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JAN 8 1998

Decision 98-01-024 January 7, 1998

ORIGINAL
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)

O P I N I O N

On September 24, 1997, the Commission issued Decision (D.) 97-09-115 (the Decision) extending local exchange competition into the service territories of the mid-size incumbent local exchange carriers (MSLECs), Roseville Telephone Company (RTC) and Citizens Telephone Company (CTC).

The Decision noted the argument of CTC that a MSLEC cannot compete against the two major incumbent local exchange carriers (ILECs), Pacific Bell (Pacific) or GTE California (GTEC), because Pacific and GTEC average their rates over a significantly larger, more diverse statewide customer base than that of any MSLEC. This could place the MSLECs in a distinct disadvantage CTC alleged. The Decision directed the administrative law judge (ALJ) to take further comments on whether or not Pacific and GTEC should be permitted to compete as competitive local carriers (CLCs) in the MSLECs' territories. Pacific and GTEC were permitted to file requests for CLC authority within the MSLEC territory, but the Decision stated that the Commission would not approve their requests until after review of parties' comments on this issue to determine if there are any anticompetitive concerns that may warrant deferral of such approval.

Pursuant to an ALJ ruling, comments on this issue were filed on October 20, 1997 with reply comments filed on November 10, 1997.

Comments were filed by the MSLECs, by Pacific and GTEC, by AT&T Communications (AT&T) and MCI Communications (MCI), by the Office of Ratepayer Advocates (ORA) and The Utility Reform Network (TURN).

Parties' Positions

RTC proposes that Pacific and GTEC should not be permitted to compete in the MSLECs' territories until two conditions are satisfied: (1) that Pacific and GTEC be prohibited from extending their geographically average rates to the territories of the MSLECs; and (2) that the MSLECs be given the flexibility to adjust their local exchange services to respond to competition as it evolves. RTC claims such pricing flexibility is essential to allow the MSLECs a reasonable opportunity to compete with much larger carriers, such as Pacific and GTEC, that can provide service at lower rates due to their much larger sizes and their ability to direct strong economic force in the direction of the MSLECs' service areas.

RTC argues that Pacific and GTEC should not be allowed to use revenues derived from their virtual statewide control over local exchange services to enter MSLECs' territories with subsidized below-cost rates.

Since each of the ILECs with service territories located in different parts of the state must develop an average rate for services based on the average cost to serve each specific geographic area, the resulting rates may not accurately reflect the costs to serve any specific exchange or subset of that geographic area.

RTC states that if Pacific is allowed to price its services as a CLC at its statewide average ILEC rates, Pacific would be pricing many of its services below its costs. Therefore, RTC asks the Commission to prohibit continued use of geographically averaged rates that allow for entry by any CLC into MSLEC territories on a below-cost basis, or, at a minimum, to allow such practices to be challenged.

RTC argues that a subsidized price destroys competition, whether that price is charged by the ILEC under Commission mandate (as in Pacific's service territory) or whether that price is extended into the MSLEC territory by an adjacent carrier. When

the area in question has above-average costs to serve, the anticompetitive gap between subsidized price and cost is even greater.

RTC believes that geographic rate deaveraging would cause Pacific and GTEC to price their services closer to actual cost and prevent them from realizing unfair competitive advantages as they enter RTC's service area. RTC therefore proposes that Pacific or GTEC not be permitted to enter the MSLEC's service territories before they deaverage their rates within these areas.

While RTC is not now asking the Commission to implement rate deaveraging for Pacific and GTEC on a statewide basis, it believes such a step will eventually be required if competition is to flourish throughout the state. RTC proposes at this time only that the ILECs, as well as any other competitor entering the territory of a MSLEC, must price at or above their costs of providing service in that area. RTC recommends that retail services offered by resellers specifically be required to be priced above the wholesale rates of the underlying ILEC, or else, the reseller should be presumed to be pricing its services below costs. RTC proposes that the Commission open an investigation into any CLC reseller that proposes to price its services below the ILEC's wholesale rates before the CLC's rates are allowed to go into effect. Similarly, if a new competitive entrant plans to provide services via unbundled network elements at an aggregate rate lower than the aggregate rate charged by the MSLEC plus the entrant's costs for its own facilities, RTC proposes the Commission establish an investigation into such rates and not allow these rates to go into effect. Finally, RTC proposes that the Commission establish a policy of investigating a CLC's rates if the applicant is to provide service using its own facilities at rates below the costs of the ILEC or the costs identified by the Commission through the cost proxy model, which is designed to calculate the forward-looking costs of an efficient provider.

