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Decision 98-07-033 July 2, 1998

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Pacific Bell (U 1001 C), a corporation, for approval of rate reductions to offset the explicit subsidy support ordered in Decision 96-10-066.	Application 97-03-004 (Filed March 6, 1997)

(See Appendix E for Appearances)

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TABLE OF CONTENTS

OPINION

Summary

In this decision, we adopt $305.2 million in price ceiling reductions for Pacific Bell (Pacific) as a permanent offset for its receipt of universal service funds from the California High Cost Fund (CHCF-B). In Decision (D.) 96-10-066, we afforded the five large and mid-size local exchange carriers (LECs) participating in the CHCF-B the opportunity to request a permanent rate reduction offset rather than using the surcredit mechanism we adopted. Pacific is the first LEC to make such a request.

Pacific and other parties present six proposals for a permanent offset. The proposals differ as to which services are recommended for reduction, and the amount and structure of the reduction for each service.

The goals that guide us in choosing the most appropriate permanent offset are: (1) to target the services parties demonstrate contain implicit subsidies; (2) to ensure the rate reductions we adopt result in sustainable prices; and (3) to reduce the rates within these services in a manner which benefits the broadest base of customers.

In addressing our first goal, the targeting of specific services, we recognize that not all of Pacific's services provide implicit subsidy support for universal service. The services identified by parties all contribute a high margin of revenue over direct costs; this contribution is available to meet Pacific's shared and common costs and to provide an implicit subsidy toward the cost of other services.

We meet our second goal, sustainable prices, by reducing implicit subsidies from services that face competition today or may face competition in the future in a manner that does not provide Pacific an unfair competitive advantage. In order to ensure that Pacific cannot unilaterally raise these prices,

we also lower the price ceiling for these services to the level of rates herein adopted.

To achieve broad-based customer benefits, our third goal, we reduce implicit subsidies in all the services that we identify as providing implicit subsidy support and we do it in a manner that provides benefits to the greatest number of customers within each service.

While we allocate price ceiling reductions to all identified high margin services, we provide the largest reductions to toll because it has the highest contribution margin and has historically contributed the highest implicit subsidy support. We allocate the toll reductions only to the basic residential and business schedules, not to the discount calling plans, and we do not set prices below levels now existing in the competitive market. We maintain the Commission's existing policy of parity between residential and business prices, providing the funds to support this by a lesser reduction in ceiling prices for custom calling services.

Also at issue in this proceeding is the elasticity factors that should be applied to toll or switched access price reductions for Pacific to reflect the demand stimulation caused by price changes. We find the elasticity study presented by Pacific is reasonable for Pacific given its current market conditions and, therefore, we adopt its factors. We find the record here does not allow us to make a determination regarding the reasonableness of these elasticity factors for GTE California, Inc. (GTEC).

The specific price reductions we adopt are attached as Appendix C. A comparison table of the parties' proposals with our adopted revenue reductions is shown on the next page.

Table 1
Pacific Bell A.97-03-004
Summary of Parties' Proposals and Adopted Revenue Effects
($000)

Service	Pacific	ORA	TURN	MCI/AT&T	Sprint	EPRM (1),(2)	Adopted (2)
Access - Switched				(131,740)	(13,500)	(14,500)	$ (63,600)
Access - Transport (NIC)	(7,400)	(52,000)		(131,322)	(139,000)	(9,400)	
Subtotal (3)	(7,400)	(52,000)	-	(263,062)	(152,500)	(23,900)	$ (63,600)
Business Toll - Basic	(72,000)					(17,200)	($35,100)
Business Toll - OCPs	(53,300)					(18,400)	
Total Business Toll	(125,300)	(68,000)	-	-	-	(35,600)	($35,100)
Residence Toll - Basic	(140,600)					(47,200)	($118,900)
Residence Toll - OCPs	(31,900)					(10,300)	
Total Residence Toll	(172,500)	(93,000)	-	-	-	(57,500)	($118,900)
Total Toll	(297,800)	(161,000)	-	-	-	(93,100)	(154,000)
Zone Usage Measurement			(110,200)			(11,000)	($18,600)
Local Usage			(194,000)			(36,600)	($61,900)
Total ZUM/Local Usage	-	(77,500)	(304,200)	-	-	(47,600)	(80,500)
Custom Calling		(14,700)				(20,100)	($7,100)
Other - Unspecified				(42,138)	(152,500)	(120,500)	
Totals (4)	(305,200)	(305,200)	(304,200)	(305,200)	(305,000)	(305,200)	(305,200)

(1) See Appendix A
(2) Rounded to nearest $100,000.
(3) Includes revenues of services for which reductions were requested .
(4) Totals may not add to $305.2 million due to rounding.

I. Procedural Background

A. *Overview*

In Rulemaking (R.) 95-01-020 and Investigation (I.) 95-01-021, which were consolidated and filed on January 24, 1995, the Commission opened a proceeding to develop rules to pursue universal service goals in a competitive telecommunications environment. This proceeding is part of our comprehensive review of how state regulatory policies need to respond to the opening of monopoly markets to competition. It is also one of the three proceedings the Commission initiated to facilitate the opening of local exchange telecommunications markets to competition.

The transition from monopoly to competitive telephone markets began at the federal level in long distance competition. This accelerated in 1982 with the divestiture by American Telephone and Telegraph Company of its local exchange telephone service under an antitrust consent decree between the U.S. Department of Justice and American Telephone and Telegraph Company (the Modified Final Judgment). Recognizing the inroads of competition into local exchange markets, the Commission in 1987 took the first step to convert the regulation of its LECs to an incentive form of regulation.

In I.87-11-033, the Commission stated its intent to explore the implications of both relaxing its ban on intraLATA (Local Access Transport Area) competition and reforming its pricing policies. This investigation developed a New Regulatory Framework (NRF) for California's two largest LECs, Pacific and GTEC, and culminated in the Implementation Rate Design (IRD) decision, D.94-09-065, which opened intraLATA toll markets to competition beginning January 1, 1995 and undertook a revenue rebalancing and rate design to move the price of services toward cost while reflecting expected levels of competition.

Building on the foundation laid in I.87-11-033, the Commission in its November 1993 report *Enhancing California's Competitive Strength: A Strategy for Telecommunications Infrastructure* stated its intent to open all telecommunications markets in California to competition by January 1, 1997. The legislature adopted this policy in Assembly Bill (AB) 3606, codified in Section 709.5 of the Public Utilities Code.

In D.94-12-053, the Commission adopted a roadmap plan to facilitate the introduction of local exchange competition. This plan recognized three areas of technical and policy issues related to local exchange competition that would need to be addressed in a coordinated manner in separate proceedings. Today, this plan moves forward with: technical costing issues related to the unbundling of network elements (UNEs) and Operations Support Systems (OSS) and pricing issues for UNEs and wholesale service being handled in the Open Access and Network Architecture Development (OANAD) proceeding, R.93-04-003/ I.93-04-002; issues related to universal service being handled in R.95-01-020/ I.95-01-021; and the implementation rules governing local competition being handled in R.95-04-043/I.95-04-044.[1]

B. Comments on the Proposed Decision

Pursuant to Public Utilities Code Section 311, the proposed decision of the assigned administrative law judge was mailed to all parties. Comments and reply comments on the proposed decision were timely filed by Pacific, AT&T Communications of California, Inc. (AT&T), MCI Telecommunications Corporation (MCI), Office of Ratepayer Advocates (ORA), Sprint

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[1] See also D.95-07-050 (60 CPUC 2d 536) for additional background on the universal service proceeding Order Instituting Investigation (OII)/Order Instituting Rulemaking (OIR).

Communications Company L.P. (Sprint), and The Utility Reform Network (TURN); opening comments only were filed by the two groups representing the small LECs. This decision makes several changes based on parties' comments.

The major change we adopt is in response to Pacific's comments that the proposed decision erred in not recognizing that the toll price reductions it proposed for residence and business basic message toll service had dropped to levels that could effect the viability of some of Pacific's discounted optional calling plans. We correct this inadvertent error by reducing the amount of toll reductions to a level that does not drop below any of Pacific's toll discount calling plans. We reallocate the available revenue resulting from our toll changes to a further reduction to switched access service prices.

Also in response to comments, we (1) change three custom calling prices in Appendix C, (2) provide further support for our discussion on switched access service elements, (3) round the toll, local usage, and ZUM prices adopted in Appendix C to four places to the right of the decimal point in order to accommodate Pacific's billing system, and (4) adopt recommended minor revisions to the decision for purposes of clarification and correction.

C. The Universal Service Proceeding

In D.96-10-066, the Commission finalized the universal service rules that it originally proposed in D.95-07-050. The legislature through AB 3643 (Stats. 1994, Chapter 278), which became effective January 1, 1995, provided guidance as to the type of issues the Commission should address in the universal service OIR/OII. Specifically, AB 3643 directed the Commission to examine the current and future definitions of universal service in telecommunications with the following objectives:

(1) Define the goals of universal service given the new technologies and increasingly competitive markets, with emphasis on the role of basic service in education, health care, and in the workplace.

(2) Delineate the subsidy support needed to maintain universal service in the new competitive market.

(3) Design and recommend equitable and broad based subsidy support for universal service in freely competitive markets.

(4) Develop a process to periodically review and revise the definition of universal service to reflect new technology and markets.

(5) Address the issues of "carrier of last resort" and "franchise obligations." (Stats. 1994, Chap. 278, Sec. 2(a).)

In developing its final rules, the Commission first proposed draft rules for written comment and, after reviewing the comments, held a full panel hearing. Following this, the Commission co-hosted with the State and Consumer Services Agency 13 public participation hearings, and then held workshops and evidentiary hearings on issues pertaining to the formulation of a proxy cost study for determining the cost of basic services.

In D.96-10-066, the Commission decided that the five large and mid-size LECs (Pacific, GTEC/Contel, Citizens Telephone Company, and Roseville Telephone Company) would be included in a proxy cost model calculation for determining universal service support. They, as other carriers of last resort (COLRs) who serve high cost areas in their service territories, are eligible for subsidy support through the newly created CHCF-B.

As required by Ordering Paragraph 8 of D.96-10-066, all California telecommunications carriers, effective with the billing cycle that began February 1, 1997, are required to charge all end users the CHCF-B surcharge, initially set at 2.87%, for all telecommunications services except Universal Lifeline

Telephone Services billings, rates set by contract prior to September 15, 1994, coin-sent paid calling, debit card messages, one-way radio paging, usage charges to coin operated pay telephones, and directory advertising

The 17 smaller LECs in California are not subject to the rules applicable to the CHCF-B fund. Instead, the smaller LECs continue to be eligible for universal service support under the preexisting California High Cost Fund, now referenced as CHCF-A.

In order to avoid a windfall to the five large and mid-size LECs, the Commission directed that any explicit subsidy support received from the CHCF-B shall be reduced by the same amount through an equal percentage reduction for all services except for basic service rates. In D.96-10-066, we afforded the five large and mid-size LECs the opportunity to request by application a different offset methodology that would reduce rates or price caps downward to permanently offset the explicit subsidy support.

D. Pacific's Application

On March 6, 1997, Pacific filed its application requesting that the estimated $305.2 million it will receive each year from the universal service fund be offset by $297.8 million in permanent reductions to residential and business toll ceiling prices and $7.4 million in reductions to switched access ceiling prices. Timely protests to the application were filed by AT&T, Evans Telephone Company et al. (small LECs), GTEC, MCI and Sprint, ORA, TURN, and WorldCom Inc.

