the pool of potential entrants into the California long-distance markets.

Dr. Mayo stated that an examination of market share characteristics does not support the contention that AT&T holds "significant market power." Of the total activated capacity necessary to serve the intrastate toll market in California, AT&T has approximately 21.5 percent, LDDS-Worldcom has 18.5 percent, MCI has 13.9 percent, Sprint has approximately 9.6 percent, and the remaining 18 facilities-based resellers together possess 36.7 percent of existing capacity.[12] He declared that AT&T's market share of total activated transmission capacity is "well below the level generally thought to be necessary to confer significant market power." (*Id.*) Further, the current figure is down from the 39.5 percent share that AT&T held in 1990.[13]

Dr. Mayo contended that the California marketplace's demand characteristics reinforces the conclusion that there is effective competition. Rapid growth in the use of long-distance service has promoted competition by reducing the risk to new entrants. (Ex. 12 at 6.) Dr. Mayo testified that in terms of market demand growth, interstate switched access minutes have grown nationally an average 9.4 percent annually since 1984. This market growth is evident in the numbers of California interexchange entrants in recent years. Mayo declared that while the California market has grown by over eight percent per year since 1987, an overwhelming portion of that

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[10] *Id.* at 28.

[11] *Id.* at 5.

[12] This is exclusive of LEC capacity. *Id.* at 31.

[13] Ex. 1 at 8, Appendix 9; Ex. 12 at 5.

growth has gone to AT&T's competitors. (Ex. 12 at 37.) With regard to the distribution of demand factor, Dr. Mayo noted that the demand for telecommunication services in California are highly skewed. Consequently, the concentration of use by a small percentage of customers makes all carriers more vulnerable to competitive attacks by rival firms. He cited the Commission's Advisory and Compliance Division's[14] 1992 Monitoring Report as consistent with this assessment.

Finally, Mayo reported that California telephone customers have shown "a remarkable and unabated willingness to switch long-distance carriers." (*Id.*) Millions of Californians switched carriers in 1995. AT&T argues that the success of the NDIECs is evidence of customer satisfaction. If the new services and custom-tailored pricing plans did not satisfy customers, they would not purchase the services of the NDIECs. However, the statistics demonstrate NDIEC success: they have won half the California market, quadrupled AT&T's facilities base, and have had a growth rate three times that of AT&T. (AT&T Opening Brief at 17.)

B. ORA

ORA states that the Commission's definition of a dominant telephone corporation describes it as a firm that "has the market power either to extract monopoly profits or to price predatorily, while the non-dominant [telephone corporation] has the power to do neither."[15] The Commission has not found, it submits, that AT&T no longer has market power. (ORA Opening Brief at 3.) ORA asserts that the evidence presented in this proceeding demonstrates that while AT&T's dominance of the California interexchange market continues to decrease, the company retains the ability to extract unreasonably high profits on its intrastate services from California ratepayers. Accordingly, ORA contends, even if the Commission finds that AT&T is non-dominant, it is appropriate to continue to treat AT&T differently than NDIECs.

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[14] Currently known as the Telecommunications Division.

[15] D.84-06-113, 15 CPUC 2d 467.

ORA recommends that, at a minimum, the Commission impose certain "reasonable conditions" on AT&T for any recategorization of the company as non-dominant. These conditions are not ones that we generally impose on NDIECs. ORA suggests that we require AT&T to:

- Report its rate of return information annually;
- Report annually its changes in prices for the previous calendar year, for residential and business MTS, stated separately, by time of day and by interLATA versus intraLATA services;
- Report annually its average price per minute for residential and business MTS for the previous calendar year and average price per minute for all switched services for the previous calendar year, stated separately, by time of day and by interLATA versus intraLATA services. The report shall provide the average price per minute information for each month during the report year;
- Provide annually to each of its residential subscribers information regarding the AT&T services, including discount plans, which are available to the subscriber and include the pricing, terms and conditions of the services; and[6]
- Continue to be subject to the notice requirements of D.94-05-021, as affirmed by D.96-07-060, prior to taking back its own billing services.

ORA further proposes that the Commission view AT&T as an affiliate of a competitive local carrier for purposes of the relief granted by D.96-09-098 pursuant to Public Utilities Code Section 495.7. And, it recommends that we review AT&T's monitoring and reporting requirements, apart from those already cited, in order to determine "if those...or some different reporting requirements are necessary in order to continue to monitor the intrastate interLATA market." (ORA Opening Brief at 5.)

ORA submits that these conditions, imposed for three full calendar years, are essential to gauge the effects of the nondominant status of AT&T on the marketplace and to ensure that customers are aware of AT&T's available service offerings. ORA

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[6] ORA requests that AT&T provide this information in the seven languages that it agreed to for CLC notification and billing in R.95-04-043/Investigation 95-04-044, and the company should submit the notice to Commission staff for review and approval prior to its release.

proposes that the conditions would automatically expire unless a party files a petition for modification to extend some or all of the stipulations beyond the three years.

ORA also maintains that the evidence presented in this matter demonstrates that competition is not flowing through cost reductions. The Commission ordered access charge reductions in D.94-09-065. ORA argues that AT&T has not fully flowed through its access charge reductions, and the Commission should not grant the company non-dominant status until AT&T does so. ORA cites AT&T's intrastate earnings for the years 1991, 1992, 1993, 1994 and 1995 as 24.91 percent, 18.41 percent, 16.66 percent, 43.35 percent and 78.70 percent, respectively. (ORA Opening Brief at 7; Ex. 2, attachment 6.) It notes that AT&T's interstate earnings, under the FCC's price cap regime, for 1990, 1991, 1992, 1993 and 1994 are 13.73 percent, 13.41 percent, 12.77 percent, 13.49 percent and 13.26 percent, respectively. (*Id.*, Ex. 10.) In light of the distinction between intrastate and interstate earnings, ORA urges us to continue monitoring the intrastate interLATA market and AT&T's rate of return, even if we grant non-dominant status.