Like Roseville, CTC claims that Pacific is able to provide service at a lower rate than any other ILEC because its service base is largely in densely populated areas. CTC, in contrast, serves primarily rural areas, yielding a significantly smaller customer base over which to spread the averaged costs.

CTC claims that statewide averaging gives Pacific a clear competitive advantage over the MSLECs and, in a competitive market, will penalize CTC for aligning its rates to more accurately reflect costs unless some modifications are made to level the playing field. CTC further alleges that statewide averaging provides a competitive benefit to Pacific in regard to the universal service fund subsidy because Pacific's below-cost rates entitle it to a greater universal service fund subsidy per line than the other LECs. CTC argues that Pacific can then use the subsidy funds to reduce rates on other services which are more competitive.

CTC raises the further concern that Pacific could easily expand its existing facilities, which are located along common boundaries with the MSLECs, at minimal investment and win the MSLECs' most profitable customers with lower rates. At the same time, Pacific would not be required to serve less profitable customers as do the MSLECs.

To remedy the alleged competitive imbalances, CTC proposes that the Commission establish a proceeding to review the entire geographic deaveraging issue. At a minimum, CTC believes the ILEC rate-setting rules should be reviewed to determine whether Pacific can, and should, be required to use more cost-based prices in the MSLECs' territories than its current statewide averaged prices.

Pacific disagrees with the premise that the ILECs pose an competitive threat to the MSLECs. If the rationale for exclusion of Pacific from competition is that it has substantially lower average cost than the MSLECs, Pacific claims that rationale may be untrue. Pacific claims that its average costs may actually be higher than that of the MSLECs because Pacific serves a much larger rural area than does either of the MSLECs. The cost of providing service in rural areas is usually higher than the cost of providing service in urban areas.

Even if its average costs are lower, Pacific does not believe it should be excluded from entering the MSLECs' market since lower costs would enhance competition. Pacific argues that it would be unfairly discriminatory to exclude the ILECs from entry into the MSLEC territories.

GTEC disputes the premise that the statewide averaging of rates charged within its service territory can be extended to apply to its service as a CLC operating within the MSLEC service territory. As a CLC, GTEC is required to keep separate accounting records which are distinct from its ILEC business. GTEC argues that its resulting rates as a CLC would therefore not be averaged over its LEC customer base. To the extent there may be economies of scale which may influence its costs, GTEC argues that other large CLCs would similarly experience such economies. GTEC also raises concerns that it would be impeded from competing for large customers with multiple locations throughout the state, including offices in the MSLECs' territories. GTEC notes that such customers often prefer to deal with a single carrier that can serve all their locations.

TURN opposes the proposals of the MSLECs to institute proceedings for geographic rate deaveraging at this time. TURN argues that the MSLECs have failed to justify why Pacific and GTEC should be either excluded from entering the MSLECs' territories or else be treated differently from other CLCs. TURN argues that the ability of the ILECs to average rates in their own service territories has no bearing on their CLC rates. TURN denies that the universal service fund mechanism provides any opportunity for the ILECs to improperly subsidize their services offered as CLCs. Even if CTCs' claims regarding subsidized below-cost pricing had validity, TURN also challenges CTC's claims concerning the high level of Pacific's costs. In its comments, CTC had argued that Pacific's statewide average cost per access line was \$25.28. Yet, as shown in Appendix D of D.96-10-066, this average cost refers only to subsidized lines. Pacific's actual cost is less than \$20.30 per line according to the modified Cost Proxy Model (A. 97-03-004). TURN sees no inherent problem with the ILECs charging less than the MSLECs for a service where it is due to greater efficiencies or innovations which are driven by competition.

ORA agrees with TURN and objects to any policy which discriminates against Pacific and GTEC by prohibiting their entry into the MSLECs' territories. ORA views such a policy as violating Section 253 of the Act which prohibits states from imposing barriers to competition in a telecommunications market. ORA believes that Pacific and GTEC will likely price their services as CLCs in the MSLEC territories closer to the rates

of RTC and CTC than to their own current-tariffed rates since the costs of service are inherently higher in the MSLEC territories. ORA supports full competitive entry for all carriers, including the ILECs.