In its application, Pacific requests to include this proceeding in the Commission's experimental Senate Bill (SB) 960 program. Under the experimental program, the Commission selected a representative sample of proceedings to operate under experimental rules and procedures in order to gain experience with management of Commission proceedings under the requirements of SB 960; the requirements of SB 960 became effective on January 1, 1998. The experimental rules that govern this proceeding are set forth in Resolution ALJ-170, adopted January 13, 1997 (Experimental Rules).

On March 11, 1997, Pacific amended its application to include a proposed scoping memo pursuant to Experimental Rule 3.a. All interested parties submitted prehearing conference (PHC) statements addressing Pacific's proposal, a PHC was held on April 24, 1997, and additional PHC comments were filed by parties on May 5, 1997.

On July 11, 1997, Assigned Commissioner Knight issued a Final Scoping Memo (Scoping Memo). Pursuant to Experimental Rule 5, the Scoping Memo confirmed the categorization of this proceeding as "ratesetting," adopted a procedural timetable (with projected submission date), and specified the issues to be addressed.[2]

In the Scoping Memo, Commissioner Knight ruled: (1) to proceed with Pacific's application in order to implement rate reductions in a timely manner, recognizing that there is uncertainty until the CHCF-B is operational and that the Commission may need to revisit the rate reduction it adopts here; (2) to examine elasticity in this proceeding; (3) to not address the concerns of the 13 small LECs who currently elect to participate with Pacific in pooling and settlement arrangements for toll, access, and private line services in this proceeding, but to refer those issues to the existing CHCF-A filing mechanism; (4) to deny GTEC's request that the Commission delay Pacific's ability to

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[2] The scoping memo adopted a projected submission date of December 17, 1997. A Joint Assigned Commissioner and Administrative Law Judge's (ALJ) Ruling on November 7, 1997, changed the submission date to February 20, 1998 to reflect the late adjournment of the hearings, the holiday season, and the schedules of the new rulemaking and investigation on OSS performance and the OSS phase of the OANAD proceeding.

implement all of its requested rate reductions until after Pacific raises its basic service rates to the statewide average cost of providing basic service; (5) that D.96-10-066 allows Pacific to request a permanent reduction in the manner set forth in its application and that the merits of its proposal will be litigated in this proceeding; and (6) to limit the use of cost data in this proceeding to costs that have already been adopted by the Commission.[3]

Evidentiary hearings were held in San Francisco on October 14 through November 5, 1997. Pursuant to Experimental Rule 9(b), a closing argument was held on October 28, 1997. Opening briefs were filed on January 9, 1998 and reply briefs on February 20, 1998, at which time the matter was submitted.[4]

Interested parties who participated in the hearings are Pacific, AT&T, the Facilities-Based Carriers (FBC), GTEC, MCI, ORA, Sprint and TURN.[5]

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[3] In ruling on the small LECs' request, the Assigned Commissioner stated that he expected Pacific, subsequent to a decision in this proceeding, to work expeditiously and diligently with the small LECs in order to determine the "industry" settlement effects resulting from this decision and to provide each small LEC a report of its share of the industry settlement effects so that each LEC can make a determination as to whether it should seek recovery from CHCF-A. Further, Pacific should concurrently serve the Commission's Telecommunications Division a copy of this report, together with supporting workpapers.

[4] Pursuant to Experimental Rule 9(d), a final oral argument before a quorum of the Commission will be held. Pursuant to ALJ Resolution 175, the closed session provisions of the final SB 960 rules do not apply to this proceeding.

[5] FBC consists of ICG Telecom Group, Inc., NEXTLINK California LLC, and the California Cable Television Association.

II. Permanent Offset for Pacific's Explicit Subsidy Support

A. Issues

The primary issue before the Commission in this proceeding is what is the appropriate permanent offset for the CHCF-B universal service fund subsidy support authorized Pacific in D.96-10-066. In that decision, the Commission adopted as an initial offset mechanism an equal percentage reduction methodology (EPRM) for all rates, except for residential basic service. The Commission adopted this mechanism because it resulted in the most competitively neutral outcome in the short term and provided an immediate offset without much controversy.

Parties in this proceeding present six different proposals for the Commission's consideration. Underlying each proposal is a recognition that the rate reductions are revenue neutral to Pacific, and are being funded by a universal service surcharge on the monthly bills of all retail customers of telecommunication services in California. Each party addresses the goals the Commission should follow in deciding which services should be reduced, which customers using those services should benefit, and what the effect of this reduction should be on Pacific's monopoly and competitive markets.

In addressing the issue of benefits to customers, several parties recommend the Commission apply little or no reductions to switched access services because these reductions may not be flowed through to the customers who pay the CHCF-B surcharge. The purchasers of switched access service are the interexchange carriers (IXCs), who use this service to provide toll service to their retail customers. TURN, Pacific, ORA, and FBC all question whether and how price reductions to switched access service will be flowed through to the customers of toll services, especially the less elastic toll customers.[6]

In raising this issue, parties cite to D.96-10-066, where the Commission chose to directly surcharge all customers of telecommunications services in California rather than adopt a funding mechanism that surcharged the telecommunications carriers. In D.96-10-066, the Commission states it chose its funding mechanism to ensure (1) that customers of less elastic services and customers who live in high cost areas do not pay higher charges than customers of competitive services, i.e. that the funding mechanism be "competitively neutral," and (2) that all customers would be clearly informed of the source of the subsidy.

Also at issue in this proceeding is the elasticity factors that should be applied to any price reductions to toll and switched access to reflect the demand stimulation caused by price changes. The higher the magnitude of the elasticity factor used, the greater the rate reductions Pacific will need to maintain revenue neutrality. As discussed in Section III, we adopt an elasticity factor of -0.20 for toll and -0.24 for switched access. We use these elasticity factors to compute the pricing reductions we adopt in this section.

In order to implement a permanent rate reduction proposal in this decision, we need to address several issues. First, we discuss the current status of the CHCF-B fund and establish when the offset we adopt here is to be effective. Next, we specify the actual ceiling rates, price floors, or surcredits that

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[6] We use the generic term elasticity to refer to the price elasticity of demand. The price elasticity of demand is the percentage change in demand generated by a 1% change in price. (See Section III below.) Therefore, an elastic customer is one whose amount of usage of a service is most sensitive to price changes.

our choice of a permanent offset provides and adopt a procedure for reconciling Pacific's $305.2 million estimate with its actual draw. Finally, we decide whether to adopt a mechanism to annually true-up changes in Pacific's actual draw from the universal service fund with the adopted ceiling rate reduction offset.

B. Parties' Proposals

1. Pacific

In its application, Pacific proposes to reduce rates for its highest margin service, intraLATA toll, by $297 million and to reduce another high margin service, switched access, by $7 million. Switched access is the switching and transmission service provided by Pacific to connect end-users with IXCs and vice versa; for the IXC it is a building block of toll service.

Pacific requests to reduce toll prices for both its basic service and its discounted Optional Calling Plans (OCPs), and requests to change the threshold for residential customer discount eligibility from $5/month in toll calls to $20/month. Pacific allocates $172.5 million to residential toll reductions, for an average 24% price decrease and $125.3 million to business toll reductions, for an average 28% price decrease. It states its proposal benefits virtually all customers.

Pacific states that adoption of its proposal will level the competitive playing field by removing the implicit subsidies from toll and setting these prices in line with those of its competitors. It testifies that toll is the market where it faces its most competition and where its prices contain the highest level of subsidy. It concludes that when presubscription is allowed for IXCs, Pacific's current toll prices will no longer be sustainable.[7]

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[7] Presubscription is defined in D.97-06-104 as the ability of a telephone customer to designate (or presubscribe to) a communication carrier and thereafter dial toll calls within a LATA without having to dial additional numbers.

In testimony, Pacific presents an analysis showing that the relative contribution levels, using revenue to cost ratios, is higher for toll than access, even after its proposed price reductions. In its opening testimony Pacific emphasizes that toll provides more contribution per minute than does access. In reply testimony, Pacific disputes AT&T's relative contribution analysis and demonstrates that toll has a higher revenue to cost ratio than access. It asserts that the IXCs are currently earning high profit levels because they did not flow through to customers all of the substantial switched access price reductions adopted by the Commission in IRD and that the IXCs can match the proposed toll price reductions by simply reducing their profits to fair and reasonable levels.

Pacific states that no anti-competitive price squeeze occurs between toll and switched access prices under its proposal because Pacific's rates remain above the price floors established by the Commission. It asserts that it faces the same economic cost as do its IXC competitors when providing access to itself because Pacific's cost includes the opportunity cost of not selling access to the competitor at the retail rate and collecting its authorized contribution.

It does not recommend rate reductions for local usage and zone usage measurement (ZUM) and custom calling services, stating that the price distortions in toll calls need correcting prior to addressing these services. Pacific asserts that toll has a higher contribution margin than either service. Further, for custom calling services, the volume of services any one customer can order is limited. For local usage, Pacific asserts the Commission should look at local access lines as well and consider the low margins for these services. For ZUM, Pacific states that intraLATA toll calls are priced much higher than ZUM calls of the same distance and therefore should be the first category to receive price reductions.

Pacific asserts that in D.96-10-066 the Commission granted it the right to determine which prices to permanently reduce to offset its receipt of CHCF-B funds and that its proposal should be adopted without modification.

2. AT&T

AT&T proposes that Pacific's receipt of CHCF-B funds be offset by reducing switched access prices to economic cost in order to promote economic efficiency. It asserts this is competitively neutral and results in considerable consumer benefits. Specifically, AT&T proposes $263 million in price reductions to switched access with the Commission choosing the services to receive the remainder of the offset.

It pledges to pass through the cost savings it receives from switched access price reductions to its residential customers proportional to the amount of revenue these customers currently contribute. In response to criticism that it did not flow through IRD reductions, AT&T presents a study which shows that between 1987-1995 it reduced toll prices in excess of the Commission-ordered access charge reductions.

AT&T testifies that the Commission should target for rate reduction the services where competition itself will not reduce the rates to cost. Another reason supporting switched access reductions is that price reductions to inputs at earlier parts in the production chain have larger beneficial economic impacts. Pacific's proposal amounts to a vertical price squeeze and is therefore anti-competitive as well as inefficient.

In its testimony, AT&T recommends the use of a price markup calculation (i.e., the markup as a percentage of the price) for comparing levels of contribution, not the total dollar of contribution. Using a price markup comparison, AT&T's calculations show a higher markup for access than toll. There is no need to allocate a shared cost that the incumbent incurs and the competitors do not. Even if there were a need, AT&T argues that it would be efficient to allocate the "burden" by an equal percentage markup so as not to disturb the relative price ratios.

3. MCI

MCI also recommends the rate reduction offset be targeted to reduce switched access prices to direct economic cost. With AT&T, it sponsors a tariff exhibit showing specific rate element reductions. MCI states that the Commission should:

1. reduce the prices for services currently and historically priced substantially above economic cost in order to support universal service;
2. reduce the prices for the least competitive and most essential services and, thus;
3. order those price reductions that would best promote competition, consumer welfare, and economic growth in California.