ORA further contends that, according to AT&T's own testimony, future price decreases will result from the introduction of technology and not from any increases in the level of competition.[17] Thus, ORA insists, there is no reason to believe that Californians will see lower rates in the interLATA marketplace with the entry of LECs into the market. In fact, monitoring should continue, ORA states, because there is a distinct possibility that AT&T's rates will increase if the Commission designates AT&T non-dominant.

ORA notes that, during consideration of AT&T's request at the FCC for non-dominant status,[18] the company "volunteered to institute two optional calling plans

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[17] *Id.* citing testimony of John Sumpter, Reporter's Transcript (RT) 52:6-15.

[18] Granted in FCC 95-427 (October 12, 1995).

to mitigate any impact of increases in AT&T Corp.'s basic residential rates." (ORA Opening Brief at 8.) ORA maintains that once the Commission designates AT&T as non-dominant, the company will be able to increase prices and give no recourse to the most vulnerable users—low income residential customers. It urges us to find a way to implement the Price Protection Plan proposed in the settlement agreement.

Finally, ORA argues that the relatively small number of AT&T customers[9] enrolled in its discount plans indicate that AT&T has inadequately marketed the plans and poorly noticed its customers. ORA contends that "discount plans are the only access to lower than tariffed rates, even though they apply only to calling patterns in excess of $10 per month." (ORA Opening Brief at 10.)

C. TURN

TURN asserts that the evidence shows that the market has failed to keep AT&T's rates and earnings at reasonable levels. Thus, TURN contends, the market is not sufficiently competitive. It argues that regulatory oversight of AT&T's pricing is still necessary, and the Commission should deny the company's request for non-dominant status.

First, TURN maintains, AT&T's own data show that the company failed to live up to its representation that the market would compel the pass-through of industry-wide access cost reductions. The company's ability to retain access savings illustrates the need for continued regulation until the Commission can be sure that competition forces the flow-through of cost savings to ratepayers. (TURN Opening Brief at 4.)

Second, TURN submits, AT&T's rates of return have "skyrocketed since AT&T was given pricing flexibility." (*Id.*) at 2. AT&T's intrastate rates of return for 1994 and 1995, 43.35% and 78.70% with net income of $180.86 million and $324.32 million,

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[9] AT&T reports that between 41 and 45 percent of its presubscribed customers have signed up for one and/or both of its domestic or international discount calling plans. (Ex. 2, attachment 28, 2 RT 130:09-21.)

respectively, are the highest levels of profit the company has ever achieved in California. (*Id.* at 4-5 citing Ex. 2, attachment 6.) TURN insists that access cost savings represent a significant amount of the company's 1995 profits.

Third, it claims, almost two years after the IRD access charge reductions went into effect, AT&T has either increased rates or slightly reduced rates by amounts that fall far short of the access charge reductions for key services[20] used by residential and small business customers. TURN asks the Commission to order AT&T to pass-through the full benefits of the IRD access charge reductions for each service that benefited from these cost reductions.

Fourth, TURN declares, AT&T's generally lower *intra*LATA rates show that competition is failing to drive *inter*LATA rates to levels that reasonably relate to AT&T's costs. TURN maintains that AT&T's interLATA residential and commercial MTS rates, as compared to its intraLATA rates, would be less, and AT&T's interLATA, as compared to its intraLATA, service charges for credit card and operator handled services would be lower in a more competitive market. (TURN Opening Brief at 10-11.)

Fifth, TURN contends that AT&T has taken advantage of the lack of adequate information about service charges to raise those rates dramatically. TURN urges that the Commission order AT&T to separately show service charges on its bills, rather than roll them into the total cost as they now do. TURN requests that we order the company to rescind its most recent directory assistance and service charge increases.

IV. Discussion

A. Evolution of the Observation Approach

In D.87-07-017, we established two alternative approaches for reviewing applications by AT&T for increased regulatory flexibility. The Prediction Approach relied on economic criteria to predict the effect on the interexchange market of granting AT&T regulatory relief. However, given the existence of conflicting data and theoretical

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[20] Message toll service (MTS), credit card calls, and operator assisted calls.

approaches, the Commission concluded that the status of AT&T's market power was "not likely to be clearcut any time in the reasonably near future." (24 CPUC 2d 541, 550 (1987).) To avoid a "quagmire of uninterpretable information" (*Id.* at 550), we adopted the Observation Approach as an alternative route for AT&T to follow when requesting regulatory changes. Under the Observation Approach, the Commission would grant AT&T regulatory flexibility in stages and closely monitor the effects on the market and customer satisfaction, rather than trying to forecast outcomes.

Since then, AT&T has retained the "dominant" IEC label, but we have granted increasing regulatory relief in recognition of the inroads made by its competitors. In D.88-12-091, the Commission approved limited pricing flexibility for several AT&T services[21] and relaxed the requirements for introducing new services.[22] Along with these changes, we approved a Monitoring Plan designed to measure the impact of reduced regulation on AT&T's competitors and enable us to restore tighter controls if necessary.[23] We also imposed several restrictions on AT&T that did not apply to NDIECs. For example, we required AT&T to maintain statewide average rates and introduce all new services on a statewide basis. (30 CPUC 2d 384, 427 (1988).)

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[21] For MTS, WATS, 800 service, and private line service, the Commission established rate bands of plus and minus 15 percent from so-called "reference rates" established in AT&T's last formal rate case. (30 CPUC 2d 384, 397-98 (1988).) We permitted AT&T to make changes within the established rate bans on five days' notice through advice letter filings, and eliminated the requirement that AT&T notify its customers in advance whenever it exercised its rate flexibility. (*Id.* at 411.)