ORA does believe, however, that to guard against cross-subsidization, the ILECs' CLC operations should be accounted for separately. ORA also proposes that, to prevent potential cross-subsidization between the ILECs and their CLC affiliates, each ILEC should file and receive Commission approval of its interconnection agreements and price sheets applying to ILEC services and facilities provided to its CLC affiliates. The ILEC would bear the burden of proof that it offers its CLC affiliate terms and conditions no more favorable than it offers to nonaffiliated CLCs.

AT&T and MCI argue that if Pacific and GTEC seek to enter the MSLECs' territories as CLCs, they should be regulated as dominant carriers subject to the same price floor, service categorization, and cost justification requirements that apply in their own incumbent service territories. AT&T and MCI claim such treatment is necessary due to the ILECs' entrenched local exchange monopoly within their own territories which create inherent economies of scope and scale in the ILECs' provision of local exchange services. AT&T denies that it possesses comparable advantages to the ILECs due to its size. Unlike the ILECs, AT&T claims it lacks monopoly power in any of the markets in which it operates since it has been granted nondominant interexchange carrier status by this Commission.

Discussion

We find no valid basis to prohibit Pacific or GTEC from competing as CLCs within the MSLEC territories merely because of the geographically averaged rates in effect within Pacific's and GTEC's own territories. In Phase II of this proceeding, we previously acknowledged the merits of geographic deaveraging of LEC retail rates as a way to promote economic efficiency and a level playing field among competitors (D.96-03-020, mimeo. pp. 20-21). We did not, however, delay the opening of local exchange competition within the ILECs' territories until deaveraged rates could be developed. Likewise, we find no good reason to delay extending the benefits of

competition into the MSLEC territories until such a proceeding could be concluded. The process required to undertake the deaveraging of ILEC retail rates would entail significant time and resources. It would not be conducive to a competitive market to deny the entry of the ILECs until such a massive undertaking could be completed. Under Section 253 of the Act, "[n]o state or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service." Therefore, we may not legally erect or perpetuate barriers to entry within the MSLECs' territories.

Moreover, we conclude that the MSLECs will not be unfairly disadvantaged if Pacific and GTEC enter their territories merely because the ILECs' rates have not been deaveraged. As noted by various parties, the authorized tariff rates which apply within the home territories of Pacific and GTEC in their capacity as ILECs are not applicable outside of their incumbent ILEC service territories. Pacific and GTEC in their capacity as CLCs entering into the MSLEC territories are subject to the same pricing provisions as other CLCs. The pricing rules governing Pacific's and GTEC's ILEC tariffs have no bearing on their CLC tariffs. Therefore, the objections which the MSLECs raise concerning the alleged anticompetitiveness of ILECs' averaged rates do not apply to Pacific or GTEC in their capacity as CLCs in the MSLEC territories.

Likewise, the costs of service incurred by Pacific and GTEC within their home ILEC territories are separate and distinct from their costs of service as CLCs outside of their ILEC territories. In D.95-12-057, we required all CLCs, including Pacific and GTEC, to keep their books and records in accordance with the Uniform System of Accounts specified in Title 47, Code of Federal Regulations, Part 32. This same requirement shall apply to CLCs entering into the MSLEC territories. Thus, Pacific and GTEC are specifically be required to keep separate books for their CLC operations distinct from their ILEC operations. In this manner, the costs of service incurred within Pacific's and GTEC's home territories in which they serve as ILECs will not be averaged in with their costs to serve as CLCs. We will not rule upon ORA's proposal to prevent potential cross-subsidization between the ILECs and their CLC affiliates by requiring each ILEC

to file and receive Commission approval of its interconnection agreements and price sheets applying to ILEC services and facilities provided to its CLC affiliates.

First, there is no requirement that the ILECs create separate affiliates to compete outside their home territory. Second, even if the ILECs chose to create CLC affiliates to compete outside of their territory, we find no use in creating safeguards that would not apply to other CLCs. Third, we have not allowed facilities-based CLCs affiliated with ILECs to compete in the ILECs' territories. ORA's safeguards may make sense in this instance if and when it presents itself. Of course, resale-based CLCs affiliated with ILECs must purchase wholesale services from the ILECs' wholesale tariffs, as all CLC resellers do, and are subject to an affiliate-transaction rules in any other case.