MCI views switched access as a bottleneck service and testifies that continuing above-cost pricing leads to three types of inefficiencies: allocative (economic welfare); productive (not enough incentive to provide service at lowest cost); and dynamic (no incentive to innovate). The Commission's imputation rules, even with a structural separation (i.e., having toll operated by a separate subsidiary), is ineffective in mitigating the price squeeze problem because only Pacific incurs the economic cost of access whereas its toll competitors must incur the retail rate.

MCI asserts that it did pass through all IRD access reductions but the time period presented by Pacific is too short; MCI cites AT&T's study as evidence of its flow through. It pledges to pass through to consumers any reductions in switched access prices adopted here.

4. Sprint

Sprint recommends the Commission focus reductions on switched access in order to avoid a price squeeze by Pacific. It recommends the elimination of the Network Interconnection Charge (NIC), one of four rate elements of the switched access tariff that were created specifically as subsidies.

Elimination of the NIC is an approximate $139 million rate reduction. Sprint recommends the Commission impute a corresponding $139 million reduction to Pacific's intraLATA toll price floors, thereby allowing Pacific the ability to match the switched access reduction. The remaining $27 million should be used to reduce the local switching element, to be matched with an equal amount of additional reductions to Pacific's toll price floors.

Sprint also commits to passing through any switched access reduction. It does not provide any specifics as to how this will be done.

5. FBC

FBC recommends that the interim EPRM surcredit be adopted as permanent for Pacific as it is the most competitively neutral proposal. A principle the Commission should adopt is to reduce prices to those who contribute to the CHCF-B.

FBC states that Pacific's proposal only serves its own interests and has already been rejected in D.96-10-066. Pacific would have to reduce its toll rates in any case to respond to competition; CHCF-B funds should not be used to finance Pacific's competitive response.

FBC explains why the EPRM is consistent with the FCC's actions in its recent *Access Charge Reform Order I* and the IXCs' proposals are not. It states the FCC found that because universal service costs are intermingled with other costs and implicit subsidies cannot be readily distinguished from other costs, the FCC chose not to reduce interstate access charges to cost but instead to restructure them, relying on regulatory changes and market forces to move access charges gradually, not immediately, toward cost.

6. ORA

ORA states that D.96-10-066 provides clear direction that CHCF-B funds should be evenly distributed among many services and classes of customers. Its proposal does this on a competitively neutral basis and in a manner that does not pose an administrative burden. ORA's proposal in its direct testimony is to reduce toll by $218 million (residential by $134 million and business by $84 million), switched access by $52 million, custom calling services by $13 million, and Centrex services by $23 million.

In its reply testimony, ORA changes it recommendation to reflect the benefits of reductions to local usage and ZUM. Its proposal is to reduce toll by $161 million (residential by $93 million and business by $68 million), switched access by $52 million, local usage and ZUM by $78 million, and custom calling by $15 million.

ORA testifies that Pacific's request to substantially reduce only toll rates is neither competitively neutral nor does it foster universal service. It believes Pacific's targeted toll reductions are anti-competitive and need to be balanced by sufficient decreases to switched access and other services. It proposes to reduce the NIC element of switched access by 50%. To address the problem of the IXCs not passing through all of the access reduction, ORA recommends the Commission order a pass through.

ORA reports that the contribution from current residential toll ceiling rates (based on average revenue per minute) is less than the contribution from current business toll rates. Under Pacific's proposal however, this relationship would reverse, and residential toll service would provide more contribution than business toll service.

Another ORA concern is Pacific's proposal to change the current residential direct discount plan by raising the volume threshold from $5 to $20/month. ORA believes this will disproportionately harm low-income residential customers and recommends it not be adopted.

7. TURN

TURN recommends the Commission apply three criteria in considering which rates to reduce. First, and most importantly, the Commission should take into account the degree of competition which exists now, or will in the near term, for a given service. Second, the Commission should consider the degree to which a given service is currently priced above cost. Third, the Commission should consider the extent to which the service under consideration is essential to users of the network, i.e. which rate reductions will best promote our universal service goals.

Based on the above criteria, TURN recommends a $194 million reduction to local usage prices and a $110 million reduction to ZUM prices. Local usage and ZUM are local exchange services which are among Pacific's least competitive services. TURN favors reducing local usage and ZUM over custom calling services because the former are essential services while custom calling features are discretionary. Local usage and ZUM are also more essential services than toll or custom calling.

TURN does not favor using CHCF-B funds to reduce switched access charges because it believes customers, not carriers, should be the direct beneficiaries of offsetting rate reductions. While the Commission could order a mandatory flow through of any switched access reductions, TURN does not see this as a workable solution because structuring and enforcement of a flow-through requirement would be fraught with administrative problems. TURN believes the IXCs, if not closely monitored, will try to flow through a disproportionate amount of access charge reductions to their highest volume customers and to new customers in promotional offerings.

In support of its position, TURN compares the IRD access charge reductions of about 2.5 cents per minute for Pacific with how AT&T's rates have actually changed since IRD. It states some rate schedules actually increased, such as commercial Message Telecommunications Services (MTS) rates, and both residential and commercial calling card rates. Residential MTS rate reductions since IRD fall far short of the access charge reductions. To the extent AT&T passed through its IRD access cost reductions at all, most of the rate reductions bypassed the basic toll service used by many residential and small business customers.

C. *Discussion*

1. Commission Goals

The purpose of this proceeding is to offset Pacific's estimated $305.2 million annual draw from the universal service fund, CHCF-B, in order to avoid Pacific receiving a windfall of both a subsidy from the CHCF-B fund and monies from the implicit subsidies contained in rates for services which are priced to help offset the costs of universal service.

Our goals in adopting a rate reduction are to (1) target the services parties demonstrate contain implicit subsidies; (2) ensure the rate reductions we adopt result in sustainable prices; and (3) reduce the rates within these services in a manner which benefits the broadest base of customers.

In targeting specific services, we recognize that not all of Pacific's services provide implicit subsidy support for universal service. The services identified all contribute a high margin of revenue over direct costs that is available to meet Pacific's shared and common costs and to provide an implicit subsidy toward the cost of other services. The record in this case establishes

Pacific has extremely high contribution margins for the following services: intraLATA residential and business toll, switched access, local usage and ZUM, and custom calling services.[8]

We measure contribution levels using a revenue/cost ratio as this is the ratio generally used by the Commission to review relative contribution levels for services. As AT&T's witness Dr. Economides demonstrates in his workpapers, using a revenue/cost ratio yields the same results as using a profit rate when comparing the relative contribution levels of different services. However, as Pacific's witness Dr. Timothy J. Tardiff (Tardiff) points out in his reply testimony, Economides incorrectly compares the profit rate of Pacific's access to that of an *IXC's* toll. If we compare the profit rates or the revenue/cost ratios of Pacific's access to *Pacific's* toll, we find that toll has a higher relative contribution than does access.

In selecting the high margin services identified by parties for rate reduction, our first goal, we rely on the relative magnitude of the measurement, not on a precise calculation. We recognize that the Commission continues to refine cost measurement in the OANAD proceeding. This proceeding is noticed to consider only rate decreases, not increases, and these rate decreases apply only to Pacific, and only within a range of $305.2 million. Recognizing the scope and limitations of this proceeding, we will not use the measurements on this record to equalize margins between services or to reduce the price of any service close to its existing price floor.

Our second goal, to ensure the rate reductions we adopt here result in sustainable prices, requires us to remove implicit subsidies from services

[8] The elements of switched access identified by parties for reduction are the NIC and the call setup and minute of use (MOU) rate elements of Pacific's LS1 and LS2 tariffs.

that face competition today or may face competition in the future but not in a manner that provides Pacific an unfair competitive advantage. It also means that for toll, local exchange/ZUM, and custom calling services, all services where Pacific has pricing flexibility, we should set the price ceilings at the new reduced rates and charges. By reducing Pacific's authorized price ceilings for these services, we ensure that Pacific cannot unilaterally raise these prices, thereby negating or redirecting our adopted offset; Pacific must file an application to raise its service price ceilings.

Under the procedures adopted in NRF, in D.96-10-066, we found that the need for sustainable prices is a primary reason for establishing the CHCF-B surcharge:

> With the introduction of competition, multiple carriers will be competing for the same customers. The implicit subsidies of averaged rates, and services priced above cost to support services priced below cost, will no longer be sustainable in a competitive market. Therefore, revisions to the mechanisms for the funding of high cost areas are needed so that the CLCs, and the incumbent LECs, can have access to universal service funds on a competitively neutral basis. To that end, as discussed later in this decision, we have created a new explicit subsidy support mechanism for high cost areas of the state. This fund shall be known as the CHCF-B. The purpose of this fund is to replace the implicit subsidies that are used to support universal service, with an explicit funding mechanism. (*Id.* at 17.)

This record provides no bright line to distinguish (1) how much of the contribution margin of a service is an implicit subsidy rather than a proper allocation of shared and common costs and (2) at what level a price reduction using CHCF-B funds constitutes an unfair competitive advantage to Pacific. All high margin services identified by parties have some level of competition today, although testimony reflects that Pacific's competitors have achieved only a very small market-share for switched access and local usage/ZUM services.

Recognizing our pricing information is imprecise and that if we err in setting too low of a price Pacific will obtain an unfair competitive advantage, we will leave a substantial contribution margin in every service we reduce.

Therefore, we do not reduce any service near the price floors the Commission has previously determined are sufficient to prevent anti-competitive behavior. Despite the urgings of the IXCs, this is not the proceeding where we will reexamine our imputation standard.

To further our third goal, we agree with ORA that the benefits of the rate reduction offset should be broadly distributed among the customers who are paying the CHCF-B surcharge. Pacific customers should not be required to pay twice to support universal service.

To achieve broad-based customer benefits, we reduce implicit subsidies in all the services that have been identified as providing subsidy contributions to universal service and we do it in a manner that provides benefits to the greatest number of customers within each service.

Several parties question whether we meet our goal of broadly distributing the benefits of price reductions to the customers paying the CHCF-B surcharge by reducing the price of switched access service. The customers of this service, IXCs, do not pay CHCF-B surcharges. Pacific, FBC, ORA, and TURN argue that rate reductions to switched access services will not be completely flowed-through to the IXCs' customers and that the reductions that are flowed-through will be in the form of discounts to large volume customers and special promotional offers to new customers.

AT&T addresses the charge that it did not flow through the IRD rate reductions by testifying that competition does not work perfectly or immediately, but it will pledge in this proceeding to immediately reduce its intrastate toll rates by the entire amount of any access rate reduction attributable to its residential services. MCI and Sprint offer similar pledges.

We do not find the IXCs' pledges are sufficient to establish that any switched access price reductions we adopt will be completely and timely flowed-through to a broad-base of IXC customers. In their testimony and briefs, the IXCs do not provide adequate details to establish that their pledges can be effectively implemented, monitored, and verified by the Commission. Therefore, we are cautious in applying CHCF-B funds to reduce switched access services.

Another high margin service that parties testify should not receive CHCF-B funded price reductions is local usage. Pacific asserts that the higher margins for residential and business local usage are appropriate because the margin on business measured access lines is low and the prices for residence measured access lines are currently below cost. TURN disputes this, stating that Pacific has not examined its costs by geographic area and population density; it believes that if this were done, it is more likely that Pacific's measured lines would be found to be easily recovering their costs on a statewide basis. We find merit in TURN's position. We also do not agree with Pacific's premise that all implicit subsidies should remain in local usage to support local access lines.