[22] The Commission eliminated the requirement that AT&T file a formal application before introducing new services, and instead allowed AT&T to use the advice letter process applicable to its competitors. (24 CPUC 2d 384, for 18.) However, we expressly retained the option of requiring a formal application for controversial proposals. We also rejected AT&T's request to reduce the notice requirement for proposals already approved by the FCC, as allowed NDIECs. (*Id.*)

[23] The Monitoring Plan adopted in D.88-12-091 (Appendix C), as modified by D.93-02-010, required AT&T and other IECs to regularly submit detailed information relating to the effects of limited flexibility on overall market competitiveness as well as customer service and satisfaction. In D.94-04-042, we imposed additional reporting requirements on AT&T as part of the settlement agreement in the AT&T/McCaw Cellular merger proceeding.

In D.93-02-010, by eliminating rate band pricing for WATS, MTS, 800, and private line services, we granted AT&T further rate flexibility and put it on the same footing as NDIECs with regard to pricing. We allowed AT&T to reduce its rates on five days' notice, and to increase its rates on five days' notice for minor increases and 30 days' notice for major increases. (48 CPUC 2d at 31, 57-58 (1993).) At the same time, the Commission retained several safeguards against the misuse of AT&T's flexibility. Along with reaffirming the restrictions adopted in D.88-12-091, we required AT&T to maintain all prices above long run incremental cost to prevent predatory pricing. (*Id.* at 56.) Moreover, we kept the Monitoring Plan in place and expressly retained the right to rescind the regulatory flexibility granted to AT&T if warranted. Still, most recently, we permitted AT&T to take back its billing functions from the LECs after finding that customers dissatisfied with AT&T's billing practices could easily switch to another carrier. (54 CPUC 2d 411, 419 (1994).) In all, we find that the step that we take today is part of the natural progression in the Observation Approach.

B. Evaluation of Criteria

As we stated in D.93-02-010, an evaluation of all the Observation Approach criteria established in D.87-07-017 is necessary in determining whether AT&T is operating in an effectively competitive market.

1. Determination of the Relevant Market

AT&T argues that the relevant market for purposes of this analysis is the "entire California interexchange market." (AT&T Opening Brief at 10; Ex. 12 at 14.) Dr. Mayo testified that firms currently providing any one of the toll services (e.g. MTS) may very easily begin to provide other toll services (e.g. WATS). Thus, he recommended, the relevant product market to look at is the set of long-distance toll services. He stated that every service of AT&T has competitive alternatives, whether MTS, Private Line or high volume inbound services. Given access to capacity (through ownership or long-term lease), firms can readily provide any type of interexchange service in California. (Ex. 12 at 14, 28.) Dr. Mayo maintained that the high degree of "substitutability of vendors across the geographic regions of the state" denote that the relevant geographic market is, at a minimum, as large as the state of California. (*Id.* at 14.)

TURN contends that AT&T has ignored the Commission's interest in the "different submarkets which make up the overall market" and focused instead on the California interexchange market. TURN insists that its examination of the price changes for such key residential and business services as basic MTS, operator handled and calling card services, and directory assistance services highlights the impacts on particular services and particular customer groups. TURN maintains that AT&T has exploited its pricing flexibility by declining to pass through the full IRD access cost reductions for these services and by implementing rate increases that were substantial and without cost justification for directory assistance and operator/credit card services.

AT&T's presentation about the relevant market appears to be more a matter of contending that the passage of time as well as certain advances in technology have eroded the distinctions between "submarkets or market segments" and the "overall intrastate interLATA market" than a question of ignoring the Commission's interest in an analysis of the different submarkets which make up the overall market. There seems to be no challenge to the record evidence that every service of AT&T has competitive alternatives. In this proceeding, contrary to the case which evaluated the criteria over six years ago, no economic witnesses testified about the continuing significance of comparative submarket analysis. We find persuasive AT&T's contention that today, the high degree of supply-side substitutability, in terms of toll services, combined with the high degree of substitutability of vendors across the geographic regions of the state delineate a relevant market that is the California interLATA market.

TURN's focused perspective on AT&T's rates for MTS, operator handled calls, credit card calls and directory assistance service is silent with respect to the competitors' rates for these services. No party presented evidence in this proceeding that revealed that AT&T's prices were significantly higher than its competitors. At the same time, it is apparent from Ex. 1 and 2[24] that AT&T is losing market share at an almost constant rate. Moreover, the record indicates that if AT&T attempted to raise its prices to above market or supracompetitive levels, its competitors could absorb all of AT&T's customers on their own facilities and still have excess capacity. This does not suggest to us that the California interLATA market is ineffectively competitive.

2. Market Share

The evidence shows that AT&T has lost significant market share over the last ten years. In D.93-02-010, we found that AT&T was losing market share, at various rates, in all segments of the market.[25] In spite of having the same tariff filing authority as its competitors since 1993, AT&T has continued to lose market share so that its intrastate share based on minutes of use now stands at 55%. (Ex. 2, attachment 1.) In 1990, we noted that the market share on a minutes of use basis had decreased for the company from 70% in 1989 to approximately 67%. With respect to transmission capacity, AT&T's competitors now control 80% of the active capacity in the state. (Ex. 1 at 8, 10.)

In 1995, AT&T's interstate market share was 49% of revenues, 55% of minutes and 66% of presubscribed lines. (Ex. 2, attachment 3.) AT&T asserts that this data reveals not only that the company is losing market share, but also that the customers leaving AT&T tend to make more calls and subscribe to premium services. AT&T further submits that the explanation for this is that the market is highly skewed -- a small percentage of its customers provide the majority of its revenue—and this characteristic facilitates competition. The record substantiates what we earlier determined in 1993: there has been a continuously declining trend in AT&T's market share.

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[24] Pages 8 and 10 and attachments 1 and 3, respectively.

[25] 48 CPUC 2d 31, 45, Finding of Facts 18-25 (1993).