In addition to raising concerns about Pacific pricing its services below costs, CTC also is concerned about Pacific's ability to incur only a minimal incremental investment to build out its system into adjacent MSLEC service territories. To the extent Pacific's physical proximity to the MSLEC service boundaries permits it to cost-effectively build out its facilities, Pacific's ability to compete will likely be enhanced. Yet, Pacific will still be facing competition not only from the MSLECs that have the advantage of incumbency, but also from other large CLCs such as AT&T and MCI with significant financial resources to build their own facilities. While Pacific is positioned to realize certain economies of scale and scope resulting from the proximity of its existing local exchange facilities to the MSLECs' service territories, its position as a new CLC entrant is not that of dominant carrier. We see nothing inherently anticompetitive about a particular CLC, through economies of scale, being able to offer service more efficiently than certain competitors. In any event, the ability of Pacific to reduce its prices in response to its lower costs is a different issue from its ability to reduce prices below its specific costs of service. We solicited comments only on the issue of the implications of below-cost pricing by the ILECs. It is beyond the scope of our present inquiry to address the implications of the ILECs' or other large CLCs' ability to reduce prices because their costs are lower or their operations are more efficient than that of the MSLECs. We previously considered parties' concerns regarding competitive imbalances

between large CLCs and the MSLECs in devising the interim rules adopted in D.97-09-115. We shall not repeat that process here.

We are likewise not persuaded that the universal service funding mechanism provides any unfair competitive advantage to Pacific or GTEC in entering the MSLEC territories. As noted by TURN, the Commission has already adopted measures to ensure that the ILECs do not receive any "windfall" from the universal service fund which could be used to unfairly lower prices for competitive services. In D.96-10-066, the Commission ordered Pacific, GTEC, and the MSLECs to reduce all of their rates within their incumbent territories, except for basic service, by an equal percentage to offset revenues received from the universal service fund. None of these universal service fund rate reductions would apply to rates offered by Pacific or GTEC outside of their incumbent territories in their capacity as CLCs.

The amount of universal service fund subsidy which is applicable to Pacific within its home territory would have no bearing on the subsidy it would receive as a CLC in the MSLEC territories. Under the rules adopted in D.96-10-066, the amount of support which any qualifying carrier would receive is determined by reference to the rates of the incumbent carrier in that service territory. Thus, any universal service fund support which Pacific would receive as a CLC serving a high-cost customer in CTC's territory would be measured against CTC's rates. All CLCs serving in a given high-cost area receive identical subsidy amounts under the universal service fund mechanism that the incumbent would be eligible to receive. Pacific or GTEC would therefore realize no competitive advantage over the MSLECs resulting from the universal service fund support available within the Pacific's and GTEC's own home territories. Consequently, the universal service fund mechanism does not create any incentive for Pacific or GTEC to engage in below-cost pricing when providing service in the MSLEC territories as CLCs.

Although the MSLECs claim that they are not being provided appropriate pricing flexibility to respond to the competitive pricing ability of Pacific and GTEC, we disagree. In D.97-09-115, we granted the MSLECs additional pricing flexibility to become effective with CLC entry into their territories similarly to what was granted to

Pacific and GTEC in D.96-03-020. These measures included (1) reclassification of most local exchange services from Category I to Category II, (2) authorization to implement pricing flexibility for Category II services once price floors were determined, and (3) phased-in implementation of pricing flexibility for customer-specific contracts for Category II services. We concluded that these measures were adequate for the present time. We left open the option of granting additional flexibility as competition grows. We have already explained in our prior decision why additional pricing flexibility for the MSLECs is not appropriate at this time.

Since we find no anticompetitive effects result from the ILECs' ability to charge average rates within their own incumbent territories, we decline to impose the restrictions on Pacific's and GTEC's prices for their CLC services, as proposed by the MSLECs. Merely because Pacific or GTEC may charge a rate which is below that charged by the MSLEC does not necessarily mean the rate is anticompetitive. The whole point of a competitive market is to provide the incentive for competitors to offer consumers lower priced services than would be available merely from a single incumbent monopoly provider. If we were to prohibit CLCs from charging less than the incumbent utility for a given service, we would be largely undermining the benefits of competition since the incumbent's rates would become the default. If a CLC were to propose a rate that is deemed unfair or unreasonable, parties have recourse to file a complaint as provided in the Commission's Rules of Practice and Procedure (see Article 3)

Findings of Fact

1. Within the incumbent local exchange territories of Pacific and GTEC, their authorized retail rates are based upon average costs which are spread over a diverse customer base.
2. Under the existing rate structure based on statewide averages, the retail rates of Pacific and GTEC charged within their incumbent service territories do not reflect the differences in costs of serving different geographic regions.