MCI and Pacific question if the Commission, in calculating the amount of support needed for universal service, used local usage revenues to offset the universal service fund. The record in this proceeding does not provide a clear answer. However, Column G, in Appendix D of D.96-10-066, establishes that the answer is no. We find that local usage and ZUM are high margin services that meet our adopted goals.

Parties suggest other goals which we do not adopt today. For example, all parties except Pacific testify that our adopted permanent rate reduction offset should be competitively neutral as this is a goal adopted by the Commission in D.96-10-066. We do not agree. In D.96-10-066, we adopted an interim mechanism that in the short term would be competitively neutral, the EPRM, because it was expedient, not because it best met our goals. We stated: "Neither the CLCs or the incumbent LECs gain an advantage as a result of the adoption of an across the board reduction. Although some of the services provide greater contribution toward universal service than other services, an across the board reduction will result in an immediate offset without much controversy" (*mimeo.* at 208).

A concern with the EPRM, first raised in the universal service proceeding and not resolved on this record, is whether applying a 7.029% surcredit to Pacific's services would leave any service with prices below cost.

In addition, if the Commission adopts FBC's proposal, we would apply rate reductions to services that no party demonstrated were providing an implicit subsidy to universal service. This is a significant concern because, as Appendix A shows, it would result in these services receiving nearly 40% of the total rate reduction offset.

For the reasons discussed above, as well as our preference to provide reductions directly to prices rather than use a billing surcredit, we do not adopt FBC's proposal.

Another goal we do not adopt is to exclude certain high margin services from rate reductions. AT&T, MCI, and TURN ask the Commission to adopt as a criteria that rate reduction offsets should only be applied to monopoly services for reasons of economic efficiency and fairness. Pacific, with GTEC's support, advocates that the Commission grant it complete discretion to offset its receipt of universal service funds by reducing prices on its most competitive services.

We do not adopt either position. Our goal is to reduce subsidies from all services identified as providing support for universal service, not to allow Pacific to target only its most competitive services nor to attempt to fully leverage the rate reductions by selecting only monopoly, or near monopoly, services for offset.

2. Adopted Rate Reductions

Based on our discussion above, we choose here to allocate the estimated $305.2 million in rate reduction offset to all identified high margin services, with a preference given to toll reductions because this service has the highest contribution margin and has historically provided the highest implicit subsidy support. We find that an initial 10% reduction to MTS toll, followed by an equal percentage reduction to MTS toll and all other identified high-margin services (i.e., switched access, local exchange, ZUM, and custom calling services) best meets our goals. Based on comments received to the proposed decision, we shift $31.3 million in reductions from toll to switched access and recognize the revenue reductions targeted to custom calling will not result in price reductions for multi-feature packages.

The goals of sustainable prices and broad-based benefits guide us in selecting the amount and structure of the rate reduction we apply to each high margin service. The structure of the rate reduction for each service selected is important because the contribution margins vary within the rate categories of each service and, in the example of toll, Pacific has already reduced the contribution margins for its most elastic customers through discount plans and contracts.

a) IntraLATA Toll Service

The record reflects that Pacific's intraLATA toll ceiling prices provide the highest margin contribution. The Commission has historically viewed toll as a service providing an implicit subsidy to other services and found in D.96-10-066, that with increasing competition, the sustainability of this pricing structure is no longer viable.

Pacific testifies that its average residential toll rates are approximately 10% higher than AT&T's average rates and that both its residential and business toll rates are 20-30% higher than MCI's. Further, Pacific states that AT&T and the other IXCs can at anytime make large price reductions and still earn fair and reasonable profits simply by flowing through the remaining IRD access charge reduction. Pacific shows that IXCs can profitably provide toll at $0.04 to $0.05 per minute, based on the $0.01 and $0.02 per minute of additional costs they incur over the current switched access price of $0.029 per minute. Sprint testifies that all toll rates proposed by Pacific are within its existing authorized pricing flexibility. ORA testifies that the residential toll prices it proposes, which are sometimes lower than Pacific's, retain a substantial margin. The above testimony will guide us in determining a sustainable price for toll.

We do not adopt the specific price reductions proposed by Pacific. All interested parties object to the structure of Pacific's toll reductions and establish that Pacific's proposal excludes many customers from any noticeable savings and concentrates most of the benefits in the hands of Pacific's largest customers.

We should target our toll reductions to Pacific's basic MTS ceiling rates. MTS includes calls directly dialed by the caller (referred to as Direct Distance Dialed calls) and calls dialed by the caller and paid by calling card or credit card. Basic MTS has higher prices that those offered under Pacific's OCPs or its contracts and the majority of Pacific's toll customers purchase service under the MTS schedule. Thus, by targeting MTS, we reduce the toll prices containing the highest implicit subsidy while benefiting the greatest number of customers.

Targeting all toll reductions to MTS is consistent with our IRD decision. In D.94-09-065, we adopted price reductions for Pacific's proposed optional and automatic discount toll plans in order to position Pacific to compete in the expanded competitive arena created by the Commission in IRD. In taking this action, we stated that Pacific was free to offer more generous discount plans through its pricing flexibility but that any resulting revenue shortfalls would not be accounted for in revenue rebalancing.

Usage charges for MTS calls are currently tariffed at uniform statewide rates, based on a series of mileage bands and on the duration of the call and the time of day of the call. Maintaining the Commission's existing policy of parity between residential and business basic MTS prices is an issue no party addressed although the toll rates proposed by Pacific and ORA result in different residential and business MTS rates. In adopting price reductions here, we will maintain the policy of parity for residential and business basic MTS. Although we choose here to maintain rate parity for these services, Pacific has pricing flexibility that could be exercised to result in rate disparity.

The additional revenue required to provide toll parity for MTS service is $26 million. We find it reasonable to use a portion of the reduction initially allocated to custom calling for the purpose of toll parity.

In applying price reductions to basic MTS, we effectively eliminate the volume discount provision of Pacific's present tariffs. This is the same result that occurs under Pacific's business toll proposal. We find eliminating the volume discount provision for residential and business MTS service benefits the broadest number of customers and use that to set the residential and business basic MTS reductions. We do not adopt Pacific's proposal to change the terms of its residential discount.

While the testimony of parties focused on the increased competition Pacific will face when it is required to offer intraLATA toll presubscription, we believe our focus should be on assessing sustainable prices in today's market. Presubscription will occur when Pacific is granted authority to enter the interLATA market. We expect that market pressures brought about by presubscription will require Pacific to lower its intraLATA toll prices; however, at the same time Pacific will have the opportunity to earn additional profits by competing in the interLATA market.

The proposed decision reduced all business and residential MTS rates 32.5%. In its comments on the proposed decision, Pacific states that this level of reduction places basic MTS toll prices at a lower level than what most customers are currently paying under two residential optional calling plans, the Service Area Plan and the Community Plan, and what some business customers are paying under the Advantage 50 Plan.[9] Pacific states that it plans to contact these customers and recommend that they switch to the lower basic MTS rates. It calculates that if all residential OCP customers migrate to basic MTS it will experience an $18.4 million loss.

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[9] The Service Area Plan costs $4.50 per month and provides a 30% discount on eligible charges from $0 to $45 and a 40% discount on charges above $45. The Community Plan costs $7.00 per month and it provides a 40% discount on calls to a designated community and a 30% discount to all other communities. The Advantage 50 Plan costs $7.50 per month and provides a 30% discount on eligible charges from $0 to $300 and a 35% discount for on charges above $300.

Pacific states that the price reductions adopted by the Commission should leave it revenue neutral; therefore, we should compensate it for its estimated $18.4 million loss by applying the same $186 million revenue reduction to toll services but spreading the revenue over a broader customer base, thereby resulting in a reduction to basic MTS prices of only 30.7%.

We recognize the proposed decision inadvertently erred in reducing basic MTS prices below some OCPs. However, we should not correct the proposed decision by adopting Pacific's proposal as this would be contrary to our decision not to allocate toll reductions to Pacific's discount calling plans, as discussed above. We also do not agree with Pacific's estimate of its revenue loss. In response to the level of basic MTS toll reductions recommended by the proposed decision, Pacific could choose to exercise its pricing flexibility to adjust the monthly charge of its OCPs for some customers rather than advising these customers to switch to basic MTS. With only 4% of Pacific's residential customers on an OCP plan, making some adjustment to the monthly charges of the plans could cost significantly less than $18.4 million.[10]

We will address Pacific's revenue neutrality concern by reducing the amount of basic MTS toll price reductions to a level that remains above Pacific's existing OCPs. Therefore, we adopt a 29% basic MTS toll reduction for residential and business customers.

Our change addresses the revenue neutrality concern raised by Pacific by reducing the revenue reduction offset applied to MTS toll by $31.3 million. Due to our elimination of the automatic discount provisions of basic MTS, our 29% rate reduction shown at Appendix C provides an average

[10] Pacific at the Final Oral Argument changed its estimated loss from $18.4 million to $26 million but did not provide a citation to any evidence or workpapers in this record.

discount for residential and business MTS customers that is substantially less than 29% and that is also below the effective average discount Pacific states applies to its residential OCP customers. We also note that the final decision's revised MTS reductions of 29% are below the initial 30% discounts offered by Pacific's residential and business OCPs.

We now turn to the issue of which of the remaining high margin services should receive the additional $31.3 million in revenue reductions. We do not chose local usage/ZUM because we are cautious to adopt price reductions beyond those recommended in the proposed decision until the cost of local access lines has been identified and fully examined. We do not chose custom calling because Pacific in its comments states that its three residential custom calling multi-feature package offerings are currently below existing price ceilings; therefore, revenue reductions applied to these services do not lower existing prices, only the authorized price ceiling.

We will apply the additional $31.3 million in revenue reductions to switched access service. Switched access service contains relatively high margins and the interLATA customers of the IXCs are broad-based and significant contributors to the CHCF-B. This is a substantial change for switched access service, bringing the total reductions to $63.6 million, a 17.6 % overall revenue reduction.

b) *Switched Access Service*

As discussed earlier, we are not adopting AT&T and MCI's proposals to target all rate reductions to switched access services. However, switched access is a high margin service and it should receive a share of rate reductions under our adopted goals, provided we have some assurance that the reductions we adopt will be flowed-through to a broad base of their customers. Our concern is only with the IXCs' customers, as we are not adopting

Sprint's recommendation to provide Pacific an equivalent rate offset to reflect its reduced imputed cost of access.

We expect a significant amount of flow-through will occur from the IXCs' competitive response to the toll reductions adopted for Pacific. In addition, another assurance is the pledges of AT&T, MCI, and Sprint. As other parties demonstrate, these pledges do not provide us the full assurance represented by their sponsors. The pledges represent only part, albeit an extremely large part, of the IXC market, and are vague and potentially administratively burdensome. Nevertheless, we will accept the pledges and direct that the three IXCs each submit to the Commission an implementation plan within 30 days of this decision and a verification report within 6 months of the rate reductions adopted here being effective. We will review the success of the pledge programs in the access charge reform proceeding.

The issue of how to design the rate reductions for switched access is complex. At the direction of the assigned ALJ, the three IXCs supplemented their testimony with marked-up tariffs specifying by rate element their recommended reductions.