3. Earnings

From the beginning of the Observation Approach, the Commission acknowledged the difficulty of devising a relevant earnings measurement since "the return on marginal investment at current replacement cost is the appropriate statistic, while recorded returns are measured relative to total embedded costs."[26] Nevertheless, in examining AT&T's earned return on equity, we have considered "consistent patterns in earnings over time" to "provide more reliable indications of the viability of a competitive marketplace."[27]

Year	AT&T's Rate of Return on Intrastate Rate Base	Net Income
1991	24.91%	$93.51 million
1992	18.41%	$108.42 million
1993	16.66%	$89.28 million
1994	43.35%	$180.86 million
1995	78.70%	$324.32 million

Ex. 2, attachment 6

TURN asks the Commission to look at AT&T's earnings from 1991 to 1995 and weigh two contentions. First, rates of return as high as 43% and 79% indicate that the market has not succeeded in keeping the Company's revenues in reasonable relation to its costs. And, AT&T's "enormous profits have been realized at a time when the market has allegedly been moving toward being fully competitive." (TURN Opening Brief at 5.) TURN notes that AT&T offers no analysis or explanation of the "trend" represented by its 1994 and 1995 rates of return.

It is not clear what kinds of assumptions we can reasonably make about trends in the level of interexchange carrier earnings, the designations of

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[26] 24 CPUC 2d 541, 559 (1987).

[27] *Id.*

dominance and nondominance, and market power from an examination of AT&T's rate of return in this proceeding. In crafting this benchmark of the Observation Approach, we hoped to get at yet another measure of AT&T's dominance by surveying its earnings' level in relation to that of the NDIECs, and gauging the profitability of the carriers' functioning in an arena with AT&T. In fact, we stated that we expected parties "to develop this measure further, particularly in the monitoring of the effects of any flexibility which may be granted."[28]

Notwithstanding, no competitors actively participated in the evidentiary hearing portion of this case. The only rate of return data in this record is that of AT&T. Comparatively, we can draw no conclusions. As we noted above, no party in this proceeding proved that AT&T's prices were significantly higher than its competitors, and the evidence shows that there is an almost constant rate of market share loss. However, the very significant increase in the rate of return on intrastate rate base is of concern to us. We cannot draw on two years of experience with high rates of return, 1994 and 1995, to determine that AT&T remains dominant, particularly since every other factor we consider points to the opposite conclusion. Still, we believe it is necessary that we continue to monitor the trend in intrastate rates of return, at least until such time as Pacific Bell or one of its affiliates in the SBC family enters the interLATA market in California. At that time, we are reasonably certain that whatever factors have contributed to the inflated rate-of-return figures will be less relevant given the entry of another powerful competitor in that market.

In its comments to the alternate pages to this order, AT&T expresses concerns about its rate-of-return report becoming available to its competitors and being used to AT&T's competitive disadvantage. This is not the purpose of our requiring the report. Hence, we will permit AT&T to file its annual rate-of-return report under seal with the Telecommunications Division. Parties wishing to see the report will

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[28] *Id.*

have to sign a non-disclosure agreement. We will also order the Telecommunications Division to monitor the contents of the report and provide the Commission with recommendations as to what course of action the Commission should take if it believes that AT&T's future rates of return remain out of line with a competitive environment.

TURN strongly criticizes the weight that it believes that the proposed decision accords to AT&T's 1994 and 1995 rates of return on intrastate rate base. While TURN has exhorted us to simply focus on AT&T's recent rates of return and argued that the escalating figures are a clear indicia of market failure, the history of earned return on equity analysis under the Observation Approach and the record of this case manifest no such clarity.

Ten years ago, we acknowledged after comments that a meaningful measurement of earnings as an assessment of market power would be difficult if not impossible[29]. Here, particularly, where each of the other criteria indicate a substantial diminution of market power, the significance of the earnings measurement is crucial. To be "meaningful" the earnings measurement, at a minimum, should: include an accurate calculation of AT&T's return on marginal investment; provide, notwithstanding AT&T's unique situation, a comparative analysis of other firms of similar risks; and contain an evaluation of the diverse jurisdictional rules of investment and expense allocation.

Instead, the analysis of AT&T's earnings in this record rests on a scrutiny of the 1994 and 1995 numbers alone. In the past, a critical element of weighing AT&T's earnings, as a criteria, was how it reconciled with the other criteria of the Observation Approach. In this proceeding, the only criteria that does not indicate diminished market power appears to be the least reliable yardstick. We are not ignoring this indicator, but we have found no support for making a determination of market power given the abbreviated measure of time and the absence of any other indicators.

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[29] Id.

ORA and TURN urge the Commission to order AT&T to fully flow through the IRD access charge reductions. Ex. 2, attachment 27 indicates that AT&T's prices were approximately $200 million lower in 1995 than only a flow through of access charge reductions would represent. AT&T witness Sumpter testified that: "...AT&T's prices were reduced. In most years, they were reduced more than access costs went down. They went down more than we were required by the Commission to reduce them. And they were reduced because the competitive marketplace from the year 1988 until the present established our rates."[30] We declined to order a mandatory flow through of access charge reductions in D.94-09-065, because we prefer to let competition efficiently direct competitors' cost savings. This record does not suggest to us that the market has failed.

In its comments on the proposed decision, TURN contends that the Commission appears unconcerned by not ordering a flow through to consumers of AT&T's access cost savings on a dollar for dollar basis. To the contrary, TURN simply has not convinced us that access cost reductions have not flowed through to consumers. Rather, we believe that the market has flowed through these cost reductions in a economically efficient manner. Moreover, TURN's argument ignores the possibility that other costs, including the increased capital costs required for infrastructure investment, might have offset access cost reductions.

To the extent that rate reductions did not flow through evenly to each and every rate, it may not be as a result of a lack of competition but rather the realignment of previously regulated rates to more sustainable levels. The rates in place before the access charge reductions resulting from the New Regulatory Framework and IRD were not the result of a totally competitive market, but rather were the product of decades of regulation tempered by only a few years of lessened regulation. Hence, it would follow that some rates would be closer to market prices than other and that cost

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[30] 2 RT 172:2-7.

reductions would flow more to some services than to others. TURN appears to advocate a return to cost-of-service regulation. This Commission continues to rely upon market forces where competition exists, such as in the interLATA telecommunications market, to ensure economically efficient rates. Again, we are not convinced that a market failure exists warranting government intervention to assure that access cost reductions flow through to consumers.