3. Pacific's incumbent service territory completely surrounds the service territories of CTC and RTC, respectively.
4. Pacific's rates for basic local service charged within the local exchanges of its incumbent territory bordering the MSLECs is lower than its costs of service based on the Cost Proxy Model developed in the Universal Service Proceeding.
5. The rates for basic service charged by the MSLECs is currently higher than Pacific's and GTEC's comparable rates charged within the latter two companies' territories.
6. To the extent that the MSLEC rates have been set higher than the corresponding rates for Pacific and GTEC, it has in response to recent general rate case applications.
7. The retail rates which Pacific and GTEC are authorized to charge in their incumbent local exchange territories do not govern what Pacific and GTEC may charge for services which they offer as CLCs in service territories of other incumbents.
8. In D.96-10-066, the Commission ordered Pacific, GTEC, and the MSLECs to reduce all of their rates within their incumbent territories, except for basic service, by an equal percentage to offset revenues received through the universal service fund mechanism.
9. Pacific and GTEC, in their capacity as CLCs, could not apply any universal service fund subsidies for below-cost rates charged for services within their ILEC territories to subsidize their CLC services.
10. Pacific and GTEC are required to keep separate books and records as prescribed under the USOA for their CLC operations distinct from their ILEC operations.
11. The requirement to keep separate CLC records distinct from their ILEC records will assure that the costs of service from Pacific's and GTEC's CLC operations can be separately quantified and compared to their CLC prices.
12. Upon entering the MSLEC territories, Pacific will realize certain economies of scope and scale due to its existing local exchange infrastructure and its proximity to the MSLEC territories, but will also be exposed to the higher costs inherent in providing service within the MSLEC territories.

13. Upon extending or building facilities into the territories of CTC and RTC, Pacific and GTEC will receive universal service fund subsidies equal to the subsidies received by CTC and RTC, in accordance with D.96-10-066.

14. Pacific's economies of scope and scale will not preclude other CLCs, particularly those with significant financial resources, from competing within the MSLEC territories.

Conclusions of Law

1. The MSLECs have failed to show that the ability of Pacific and GTEC to average their retail rates based on a diverse statewide customer base within their own incumbent territories is anticompetitive or warrants a prohibition excluding Pacific and GTEC from competing as CLCs within the MSLECs' territories.

2. Pacific and GTEC should be permitted to enter the MSLEC service territories subject to the same rules as are applicable to other CLCs, except as noted in Conclusion of Law 3 below.

3. To prevent potential cross-subsidization between the ILECs and their CLC affiliates, each of the ILECs should keep separate accounting records for CLC operations.

4. ORA's recommendation in support of certain safeguards governing the relationship between the ILEC's and their CLC affiliates is not adopted because it is premature and outside the scope of this decision.

5. While the Commission has acknowledged that geographically deaveraged rates would produce more economically efficient price signals, it is premature to undertake a proceeding to determine geographically deaveraged costs for Pacific and GTEC at this time given other priorities now before the Commission.

6. It would constitute an impermissible competitive barrier under Section 253 of the Act for this Commission to prohibit Pacific and GTEC from entering the MSLEC territories until the completion of a proceeding to determine geographically deaveraged prices.

O R D E R

IT IS ORDERED that:

1. Pacific Bell (Pacific) and GTE California (GTEC) shall be required to keep separate books and records for their competitive local carrier (CLC) operations in conformance with the Uniform System of Accounts, distinct from their incumbent local exchange carrier (ILEC) operations.

2. Subject to the requirements of Ordering Paragraph 1 above, Pacific and GTEC shall not be subject to additional barriers and restrictions on entry into the service territories of the mid-size incumbent local exchange carriers (MSLECs) except for the rules and regulations applicable to all other CLCs.

This order is effective today.

Dated January 7, 1998, at San Francisco, California.

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