The primary switched access rate element proposed to be reduced by the IXCs, and ORA is the NIC. Parties testify that the NIC is chosen because it is a noncost-based rate element and, therefore, consists entirely of implicit subsidies.

We disagree with parties' representation of the NIC. While the Commission has stated that the NIC is not a cost-based rate element, this is based on a finding that the cost components of the NIC have yet to be determined, not that there are no costs. The NIC is a per-minute charge assessed on all switched access users that is designed to recover historic costs associated with the tandem switch. The FCC determined that these costs should not be recovered from the tandem switching rate element in order to protect the small IXCs. We should not make adjustments to this rate element until we have completed a full review of the cost studies filed in OANAD and looked at specific rate elements in the upcoming access reform proceeding. (See D.95-04-073 and D.95-12-020.)

In the Access Charge Reform Proceeding,[11] the FCC examined the costs currently recovered by the Transport Interconnection Charge (TIC), which is the interstate counterpart of the NIC. The FCC substantially reduced the NIC by identifying several costs included in the TIC and reallocating those costs to other access elements. Specifically, the FCC reassigned five network elements which had been included in the TIC as follows:

- SS7 costs to local switching or signalling rate elements;
- tandem switching costs to their respective category;
- DS1/voice-grade multiplexer costs to the newly created trunk ports category within the traffic sensitive basket;
- host/remote trunking costs to the tandem-switched transport category;
- additional multiplexers associated with tandem switching to the tandem-switched transport category. (*Id.*, pp. 92-94.)

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[11] First Report and Order, *In the Matter of Access Charge Reform (et al.)*, CC Docket 96-262 et al., May 16, 1998.

Based on the findings of the FCC, it is reasonable to conclude that there are network elements whose costs are recovered through the NIC. While we recognize that the NIC needs to be revisited in light of the FCC's recent order, we do not have the record here to do this.

Therefore, in making rate reductions to switched access service, we should reduce two rate elements recommended by AT&T and MCI that do have an identified cost basis: the per call set-up charge and the access per minute charge of the local switching element of the end office rate. (Section 6.8.3.(a) of Pacific's Access Service Tariff.)

c) *Local Usage and ZUM Services*

Local usage and ZUM are services proposed for rate reductions by both TURN and ORA. TURN testifies that measured local usage for residential and business customers provides an essential service to a broad base of Pacific's customers, has a high contribution margin, and is among the least competitive services Pacific offers.

Local usage includes measured local service for residential and business customers. Flat rate residential service is not covered because it is part of universal service; Pacific does not offer a flat rate service for business. ZUM rates apply to calls that are located just beyond a caller's local calling area but within its community of interest.[11] The Commission has treated ZUM calls as more akin to local service than toll service.

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[11] TURN notes that ZUM rates, available in most metropolitan areas in Pacific's service territory, are charged for calls completed to a zone between 12 and 16 miles from a call's rate center. For customers with measured service, local usage rates apply to calls to zones that are less than 12 miles from a caller's rate center.

While TURN considers ZUM to be essentially a local exchange service, it proposes different percentage rate reductions for local usage and ZUM in order to leave the services with a uniform mark-up. In its testimony, however, TURN states that Pacific attributes the same Total Service Long-Run Incremental Cost (TSLRIC) to both services and does not separately track the revenues. Based on our record here, we will apply an equal percentage price reduction.

FBC raises the concern that the Commission's policy is to promote local competition; yet, if reductions of the magnitude recommended by TURN are adopted, the result could be to stifle competition. However, based on TURN's testimony, we find that even at the dollar levels proposed by TURN, rate reductions to local usage/ZUM will still leave sustainable prices for new competitive entrants.

d) Custom Calling Services

The category of custom calling services is the last high margin service proposed for rate reductions. Custom calling has both residential and business customers and consists of the following features, offered individually or in packages: call forwarding; call waiting; three-way calling; speed calling; call return; repeat dialing; message waiting indicator; intercom, priority ringing; repeat dialing; delay call forwarding; call return; call screen; call trace; caller ID; and blocking. The majority of customers purchasing custom calling services are residential; business customers can also obtain the features through Centrex service.

ORA is the only party to propose a rate reduction for this service and it proposes rate reductions of varying amounts to specific features that total $15 million for the category. Pacific included custom calling reductions in its original rate offset proposal in R.95-01-020/I.95-01-021.

We find that custom calling meets our adopted goals and should be included in the permanent rate reduction offset. However, we recognize that parties place a higher priority on other high margin services. ORA states in its direct testimony that it proposes a 5% reduction to Custom Calling and Centrex in order to provide a broad range of services in its proposal; in its reply testimony it withdraws its recommendation for a $23 million reduction for Centex services and applies the amount to Local Usage and ZUM.

Therefore, we find it is appropriate to reduce prices for custom calling less than for other high margin services and to apply the difference to maintain residential basic MTS toll parity. Our adopted reduction is 2.5%, spread evenly to all individual basic custom calling feature charges.

In its comments on the proposed decision, Pacific states that the current prices for three residential feature packages shown at page 2 of Appendix C are below the current ceiling prices and, therefore, the final decision should adopt price reductions for the existing ceilings, not reduce current prices. We agree that our regulatory framework supports Pacific's position and, therefore, we adopt the change. (See 33 CPUC2d 43, 122-128 and 56 CPUC2d 117, 196.)

e) *Adopted Price Reductions*

The prices that result from our adopted rate reduction offset are all substantially above adopted Commission costs, are sustainable prices, and provide benefits to a broad-base of customers using a broad range of Pacific's services. We adopt a permanent rate reduction offset that results in revenue reductions to the high margin services shown at Appendix A as follows: 16.7% revenue reduction to MTS toll, 17.6% revenue reduction to switched access, 11.9% revenue reduction to ZUM/local usage, and a 2.5% revenue reduction to custom calling. The specific ceiling prices we adopt are contained in Appendix C.

The rate changes ordered by this decision will cause Pacific's toll, access and exchange billing bases to decrease by approximately $300.3 million. These reductions in the billing bases require that adjustments be made to Pacific's Rule 33 - Billing Surcharges tariff. Therefore, simultaneous with the implementation of rates contained in Appendix C, we will order the revisions to Pacific's Rule 33 Billing Surcharges as contained in Appendix D of this decision.

We adopt final prices based on the testimony and workpapers in evidence in this proceeding. Further rate calculations are not required. A summary of our revenue reductions for Pacific based on our adopted rate reductions is provided below in Table 2.

Table 2

Pacific Bell
A.97-03-004
Adopted Rate Rebalancing Worksheet
($000)

	Service	Rate Reduction	Billing Base	Revenue Reduction	Foot-Notes
1	Residential MTS Toll	29.0%	671,297	(118,900)	1,2,3
2	Business MTS Toll	29.0%	245,023	(35,100)	1,2,3
3	Access - Local Switching	36.3%	206,276	(63,600)	1
4	Custom Calling	2.5%	285,526	(7,100)	3
5	Local Usage/ZUM	11.9%	677,231	(80,500)	
6	Total Reductions		2,085,353	(305,200)	
7	Pacific Bell Estimated USF Subsidy			305,200	

Footnotes:

1. Toll and Access Revenue Reductions include elasticity, stimulation costs, and settlement effects.
2. Toll Revenues reflect the elimination of direct discounts, resulting in an additional 10.7% rate reduction.
3. Approximately $26 million of Custom Calling Reductions were redirected to Residential MTS in order to maintain Residential and Business MTS rate parity.

3. Implementation Issues

We have several implementation issues to decide. These issues are (1) whether Pacific should implement its tariff changes through a compliance filing or through an advice letter filing subject to protest; (2) whether there should be a delay in implementing the permanent price changes; (3) the procedure Pacific should follow to reconcile its $305.2 million estimate of the offset with the amount of its actual draw from the CHCF-B fund; and (4) whether we should adopt an annual true-up mechanism.

We do not decide here another issue raised by parties, which is the method Pacific should use to return to customers the offset reductions that will be owed when it receives its CHCF-B draw for the period February 1, 1997 through the effective date of the permanent rate reduction offset. Pacific testifies it estimates its offset will be a 7.029% surcredit for the prior months and that this money should be returned expeditiously to customers, either as a one-time refund or over a six to twelve month period. The disposition of this money is an issue the Commission will address in the universal service proceeding, R.95-01-020/I.95-01-021, where all affected carriers are parties of record.

In the universal service OIR/OII, several decisions related to CHCF-B funding have recently been issued. By D.98-01-023, as modified by D.98-04-068, the Commission addresses the issue of interest and the interest rate to be paid by carriers holding CHCF-B and California Teleconnect Fund (CTF) surcharge revenues and by COLRs owed reimbursement.[13] By ALJ ruling on

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[13] The decisions do not specify the rate of interest to be paid carriers owed reimbursement for services provided under the CHCF-B program. For the CTF program, D.98-01-023 states that carriers owed reimbursement for services provided since February 1997 shall receive interest on the amounts owed based on the seven-day compound yield on taxable money market funds published in *The Wall Street Journal*.

April 28, 1998, ALJ Timothy Kenney specifies the monthly claim form to be used by COLRs for the CHCF-B and requires each COLR to submit by no later than September 15, 1998, a separate claim form for each month during the period of February 1997 through July 1998; the ruling also states that for all months after July 1998, claims forms must be submitted within one calendar month plus 15 days after the close of the month for which a claim is made.

ORA recommends in this proceeding that the Commission delay adoption of permanent rate reductions until the Commission has activated the CHCF-B trust and put in place the interim EPRM. However, we note that sufficient procedures are in place now, as referenced above, for the Commission to be able to put in place permanent price reductions without further delay. By September 15, 1998, the Commission will have Pacific's request for its CHCF-B draw through July 1998; we can specify the procedures in this decision by which Pacific's $305.2 estimate can be timely reconciled with the actual draw approved by the Commission. Therefore, we do not adopt ORA's recommendation.

On the implementation issue of whether Pacific should file its tariffs by compliance filing or subject to protest, we select the compliance filing. We do this because we herein adopt the revenue effects and rate ceilings set forth in Appendices B and C and we want to deliver the benefits of the rate reductions we adopt to customers without undue delay. The IXCs object to this process, stating that parties should be given the opportunity to protest the filings, and to litigate the specific tariff adjustments using the latest available data and adopted costs. We disagree.

The Commission made clear in the Scoping Memo and in the hearing process that its purpose in this proceeding was to timely adopt price reductions and that it would do so based on the record evidence. The Commission chose the compliance filing process to implement the prices adopted in IRD. (56 CPUC2d 117, 289.) The Commission also chose the compliance filing rather than a protestable advice letter for adoption of costs in OANAD when the cost adjustments were clearly specified in the decision. (See D.96-08-021 and D.98-02-106.)

The tariffs Pacific files to implement this decision should allow the adopted price reductions to be effective as soon as possible, but no later than 60 days after the effective date of this order. We use Pacific's $305.2 million estimate in this proceeding. Pacific should true-up this estimate when its CHCF-B claims are approved for the twelve month period immediately preceding the date rates are effective. If the CHCF-B is not activated prior to Pacific implementing its price reduction offset, it can apply to be compensated for the time value of money in a manner consistent with that set forth in D.98-01-023 as modified by D.98-04-068.