In the same vein, TURN has highlighted the issues of billing and charges on certain residential and small business services, and ORA has raised concerns about the adequacy of AT&T's customer notification of discount plans. There is no evidence before us that supports a finding of "unreasonable" for either AT&T's billing of service charges for certain types of calls or its rates for specific services. In addition, if AT&T has poorly marketed its discount plans in the face of declining market share, it is not clear why the Commission should address the matter.

4. NDIEC Facilities Ownership

In D.87-07-017, the Commission noted "that vigorous competition in the long run probably depends upon other carriers owning their own facilities. If competitors have limited capacity, their ability to take market share away from AT&T-C in the event of overpricing by AT&T-C will be similarly limited."[31]

The evidence shows that both for transmission facilities and points-of-presence (POPs), AT&T's share of the telecommunications infrastructure has gone from close to 100% in 1984 to approximately 20% in 1996. (Ex. 1 at 8-10.) As stated above, AT&T has submitted that its competitors could absorb all of its customers on their own facilities, and still have excess capacity. The company further presented uncontested testimony that all other necessary resources[32] are either readily available on the open market or are bottleneck facilities controlled by the local exchange carriers and

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[31] 24 CPUC 2d. at 560.

[32] Operator service capabilities, billing, and signaling.

provided to the interexchange market on a non-discriminatory basis through access tariffs. (Ex. 2 at 22.) In all, the record demonstrates a strong increase in the company's competitors' ownership and control of both activated and potential interLATA capacity and further confirms the shrinkage of AT&T's market power that we chronicled in D.93-02-010.

5. Ease of Market Entry and Exit

There does not appear to be any significant barrier to entry in the interexchange market. In 1984, we granted 14 carriers authority to provide interexchange service in California. Over the ensuing thirteen years, an average of approximately 40 carriers per year have entered the market. Today, there are close to 500 NDIECs operating in the state. Ex. 2[33] revealed that about 20 of California's certificated carriers are facilities-based, and the rest are resellers or specialized carriers supplying billing functions or operator services. Thirteen of the NDIECs are affiliates of LECs, including at least one facilities-based NDIEC.

No fewer than 20 carriers have entered the California market in any year. In 1993, more than 50 carriers entered. The record[34] shows that carriers are able to exit the market by selling their assets or merging with other firms. NDIECs can target specific niches to improve the efficiency and effectiveness of their marketing efforts. (Ex. 2, attachment 17.) Moreover, NDIECs that enter the industry as resellers have the flexibility of acquiring wholesale facility capacity from carriers with excess capacity or investing in their own facilities. The record illustrated several NDIECs who entered the market first as resellers and evolved into facilities-based carriers. (*Id.*) These several options demonstrate a reduced risk of entry for NDIECs.

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[33] Attachment 7b.

[34] Ex. 2, attachments 7a, 8.

6. Individual Carriers' Size and Growth Potential

AT&T witness Mayo testified[35] that the California interexchange market has grown by over 8 percent annually in the last ten years. He declared that the entry of close to 500 interexchange entrants in roughly the same time period speaks to the market's entrepreneurial pull. It appears that a number of factors suggest at least a constant, if not increasing, size and growth potential among the carriers: 1) customers' ability and willingness to switch long-distance carriers, 2) highly skewed market demand, 3) the supply-side substitutability of facilities, 4) the ability of capital to enter and leave the market, and 5) the general availability of the underlying technology.

7. Equal Access and Other Technical Factors

Today, the equal access conversion process has reached 99.98% of more than twenty million access lines. Only 4400 access lines remain unconverted. (Ex. 2, attachment 10.) In 1987, few exchanges enjoyed the services of more than ten IECs. In 1994, the majority of exchanges had over 30 IECs providing service to customers through the medium of equal access. (*Id.* at attachments 14, 19.) Moreover, the demonstrated willingness of California consumers to switch carriers supports the contention that NDIECs and customers have used the conversion to their advantage. As in D.93-02-010, we continue to regard this progress as a significant factor in effective intrastate interLATA competition.

8. Customer Satisfaction

In terms of AT&T and its competitors, the evidence indicates that customers view service quality[36] as high, consider prices to be lower than in the past, and feel that they have more options and choices to fit their communications needs than ever before. Carriers have introduced new services at an ever increasing rate since 1984. These services have addressed the interests of small and large residential and business

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[35] Ex. 12 at 37-38.

[36] From AT&T and its major competitors: Ex. 2, attachment 24.

customers. In addition, the record shows that competition has fostered the entry of NDIECs that cater to particular ethnic markets, personal interest groups, political groups and industries. All indications are that customers are responding positively to the new services and custom-tailored pricing plans, and the NDIECs are increasing in numbers and market share.

V. Conclusion

The evidence presented in this proceeding supports AT&T's contention that it no longer wields "significant market power" in any of its market segments in California. Without the significant market power that it once held, it follows that AT&T is no longer in a position to "extract monopoly profits or to price predatorily."[37] Moreover, the designation of dominant/non-dominant no longer precisely distinguishes AT&T from its competitors. We shall no longer term AT&T a dominant carrier. Consequently, we find that it is appropriate to grant AT&T complete rate flexibility. As a result, we shall no longer subject AT&T to rate of return regulation. We do not expect this regulatory change to be harmful to ratepayers. Hereafter, AT&T may bill its customers without unique restrictions. In all future proceedings, there shall be no distinction in the treatment of AT&T and all other IECs.[38]

Finally, the record does not support the recommendation that we continue to require AT&T to submit all the existing additional reports that it has filed or that we impose new reporting requirements. However, we will continue to require AT&T to report annually its rate of return on intrastate rate base until such time as Pacific Bell or an affiliate has been in the California interLATA market for a full reporting period. In all other aspects, AT&T's continuing reporting requirements shall be the same as all other IECs in California.[39] Therefore, we shall continue to monitor the interLATA

[37] 15 CPUC 2d 423, 467 (1984).

[38] See Appendix A.

[39] See Appendix A.

market by reviewing the results of data required of all IECs, as well as the rate-of-return report from AT&T. Thus, we see no need to continue the Monitoring Plan.

VI. Comments on the Proposed Decision

Pursuant to PU Code § 311 and our Rules of Practice and Procedure, the Proposed Decision of the assigned Administrative Law Judge was published on June 16, 1997. Parties then had an opportunity to file comments and replies.[40] After considering the comments and reply, we largely affirm the Proposed Decision, except for the changes made herein driven in great part by the input from TURN and ORA.[41]

VII. Comments on the Proposed Alternate Pages

Pursuant to PU Code § 311 and Rule 77.6 of our Rules of Practice and Procedure, the Alternate Pages of President Conlon and Commissioner Duque were mailed on July 17, 1997, to the parties in this case. Parties had an opportunity to file comments and reply comments.[42] Unless otherwise specified in the order, we carefully considered the parties' input but declined to make changes.

Findings of Fact

1. On May 18, 1994, AT&T filed this application requesting that the Commission designate it a NDIEC and impose upon it the same regulatory requirements as all other NDIECs.

2. On April 10, 1996, in an interim opinion, the Commission rejected the September 27, 1995 settlement filed in this proceeding.

3. This matter went to evidentiary hearings on September 11-12, 1996.

4. While AT&T has retained the "dominant" IEC label since 1987, we have granted increasing regulatory relief in recognition of the inroads made by its competitors.

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[40] We received comments from ORA and TURN. AT&T filed reply comments.

[41] We have corrected typographical errors.

[42] We received comments from ORA, TURN, and AT&T, and reply comments from TURN.

5. In 1987, we approved a Monitoring Plan designed to measure the impact of reduced regulation on AT&T's competitors and enable the Commission to restore tighter controls if necessary.

6. Today's step is part of the natural progression in the Observation Approach.

7. An evaluation of all the Observation Approach criteria pronounced in D.87-07-017 is necessary in determining whether AT&T is operating in an effectively competitive market.

8. There seems to be no challenge to the record evidence that every service of AT&T has competitive alternatives.

9. We find persuasive AT&T's contention that today, the high degree of supply-side substitutability, in terms of toll services, combined with the high degree of substitutability of vendors across the geographic regions of the state delineate a relevant market that is the California interLATA market.

10. No party presented evidence in this proceeding that revealed that AT&T's prices were significantly higher than its competitors.

11. The evidence does not suggest that the California interLATA market is ineffectively competitive.

12. In spite of having the same tariff filing authority as its competitors since 1993, AT&T has continued to lose market share so that its intrastate share based on minutes of use now stands at 55%.

13. The record substantiates what the Commission earlier determined in 1993: there has been a continuously declining trend in AT&T's market share.

14. AT&T's rates of return on ratebase for the years 1994 and 1995 are significantly higher than in previous years.

15. There is no evidence on the record to indicate that AT&T's high rates of return for 1994 and 1995 are due to that company being a dominant carrier.

16. The eventual entry by Pacific Bell or one of its affiliates will provide the interLATA market in California with another powerful competitor to AT&T.

17. The Commission declined to order a mandatory flow through of access charge reductions in D.94-09-065, because it prefers to let competition efficiently direct competitors' cost savings.

18. This record does not suggest that the market has failed.

19. Both for transmission facilities and POPs, AT&T's share of the telecommunications infrastructure has gone from close to 100% in 1984 to approximately 20% in 1996.

20. There has been a strong increase in AT&T's competitors' ownership and control of both activated and potential interLATA capacity which further confirms the shrinkage of AT&T's market power.

21. There does not appear to be any significant barrier to entry in the interexchange market.

22. A number of factors suggest at least a constant, if not increasing size and growth potential among the individual IEC.

23. Today, the equal access conversion process has reached 99.98% of more than twenty million access lines.

24. The demonstrated willingness of California consumers to switch carriers supports the contention that NDIECs and customers have used the equal access conversion to their advantage.

25. In all, customers view service quality as high, consider prices to be lower than in the past, and feel that they have more options and choices to fit their communications needs than ever before.

26. Customers are responding positively to the new services and custom-tailored pricing plans, and the NDIECs are increasing in numbers and market share.

27. AT&T no longer wields "significant market power" in any of its market segments in California.

28. The designation of dominant/non-dominant no longer precisely distinguishes AT&T from its competitors.

29. The record does not support continuing to require AT&T to submit all existing additional reports that it has filed or that the Commission impose new reporting requirements.

30. The record supports requiring AT&T to continue to file its annual report on rate of return on intrastate rate base until Pacific Bell or one of its affiliates has been operating in the California interLATA market for a full annual reporting period.

31. With the exception of the requirement maintained in the previous finding, AT&T's continuing reporting requirements will be the same as all other IECs in California.

Conclusions of Law

1. Under the Observation Approach, the Commission would grant AT&T regulatory flexibility in stages and closely monitor the effects on the market and customer satisfaction, rather than trying to forecast outcomes.

2. It is reasonable that the relevant market is the California interLATA market.

3. It is reasonable that the AT&T's declining market share as revealed by minutes of use and amount of capacity should indicate effective intrastate interLATA competition.

4. It is reasonable that the Commission cannot reach assumptions about trends in the level of interexchange carrier earnings, the designations of dominance and non-dominance, and market power from an examination of only AT&T's rates of return.

5. The shrinkage in AT&T's market power in conjunction with the strong increase in its competitors' ownership and control of both activated and potential interLATA capacity indicates vigorous competition.