Pacific recommends that any difference in the true-up of its $305.2 million estimate to its actual draw be dealt with through a one-time surcharge adjustment. However for this proceeding, we believe a targeted price reduction is preferable to a surcharge/surcredit for offsets to the CHCF-B. Therefore, we find that it would be preferable to specify that if the adjustment is within 10% of $305.2 million, Pacific should by compliance advice letter filing adjust its rates for local usage and ZUM as these are services with a combined annual billing base of $677 million. A $30.5 million adjustment would result in an acceptable net price reduction of between 7.25% to 16.25%. If the adjustment to the $305.2 million estimate is greater than 10%, we should consider whether it is appropriate to apply the adjustment to local usage/ZUM. Therefore, Pacific should file this adjustment by an advice letter, which will be subject to protest.

ORA recommends that the Commission annually track the revenues from the permanent rate reduction offset to ensure they are within a reasonable range of the amount drawn by Pacific from the CHCF-B as it is concerned that revenues could be inaccurately forecasted and that any adopted elasticity estimate, whether or not accurate, could soon be inapplicable. We do not adopt this proposal. We expect there will be some changes in the annual revenue effect of the price reductions we adopt, and the changes may be due to a number of factors both within and beyond Pacific's control. As with IRD, we find that is acceptable. We do not chose to adopt a mechanism that would blunt Pacific's incentives for efficiency and innovation.

Other parties cite to changes in Pacific's annual draw, based on the number or cost of subsidized subscriber lines, as a reason for an annual true-up. We do not adopt a true-up mechanism for Pacific's draw either. Pacific will retain an incentive to carefully manage its costs and we do not expect a large change in the number of high cost customers in the next few years.

The Commission will review the CHCF-B program in a timely manner. In D.96-10-066, the Commission set forth a review process of the CHCF-B to occur in three years. It stated a review should take place of the subsidies generated by the fund to ensure that the overall size of the fund is within reason and that the fund will be adjusted as competition and technology evolve.

III. Elasticity

A. Background

Elasticity is an economic measure that describes the relationship between the movement in two variables. The price elasticity of demand is the percentage change in demand generated by a 1% change in price. To illustrate, an elasticity measure of -.5 means that a 1% reduction in price would lead to a

0.5% increase in demand.[11] Unless otherwise noted, we will use the generic term elasticity to refer to the price elasticity of demand. In general, the elasticity value is negative since price and demand are negatively correlated (i.e. a price decrease generally leads to an increase in demand and vice versa). Economic literature often focuses on the magnitude of the elasticity measure. A measure is considered more elastic when its absolute value is higher. In this decision, we will maintain the negative sign in front of the elasticity value, but we will use the absolute value to describe the relative size of the elasticity.

We address elasticity in this proceeding because we are adopting rate reductions for specific services in order to reduce the revenues generated from those services. In order to get an accurate measure of the revenue impacts from rate decreases, we need to account for the demand stimulation created by those rate decreases. Because of elasticity, revenues will decrease by less than the percentage of rate reduction.

The Commission previously visited price elasticity in the IRD proceeding, which involved the restructuring of Pacific's and GTEC's rates and charges while maintaining revenue neutrality. In that proceeding, GTEC and Pacific submitted elasticity studies for the toll and access markets. Other parties critiqued these studies and cited several other studies of toll and access elasticity that arrived at higher elasticity measures. In D.94-09-065, the Commission adopted an intraLATA toll elasticity of -.5 and a switched access elasticity of -.44.

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[11] For large reductions, the calculation of the percentage demand increase is more accurately calculated by the formula (((P_{new}/P_{old})^e)-1) rather than the simple ratio. For example a 20% price decrease with a -.5 elasticity would yield an 11.8% increase in demand -- (((.8/1)^-.5)-1) = 11.8% instead of a 10% increase.

These figures did not come from any particular study, but fell within the range of estimates submitted in the proceeding.

In D.96-02-023, we denied several petitioners' request for rehearing of D.94-09-065 and affirmed our adopted elasticity figures and addressed the issue of properly calculating the elasticity impact on revenues. In D.97-02-049, we denied a petition for modification of D.94-09-065 by Pacific and GTEC which alleged that the elasticity factors adopted by the Commission were too high and requested various rate increases for compensation. We refused to consider issuing a true-up to account for any revenue shortfall since this would shield the company from the risk of competitive losses and undermine the principals of NRF. We also concluded that it would not be reasonable to compensate Pacific or GTEC for any alleged shortfall in its toll or access revenue without considering any possible windfall in its revenues from other services.

This application presents new estimates of intraLATA toll elasticity and intrastate switched access elasticity that are lower (in absolute value) than those adopted in IRD. Pacific argues for the Commission to adopt these new estimates instead of the IRD figures.

Several parties object to Pacific's attempt to introduce new elasticity factors in this proceeding. These parties express concern about the added complexity of introducing the elasticity issue in this proceeding. They also argue that addressing the issue might conflict with pending litigation concerning the elasticity adopted in D.94-09-065.

In his Scoping Memo, Commissioner Knight ruled that this proceeding should use current data to set the elasticity factors, stating that this was consistent with the Commission's decision to deny Pacific's Petition for Modification of D.94-09-065.

Therefore, in this proceeding, we will consider new elasticity estimates for intraLATA toll and for switched access and reexamine the correct method to calculate the revenue impact from the rate reductions.

B. *Elasticity Estimation*

1. Positions of the Parties

a) *Pacific*

Pacific's economic witness, Tardiff, estimates elasticity by using statistical regression techniques. In statistical regression, the modeler selects a particular formula to describe the relationship between a dependant variable and the many variables that affect the values of that dependant variable. Then the modeler collects data that represent those variables and measures the correlation among those collected data points.

Tardiff's toll study assumes that the MOUs of intraLATA toll is a non-linear function of Pacific's current and past toll rates, total California income, and the month of the year.

To perform his study, Tardiff collects monthly data from the period of January 1992 through September 1996. The MOUs include both Pacific's intraLATA toll and the 10XXX intraLATA MOUs carried by competitors. To represent price, Tardiff uses a price index of post-surcredit rates, with each data point representing the ratio of the current rate to the December 31, 1994 rate. The price index is then adjusted for inflation using the consumer price index. The model includes a polynomial distributed lag in the price variable to measure the long-run elasticity, accounting for the consumers' tendency to take several months to adjust their consumption behavior to a price change. To measure income, Tardiff uses inflation-adjusted California personal income. Finally, Tardiff includes variables to account for demand variations that are associated with different months in the year. By including income and monthly variables, Tardiff testifies that his study more precisely estimates the impact of the price change on the demand stimulation.

Pacific's model assumes a non-linear demand function. In order to perform a linear regression on the data, Tardiff uses the natural logarithm of the MOU, price, and income variables. The resulting sum of the estimated coefficients on the price variables represents the elasticity estimate. The toll study yields a price elasticity of -.20.

Pacific's switched access study assumes that the demand for MOUs of switched access is a non-linear function of Pacific's current and past switched access rates, total California income, and the month of the year. Tardiff collects monthly data from the period of January 1992 through September 1996. The MOU data include Pacific's intrastate *interLATA* switched access MOUs.[15] For the price variable, Pacific uses the annual average revenue per minute of feature group D switched access. As with the toll estimation, Tardiff uses a polynomial distributed lag in the price variables. Tardiff also uses the logarithm of the volume, price and income variables to perform linear regression. His study yields an elasticity of -.24.

b) GTEC

GTEC recommends that the Commission adopt the elasticity measures estimated by Tardiff. Additionally, GTEC requests that the Commission apply Tardiff's elasticity figures to GTEC if it chooses to file a

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[15] After January 1, 1995, when intraLATA competition was authorized, Pacific began recording 10XXX intraLATA switched access minutes. In order to make the 1992 -1994 data comparable to the post IRD data, Pacific attempted to eliminate the post IRD 10XXX intraLATA switched access minutes by subtracting 2.1* the 10XXX toll MOUs.

permanent rate reduction application pursuant to D.96-10-066. GTEC sponsors two witnesses.

The first witness, Dr. Kenneth Train (Train), considers four factors to be key in deriving the best estimates for price elasticity. He testifies that the data should:

(1) be as recent as possible;
(2) be for the specific product under examination;
(3) be from the geographic market area where the product is offered; and
(4) contain as large a variation in the price as possible.

Train concludes that all four of these factors are present in Tardiff's work.

Train also uses many different model specifications to estimate price elasticity using Tardiff's data. Based on his results, Train concludes that Tardiff's estimates are reasonable.

GTEC's witness, Mr. Donald Perry (Perry), testifies that Tardiff's results can be reasonably applied to GTEC. Perry applies Tardiff's elasticity measures to GTEC's 1994 intraLATA toll data in order to forecast GTEC's 1995 intraLATA toll volumes and finds that the predicted volumes are within 3.8% of the actual volumes. Perry asserts that prediction errors of plus or minus 5% are considered acceptable by econometricians and other analysts. Therefore, he concludes that Tardiff's estimate reasonably reproduces GTEC's actual experience in the intraLATA toll market following the IRD rate reduction in 1995.

GTEC recommends that it be allowed to submit its own estimate for use in its future universal service rate reduction filing. However, it would be willing to accept Pacific's elasticity analysis in its own filing to mitigate the strain on the Commission's and other parties' resources of re-litigating the elasticity issue.

c) ORA

ORA testifies that the elasticity issues are not adequately scrutinized in this proceeding and therefore, the Commission should not adopt a new elasticity measure until it convenes a workshop attended by COLRs, IXCs, and other toll providers. ORA emphasizes the large financial impact of selecting an incorrect elasticity factor, and urges caution. ORA provides both an economic witness and a policy witness.

Like GTEC's witness Train, ORA's economic witness, Dr. Thomas Reneghan (Reneghan), tests Tardiff's results by applying Tardiff's data to several different model specifications and estimating the elasticity. Reneghan concludes that Tardiff's estimated elasticity is robust with respect to the model specification.

ORA questions whether Tardiff's data adequately represent the intraLATA toll market. In rebuttal testimony, ORA's witness, Ms. Kelly Boyd (Boyd), focuses on the possible limitations of Tardiff's data. Boyd points out that Pacific's intraLATA toll study omits a significant portion of the intraLATA toll market. Boyd cites Pacific's own estimates of intraLATA toll market share that are considerably lower than its market share that would be calculated using the data in Tardiff's study. Boyd notes that the significant segment of the market that is excluded from Tardiff's study might include a group whose price responses are much more elastic than Pacific's study would indicate.

Additionally, Boyd points out that in this proceeding, the parties have relied on only one set of data whereas in IRD the Commission considered studies performed on several data sets. Also, ORA testifies that there are few publicly available alternative toll elasticity studies to corroborate Tardiff's results. Further, ORA suggests that Pacific should have conducted separate studies for residential and business toll elasticity.

ORA expresses concern with the elasticity results. For instance, ORA questions why the access elasticity is higher than the toll elasticity. ORA argues that this is seemingly illogical because access is an input to toll and consequently, access price reductions should only lead to increased access minutes indirectly through toll stimulation, and only to the extent that access price reductions are flowed through to toll price reductions. Also, ORA questions why the elasticity estimates are significantly different from the measures submitted and adopted in IRD. Finally, ORA doubts that the elasticity measures would have decreased since IRD because the market today has more competition.