6. The ease of interexchange market entry and exit demonstrated in this record reveals effective competition.

7. Individual carriers' size and growth potential should increase or at least remain constant.

8. Equal access is virtually completed in California.

9. It is reasonable that the Commission should conclude that in general customer satisfaction with the California interexchange market is high.

10. AT&T should no longer be termed a dominant carrier.

11. AT&T should be granted complete rate flexibility.

12. The Commission should no longer subject AT&T to rate of return regulation.

13. AT&T should bill its customers without unique restrictions.

14. AT&T's continuing reporting requirements should be the same as all other IECs in California, except that AT&T should be required to report annually its rate of return on intrastate rate base until Pacific Bell or one of its affiliates has been operating in the California interLATA market for a full annual reporting period.

15. AT&T's competitors should not have ready access to the annual rate-of-return report. Parties wishing to see the report should be required to sign a non-disclosure agreement.

16. There should be no distinction in the treatment of AT&T and all other IECs in future proceedings.

17. Public interest requires that the following order become effective immediately.

FINAL ORDER

IT IS ORDERED that:

1. AT&T Communications of California (AT&T) shall no longer be designated a dominant carrier.

2. AT&T shall be granted complete rate flexibility.

3. AT&T shall no longer be subject to rate of return regulation within California.

4. AT&T shall bill its customers without unique restrictions.

5. With the exception of the reporting requirement described in Ordering Paragraph 6, AT&T's continuing reporting requirements shall be the same as all other interexchange carriers (IECs) in California, as indicated in Appendix A.

6. AT&T will continue to file on an annual basis its report on rate of return on intrastate rate base. This requirement will automatically sunset when Pacific Bell or one of its affiliates has operated in the California interLATA market for a full annual reporting period. The report shall be filed under seal with the Telecommunications

Division. Parties will be required to sign a non-disclosure agreement if they wish to see the report.

7. At least annually, the Telecommunications Division will provide the Commission with a summary of AT&T's rate-of-return report, along with any recommendations the Division might have if AT&T's returns stay at levels not commensurate with a competitive market.

8. There shall be no distinction between AT&T and all other IECs in future proceedings before the Commission, as indicated in Appendix A.

9. The Monitoring Plan is hereby discontinued.

10. The Utility Reform Network's October 21, 1996 motion is denied.

11. Since all issues raised in this proceeding have now been resolved, this proceeding is closed.

This order is effective today.

Dated August 1, 1997, at San Francisco, California.

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

I will file a partial dissent.

/s/ JESSIE J. KNIGHT, JR.
Commissioner

I dissent.

/s/ JOSIAH L. NEEPER
Commissioner

I will file a written concurrence.

/s/ RICHARD A. BILAS
Commissioner

Appendix A

Existing NDIEC Regulatory Requirements

1. NDIEC rates are minimally regulated. (D.90-02-019; D.90-08-032.)

2. The Commission retains the authority to inspect NDIECs' books and to request certain data.

3. NDIECs' competitors' advice letter protests of new service offerings must address the authority under which the new service is provided and/or any discrimination as to customers of the new service in order to be valid. (D.90-08-032)

4. NDIECs are exempted by D.85-11-044 from the requirements of Public Utilities Code sections 816-830, 851.

5. NDIECs are required to retain business and billing records, four years and one year, respectively. (D.90-08-032)

6. Major price increases by NDIECs may be noticed by first-class mail. (D.90-08-032, D.91-12-013)

7. NDIECs are exempted from the following requirements: a. filing of standard contract forms in tariffs; b. one rule description per page; c. filing sample business forms; and d. filing of estimated revenue impacts of tariff revisions.

8. The Executive Director is empowered by D.86-08-057 "to grant non-controversial applications by NDIECs for authority to transfer assets and control," outside of PUC sections 851-854, so long as no protests are filed or the parties withdraw protest.

9. NDIECs file limited annual reports and submit data only on Commission request.

10. NDIECs are exempted from Sections II-B through II-G of the Reporting Requirements for Utility-Affiliate Transactions. (D.93-02-019, App. A, Sec. I-C.)

A. 94-05-042
D. 97-08-060

COMMISSIONER JESSIE J. KNIGHT JR. DISSENTING IN PART:

This decision is another step in the long process to reduce the Commission's regulation governing the long-distance market and AT&T in particular. The decision here is a major leap forward and I support the decision, but I strongly disagree with the majority with respect to the requirement that AT&T continue to provide annual reports of its intrastate return on ratebase. What some have characterized as a small requirement, I am of the view, is a weighty and pernicious impediment.

The evidence is clear, AT&T has lost significant market share over the last ten years. Despite increasing regulatory flexibility over time, AT&T's market share, by any measure continues to decline. AT&T's market share is 49% of revenues, 55% of minutes of use (down from 70% in 1989) and 66% of presubscribed lines.

AT&T's share of capacity has declined from nearly 100% in 1984 to just 21.5% today. While AT&T has the largest share of activated capacity, several of its competitors have comparable levels of capacity as well. LDDS-Worldcom has 18.5%, MCI has 13.9%, and Sprint has 9.6 percent. With the remaining 18 facilities-based carriers holding 36.7% of the capacity.

There does not appear to be <u>any</u> significant barrier to entry in the interexchange market. In 1994 California had 14 long-distance carriers. Today, there are over 500 non-dominant interexchange carriers (NDIEC) operating in the state, with 22 of these entities doing business as facilities-based carriers.

When this Commission adopted the dominant/non-dominant regulatory framework for the long distance market, it said "after equal access allows competitors to provide equivalent service, we will entertain AT&T's application for more flexible regulation". Today, 99.98% of the 20 million-plus access lines have the ability to choose their long-distance company. Each year a smaller and smaller proportion of customers are choosing AT&T to be their long distance provider.

I fully support the reclassification of AT&T as a non-dominat carrier and firmly believe that AT&T should be regulated the same as its competitors in the long-distance market. I fully support the conclusion that AT&T is no longer dominant in the marketplace and no longer wields significant market power. However, this decision does not eliminate all of the AT&T reporting requirements but retains the antiquated requirement that AT&T report its earnings. It is this regulatory hold on the past that does not receive my support.

I would prefer a decision that would sweep away the last vestiges of traditional regulation of AT&T. Not only is the evidence compelling that the long-distance market is competitive and that AT&T lacks significant market power, but also no other carrier in the California long distance telecommunication market is required to report its earnings. The only possible usage of these reports is for the Commission to use them in the future as a means of regulating the profit of AT&T. If the Commission is truly moving away from traditional rate-or-return regulation, there is no need for this information nor should the Commission tempt its inappropriate use. Like the Administrative Law Judge in this case, I believe that earnings reports are of very little use for government to analyze the marketplace and their probative value is indeed minimal.

The calculation of return on intrastate ratebase has lost its currency and relevance, as today's advanced network completes intrastate calls using assets that are not even located in California. The structure of today's telecommunication networks are increasingly non-hierarchical and calls are routed on a dynamic basis without regard to the jurisdictional nature of the call. The result is that traditional jurisdictional separations of costs no longer match well with revenues, thus the intrastate return on ratebase calculation is rendered meaningless. Furthermore, return on capital, itself a measure tied to traditional cost-of service regulation, has less and less unique relevance in the telecommunications industry; an industry that is becoming less capital intensive. It is indisputable that the major cost drivers in the business are not capital costs but rather operating expenses. Finally, we have consistently ruled that return should only be used in conjunction with other measurements of market conditions. However, it is ironic to note that in this decision, now this return information will no longer have other market information to be reviewed alongside the lone earnings report.

I regret that California chooses not to join the Federal Communications Commission and 47 other states that have ended the rate of return reporting requirements on AT&T. For this reason I dissent in part with respect to the requirement that AT&T provide annual earnings reports to this Commission. I do, however, fully support the majority's choice to commit a venial sin rather than a mortal sin in electing to sunset this requirement when an affiliate of Pacific Bell enters the long distance market.

The remainder of the decision has my full support. It is well founded on the evidence presented by AT&T's witnesses and the testimony elicited by cross examination by Office of Ratepayer Advocates (ORA) and The Utility Reform Network (TURN). The decision considered and responded thoughtfully to the comments of the parties and does an excellent job of assessing the marketplace.

In summary, the California long-distance market has been open for serious competition since 1984. Over time, it has become increasingly competitive and today it is undeniably competitive. Because of this fact, AT&T does not retain significant market power, and our regulation should be the same for all carriers in the marketplace.

Dated August 1, 1997 in San Francisco, California.

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

A. 94-05-042
D. 97-08-060

COMMISSIONER RICHARD A. BILAS, CONCURRING:

I support this decision which grants AT&T non-dominant status. It is certain that much has changed since we established AT&T in its own category in 1984. By measures such as market share, available capacity and the number of competitors, AT&T participates in a competitive industry. However, one measure seems to indicate a less-than-competitive market: AT&T's intrastate rate of return.

Critics have suggested that such a high rate of return is proof that AT&T either operates in a non-competitive industry and/or holds market power. I suggest other possible factors. The denominator used to calculate AT&T's intrastate rate of return results from regulatory allocations which may no longer make sense. Additionally, that denominator is small which will tend to exaggerate any errors caused by improper allocations. Indeed, even though the rate of return figure may provide some indication of the market and/or AT&T's market power, it is apparent that this number is used in more of a qualitative manner than in a quantitative manner. In other words, if we really believed in the accuracy of the rate of return calculation we would have been concerned whenever it rose over the 20% level or any other specific level. In contrast, we did not have enough discomfort to open an investigation when AT&T earned 43% rate if return in 1994. We know the intrastate rate of return calculation has flaws. Hence, AT&T's rate of return is used qualitatively. My belief is that quantitative numbers should provide more than a mere qualitative understanding of the market.

With those comments as background, I still support this decision because there needs to be some data flow in the short term even if the number is flawed. AT&T's rate of return may provide an indirect measure of what I believe is the critical question to determine competitive pricing—is the firm pricing at or near marginal cost?

Only in a very indirect manner will AT&T's rate of return figure assist in making the determination of whether AT&T is pricing at or near marginal cost. A high rate of return does not preclude the possibility that it is pricing at or near marginal cost. There can be many other factors, including my previously stated questions about cost allocation. Conversely, a low rate of return may not be a result of AT&T pricing at or near marginal cost. A poorly received service or an extraordinary expense could lower the rate of return.

My preference to solve this seeming dilemma would have been to require a ratio which more closely captures the concept of pricing at or near marginal cost. In fact, the record shows that such a ratio was discussed. A calculation of Average Switched Revenue per Conversation Minute (ARPM) is on the record.

In addition to giving useful information about the market, ARPM would have also addressed one of TURN's concerns in this proceeding. TURN is concerned that AT&T did not pass-through all of its access cost reductions. If the ARPM were calculated net of access charges, it would be quite obvious if access cost reductions were not being passed along to the end user.

Additionally, if the ARPM were calculated separately for different market segments, this would provide more refined data to evaluate the relative competitiveness of the different markets as opposed to AT&T's overall rate of return which is based upon all of its services.

With the shortcomings that are inherent with the usefulness of AT&T's rate of return figure that I note above, I hope that AT&T will also keep track of its ARPM by market segment to answer likely questions about its rate of return. It is also my hope that AT&T file both its rate of return and its ARPM by market segment in order to show the superiority of ARPM. If ARPM proves its usefulness, as I believe it will, I would then encourage AT&T to file a petition to modify this decision substituting ARPM for rate of return.

San Francisco, California
August 1, 1997

/s/ RICHARD A. BILAS
Richard A. Bilas, Commissioner