In its brief, ORA states its concern that Pacific underestimates toll elasticity because it assumes the existence of the 7% EPRM surcredit, which still has not been implemented. Therefore, Tardiff's study would falsely measure a demand response to an assumed price decrease which never existed.

ORA also raises concerns about the validity of using post surcredit/surcharge rates in the elasticity study. It argues that many customers might not respond to changes in their surcredits/surcharges, but rather focus only on the tariff rate. No party submitted an estimation which relied on the tariff rates for the price variable.

d) FBC

FBC recommends that the Commission adopt the EPRM as a permanent surcredit and not adopt new elasticity figures. FBC is concerned that Pacific and GTEC might gain large windfalls if these elasticity figures significantly underestimate the demand response.

FBC also concurs with two of ORA's critiques. First, FBC agrees that it is seemingly illogical to have access elasticity that exceeds toll elasticity. Secondly, it agrees that Pacific inappropriately assumes that the 7% EPRM is in place.

C. Discussion

1. Did Pacific Measure the Correct Market?

After reviewing Train and Reneghan's results, we agree that Tardiff's results are not driven by his model specification. Among the range of elasticity estimates generated from alternative model specifications, Tardiff's figures are near the high end.

However, we recognize ORA's concern that Tardiff's study might not have captured the entire intraLATA toll market. Indeed, in this proceeding and in other proceedings before the Commission, Pacific has suggested that there is a significant portion of the intraLATA toll market -- sometimes referred to as the "bypass market" -- that it has not included in Tardiff's study. We realize that this segment of the intraLATA toll market may be delivered over alternative technology and priced differently than MTS. However, it is quite likely that adjustments to Pacific's MTS rates will have impacts on consumption in this related toll market.

Nonetheless, we recognize that this bypass market existed and was growing before the price changes in IRD. Also, we do not know whether the MTS price reductions in IRD led to matching price reductions in this bypass market or whether traffic from the bypass market returned to Pacific's MTS toll volumes.

Thus, we have no record to determine whether this bypass market data should have been included in the toll elasticity study. ORA has not demonstrated that its inclusion would have affected the elasticity estimate.

ORA also argues that Pacific should have conducted a dis-aggregated study that measures residential and business elasticity separately. Pacific points out that in IRD the Commission rejected Pacific's proposal to use different elasticities for these different market segments. ORA does not provide a convincing reason why we should reject Pacific's study for not segregating residential and business toll minutes.

2. Why Does Switched Access, a Component of Toll, Have a Higher Elasticity?

FBC and ORA argue that it is illogical for switched access elasticity to be higher than toll elasticity. Pacific provides three responses. First, it argues that its switched access study captures more interLATA minutes than intraLATA minutes. Consequently, since interLATA toll has a higher elasticity than intraLATA toll, the interLATA switched access elasticity can be higher than the intraLATA toll elasticity. Secondly, Pacific argues that switched access service has relatively more alternatives, such as special access, than toll has. Finally, Pacific points out that the difference in the estimates is negligible.

In considering Pacific's three arguments, we can only accept the last one. We agree that the access study did measure interLATA traffic whereas the toll study measured intraLATA traffic. However, there is no evidence on the record to conclude that interLATA elasticity is higher than intraLATA elasticity. Indeed, in IRD the Commission did explore this question and could not conclude that interLATA elasticity was higher than intraLATA elasticity or that toll elasticity increased with distance. Secondly, although the transport portion of switched access does have alternatives, we have no basis to conclude that this makes switched access as elastic as or more elastic than toll. We note that access consumers are IXCs, not end-use toll consumers. Even though the IXCs' overall demand for access is driven by their end-users' demand for toll, the IXCs' demand for switched transport instead of special access should also be sensitive to the relative prices of those access services.

We do agree with Pacific that the difference in the measures is insignificant. In reviewing Tardiff's calculations, we note that the two measures are roughly one standard deviation away from one another. Therefore, one cannot conclude that the elasticity estimates are statistically significantly different from one another.

3. Why Has Elasticity Decreased When There Is More Competition Today?

ORA questions why Tardiff's study yields price elasticities which are much lower than those adopted in IRD. Pacific points out that ORA is confusing firm elasticity with market elasticity. Pacific argues that there is no a priori reason that market elasticity should change because there are more competitors.

A discussion about the distinction between firm elasticity and market elasticity clarifies this point. Market elasticity is concerned with the demand for a product, regardless of which firm supplies it. Firm elasticity is concerned with the response of a firm's own consumers to its price changes. Firm elasticity is never less than market elasticity. The degree to which firm elasticity exceeds market elasticity depends on the number of firms in the market and the competitive interaction among those firms. In a competitive industry, the firm elasticity is generally very high, reflecting the inability for the firm to raise its prices without losing significant demand. For example, in the gasoline market, although overall consumer demand for gasoline is rather inelastic, individual firms do not face such inelastic demand.

In the past, the distinction between firm and market elasticity was not as clear in the monopoly intraLATA toll and switched access markets because Pacific's firm elasticity was also the market elasticity. Now, however, we have competition in the intraLATA toll market.

Pacific has attempted to estimate the market elasticity for intraLATA toll and intrastate switched access services. This market elasticity measures how customers' demand for those services (regardless of the number of suppliers) respond to the price changes for those services.

It is not surprising that the market elasticity has changed since IRD. Reneghan agrees that elasticity is not a static measure; its value can change over time. Also, in linear demand functions, elasticity is not a constant measure, but rather decreases when price decreases or volume increases. Linear demand functions are common in economics and were used in some of the studies considered in IRD. Given the direction of price and volume since IRD, the lower elasticity would be an expected result from a linear demand estimation.

4. Is Price Measured Accurately?

In its brief, ORA claims that Pacific inappropriately assumes that the 7% EPRM surcredit had gone into effect. Although Pacific makes this incorrect assumption in its testimony, this does not affect its elasticity estimation. Pacific's elasticity studies rely on data from January 1992 through September 1996. Thus the EPRM, which would have gone into effect after October 1996, is not considered in Tardiff's estimation.

However, Pacific acknowledges that it did incorrectly make the EPRM surcredit assumption in applying elasticity to its rate reductions. This is discussed in the next section.

Examining Tardiff's study, we note that while Tardiff's price index demonstrates significant price variation, most of the variation is accounted for by inflation and changes in surcredit levels. The tariff rate is assumed constant from January 1992 through December 1994. After a 44% toll decrease ordered in IRD, the tariff rate is again assumed constant from January 1995 through September 1996. Tardiff's price index ignores the probability that different segments of the market have not paid the tariff rate for toll because of calling plans and contracts and might have not been affected by surcredits.

In IRD, the Commission criticized a toll elasticity study that used post-surcredit rates, arguing that customers do not view billing surcredits as price reductions for toll service. The Commission also expressed a preference for explicit rates over large surcharges or surcredits in order to provide clearer price signals. Implicit in this policy is the Commission's belief that customers respond more precisely to tariff rates than they do to post-surcredit rates.

Since there are many surcredits throughout Tardiff's study period, the studies might not precisely measure the price decreases perceived by consumers. Likewise, the studies include inflation-adjusted prices. Consumers might not respond to the relatively invisible effects of inflation when considering the price of a service. Consequently, the study might not yield the most accurate elasticity estimate possible.

However, it is unlikely that this leads to a significant under-estimate of elasticity. Large commercial consumers of toll and IXC consumers of switched access probably understand the real price that they are paying for these services, regardless of whether the effective price is embedded in surcredits. Residential and small business customers might begin to consume more toll when they discover that their total telephone payments are decreasing. Tardiff's elasticity study captures significant demand responses that are delayed by as much as 12 months.

5. Adopted Elasticity for this Proceeding

Based on the record, we find that Pacific's estimates of the elasticity of intraLATA toll and intrastate switched access market demands to changes in Pacific's price reductions are reasonable. Therefore, we will adopt the estimates, -.20 for toll and -.24 for access for the purposes of this proceeding.

Parties raise several concerns with Pacific's study. These criticisms do not convince us that Tardiff's study has significantly under-estimated elasticity. We recognize that estimating elasticity is not an exact science.

We do not consider our finding precedent-setting. Elasticity is not a static measure. Accurate studies need current data that reflect recent market changes. Thus, we are only adopting these elasticity factors for this particular proceeding and for Pacific given its current market conditions.

6. Future Elasticity Studies

The next time that parties need to establish an elasticity factor, we would prefer to see more sophisticated studies and testimony that address at least the following questions:

- What is the appropriate measure of the intraLATA market? What impact does the toll bypass market have on toll elasticity?
- What impact does the special access market have on switched access elasticity?
- Is it appropriate to measure market elastic responses to Pacific's price changes, without knowing how competitors price their services?

- Should the studies only use explicit, tariff rates for the price variable, or should the studies use inflation-adjusted, post surcredit rates?
- Should residential and business markets be estimated separately?
- What trends are affecting the market elasticity for toll and for switched access?
- What are the elasticities for local service, ZUM, and custom calling?

7. ORA's Proposal to Retain IRD Elasticity Factors Pending a Workshop

We deny ORA's proposal to delay the adoption of elasticity factors pending a future workshop. Pacific's March filing alerted the parties that elasticity could be an issue in this case. Also, the Scoping Memo directed the parties to consider elasticity in this proceeding.

Pacific has submitted a rigorous elasticity study. Several economists have reviewed the study. It would not be fair to delay the adoption of the new elasticity figure (and new final rate reductions) pending the outcome of some indefinite series of workshops. Furthermore, we are not confident that the parties would work in good faith to achieve a consensus outcome from these proposed workshops. ORA would have little incentive to conclude such workshops if the old IRD elasticity would remain in effect pending their outcome. At the same time, if we adopt Pacific's new elasticity figure pending the outcome of the workshops, Pacific and GTEC would have little incentive to cause a constructive outcome.

8. Applicability to GTEC

We deny GTEC's request that we apply these figures to GTEC for its future universal service rate design proposal. GTEC's market area does not coincide with Pacific's. Also, the data will no longer be current.

Furthermore, we would view this as a due process violation because GTEC's customers were never given notice and afforded an opportunity to participate in a matter which would affect their rates.

D. Calculation of Elasticity Stimulation

There is little disagreement among the parties concerning how demand stimulation is calculated and its overall revenue impact. Thus we briefly describe Pacific's method and other parties' objections and then discuss how we have applied this method to our adopted rate reductions.

1. Pacific's Method

Pacific's calculation of its demand response to its price changes follows a 3-stage process. In the initial step discussed above, Pacific estimates the elastic response of the whole market to Pacific's proposed rate decreases. In the next step, Pacific applies this market elasticity to its proposed rate reductions to arrive at a stimulation factor. Then, Pacific applies that stimulation factor to its own MOU data to estimate how much its market would grow from this price change. This method assumes that Pacific's market share remains unchanged.

Pacific calculates both stimulated revenue and stimulated costs by multiplying the stimulated MOUs by the new rate and TSLRIC, respectively. To calculate the revenue impact, Pacific offsets the revenue reductions over its current MOU volumes with the net revenues generated from its stimulated volumes. No party takes issue with Pacific's use of a net revenue offset instead of a gross revenue offset.

2. Other Parties' Positions

Several parties pointed out that Pacific incorrectly assumed that the 7% EPRM surcredits would have been in place by the time any reductions were ordered. Therefore, Pacific's initial calculations underestimated the size of the proposed rate reductions and consequently underestimated the size of the stimulated net revenue offset. After parties identified this flaw, Pacific in its rebuttal testimony agreed that the EPRM surcredit should not have been included.

In their access revenue calculations attached to their testimony, MCI and AT&T made adjustments to Pacific's stimulation calculation by using a post-surcredit booked revenue basis instead of a tariff billed revenue basis. The choice of a revenue base affects the measurement of the percentage rate reduction, which is an input in the stimulation calculation.

3. Adopted Method

We adopt Pacific's general method of calculating its projected demand with some clarifications. We have corrected for Pacific's initial inclusion of the EPRM. Also, we have chosen to use a surcredit rate or revenue base when calculating the stimulation.

Pacific's method of calculating the revenue offset generated by rate reductions is consistent with the methods employed in IRD. In IRD, we constructed our rate design with the assumption that Pacific should be able to capture its share of new market demand that would result from the proposed rate reductions. We also recognized that Pacific would incur some "implementation costs" in providing the stimulated volumes and thus only considered the net revenue provided by those stimulated volumes.

Our adopted rate design involves percentage rate reductions for toll service and access elements. Pacific's Rule 33 toll and access billing surcharge increments will change after the price reductions ordered in this decision by approximately one-half a percentage point. (See Appendix D.) Therefore, the stimulation factor is slightly higher using post-surcredit rather than tariff rates. Although the selection of a rate base does not materially affect the stimulation factor under our adopted rate design, we do clarify that we prefer to use the surcredited rate as the base for the rate adjustment. We recognize that customers, especially IXC access customers, are aware of current surcredits or surcharges when making their consumption decisions. Additionally, this position is consistent with the Commission's determination in D.96-02-023 that post-surcredit (or surcharge) rates be used in calculating the stimulation factor.

Pacific's actual experience might deviate from this estimation depending on how it competes and on any unexpected changes in market conditions. Nonetheless, we will not intervene in the future to ensure that Pacific captures those projected volumes. To do so would risk compensating Pacific for any competitive losses and would be counter to our NRF principles.

IV. Intercompany Settlement Effects

The Assigned Commissioner's Ruling of July 11, 1997 placed expectations on Pacific, as the administrator of the intercompany settlement pools, to work expeditiously and diligently with those small LECs that concur in its toll and access tariffs in order to determine the "industry" settlement revenue effects resulting from a Commission decision in this docket. However, we note that this decision not only changes toll and access rates and charges, but it also changes some of Pacific's local rates and charges (e.g., ZUM, Custom Calling and Local Usage). As previously noted, changes in Pacific's local rates and charges will necessarily affect Pacific's local exchange rate of return and subsequently the payments that the small LECs will receive from Pacific for providing Extended Area Service (EAS). Therefore, we will also require Pacific to provide the EAS "settlement" revenue impacts of this decision on affected small LECs.

Appendix B indicates that the total estimated industry settlement revenue impacts of the adopted rate design for Pacific on small LECs is $4,800,000 (rounded) ($3,352,300 - toll, $1,469,100 - access). The estimated toll and access settlement revenue impacts were derived using the toll and access settlement factors contained in work papers provided by Pacific during the course of this proceeding. However, this record does not contain a factor to be used for determining EAS "settlement" revenues for those small LECs that provide EAS.

Pacific shall within ten days from the effective date of this decision calculate the non-recurring and recurring industry settlements effects of the price ceiling changes adopted by this decision and serve a draft copy of its results and supporting workpapers on the Commission's Telecommunications Division and all affected small LECs. Within 25 days of the effective date of this decision, Pacific shall file by advice letter subject to protest the industry settlement effects for all affected small LECs. The small LECs may reflect their respective settlement revenue impacts, including the one-time 1998 impacts, in their annual CHCF-A filings on October 1, 1998.

Should there be disputes between the affected small LECs and Pacific regarding the settlement revenue impacts, the Commission will resolve any disputes by resolution action. If the Commission determines that the matter should go to hearing, it may open an appropriate proceeding to further review and investigate the issues.

For Pacific, any incremental difference between the estimated settlement revenue impact of $4,800,000 at Appendix B and the industry settlement revenue impact resulting from Pacific running the adopted rates and charges through its settlement models should be included in Pacific's reconciliation of its $305.2 million estimate with its approved draw.

Findings of Fact

1. In R.95-01-020 and I.95-01-021, which were consolidated and filed on January 24, 1995, the Commission opened the universal service proceeding to

develop rules to pursue universal service goals in a competitive telecommunications environment.

2. In D.96-10-066 in R.95-01-020/I.95-01-021, the Commission adopted final universal service rules and established the CHCF-B for the five large and mid-size LECs.

3. In D.96-10-066, the Commission adopted a surcharge mechanism to fund the CHCF-B and required that Pacific and the other CHCF-B COLRs offset any anticipated receipt of CHCF-B funds to avoid a windfall. The offset mechanism initially adopted is a monthly billing surcredit calculated as an equal percentage rate reduction for all services except for residential basic service and rates set by contract.

4. In D.96-10-066, the Commission afforded the five large and mid-size LECs the opportunity to request by application a different offset methodology that would reduce rates or price caps downward to permanently offset the explicit subsidy support provided by the CHCF-B.

5. On March 6, 1997, Pacific filed its application for a permanent rate reduction offset pursuant to D.96-10-066.

6. In its application, Pacific requests to include this proceeding in the Commission's experimental SB 960 program.

7. The SB 960 experimental rules that govern this proceeding are set forth in Resolution ALJ-170 adopted January 13, 1997.

8. Pursuant to Experimental Rule 5, on July 11, 1997, a final scoping memo was issued by the assigned Commissioner confirming the categorization of this proceeding as "ratesetting," adopting a procedural timetable, and specifying the issues to be addressed.

9. Eleven days of evidentiary hearings were held in October and November of 1997 in San Francisco, California.

10. The proceeding was submitted with the receipt of reply briefs on February 20, 1998.

11. The primary issue in this proceeding is what is the appropriate permanent offset for Pacific's estimated $305.2 million annual draw from the CHCF-B universal service fund.

12. Also at issue in this proceeding is the appropriate elasticity factors that should be applied to any price reductions to toll and switched access services to reflect the demand stimulation caused by price changes.

13. Not all of Pacific's services provide implicit subsidy support for universal service.

14. Toll, switched access service, local usage, ZUM, and custom calling services contribute a high margin of revenue over direct costs. This high contribution margin is available to meet Pacific's shared and common costs and to provide an implicit subsidy toward the cost of other services.

15. On a total dollar, per-minute basis, Pacific's toll provides more contribution than does access.

16. AT&T compares the profit rate of Pacific's access to that of an IXC's toll.

17. Pacific's cost of access is lower than that of an IXC that uses switched access.

18. The revenue to cost ratio for Pacific's toll is higher than that for Pacific's access.

19. Targeting all toll reductions to MTS is consistent with our IRD decision.

20. IXCs do not pay CHCF-B surcharges.

21. The pledges of AT&T, MCI, and Sprint to flow-through any switched access price reductions from this decision to their customers are not sufficient to establish that any switched access price reductions we adopt will be completely and timely flowed-through to a broad-base of each IXC's customers.

22. We expect a significant amount of flow-through of switched access price reductions will occur from the IXCs' competitive response to the MTS toll reductions adopted by this decision.

23. In D.96-10-066, the Commission did not use local usage revenues to offset the universal service fund, CHCF-B.

24. This record provides no bright line to distinguish (1) how much of the contribution margin of a service is an implicit subsidy rather than a proper allocation of shared and common costs, and (2) at what level a price reduction using CHCF-B funds constitutes an unfair competitive advantage to Pacific.

25. The five high margin services identified by the parties as containing implicit subsidies all have some level of competition today.

26. This record does not resolve whether applying a 7.029% EPRM surcredit to all of Pacific's services except basic residential service would result in any service being priced below cost.

27. FBC's proposed EPRM surcredit would apply approximately 40% of the rate reduction offset to services that no party recommended be reduced.

28. The Commission has yet to determine the cost components of the NIC rate element of switched access.

29. The two elements of switched access service that should receive the price reductions for switched access are the per call set-up charge and the access per minute charge of the local switching element of the end office rate.

30. It is reasonable to apply an equal percentage price reduction to local usage and ZUM services.

31. For this proceeding, a price reduction is preferable to a billing surcredit because customers understand and respond more precisely to price changes.

32. An annual true-up mechanism for the permanent rate reduction offset is not necessary or appropriate.

33. The price elasticity of demand is the percentage change in demand generated by a one percent change in price.

34. We account for the demand stimulation created by price changes in order to obtain an accurate measure of the revenue impacts from price changes.

35. In D.94-09-065, the Commission adopted an intraLATA toll elasticity of -.5 and a switched access elasticity of -.44.

36. In this application, Pacific presents new estimates of intraLATA toll elasticity and intrastate switched access elasticity that are lower, in absolute value, that those adopted in D.94-09-065. Pacific's toll study yields an elasticity of -.20 and its switched access study yields an elasticity of -.24.

37. Pacific's elasticity results are not driven by its model specifications; among the range of elasticity estimates generated from alternative model specifications, Pacific's figures are near the high end.

38. In his Scoping Memo, Commissioner Knight ruled that this proceeding should use current data to set the elasticity factors.

39. Pacific has estimates of its intraLATA toll market share that are lower than its market share that would be calculated using the data from its intraLATA toll elasticity study.

40. Pacific's toll elasticity study aggregated both business and residential toll traffic.

41. In IRD, the Commission considered Pacific's disaggregated elasticity study, but adopted an aggregate elasticity for both residential and business toll.

42. ORA does not provide a convincing reason why we should reject Pacific's study for using an aggregated elasticity factor.

43. The consumers of access, the IXCs, are different from the end-use consumers of toll.

44. The toll elasticity and the switched access elasticity estimates are within one standard deviation from one another.

45. The record is inconclusive as to whether Pacific should have included the bypass market in its toll study.

46. There is no a priori reason that market elasticity should change because there are more competitors.

47. Pacific estimates market elasticity for intraLATA toll and intrastate switched access.

48. Elasticity is not a static measure; it can change over time.

49. The IRD-adopted elasticity factors relied on a variety of demand studies, some of which used linear demand functions.

50. In linear demand functions, elasticity decreases when price decreases or volume increases.

51. It is unlikely that the use of post-surcredit, inflation-adjusted rates in Pacific's study leads to a significant under-estimation of elasticity.

52. Pacific's study captures significant demand responses that occur up to 12 months after a price change.

53. The EPRM which would have gone into effect after October 1996 is not considered in Pacific's elasticity studies, which relied on data from January 1992 through September 1996.

54. Pacific's estimates of the elasticity of intraLATA toll and intrastate switched access are reasonable.

55. GTEC's market area does not coincide with Pacific's.

56. GTEC's customers were never given notice and an opportunity to participate in the issue of GTEC's elasticity, an issue that can affect GTEC's rates.

57. Pacific's method of calculating the revenue impact of elasticity generated by rate reductions is consistent with the method used in D.94-09-065, with adjustments, and is a reasonable method to use for this decision.

Conclusions of Law

1. The exhibits and briefs submitted under seal in this proceeding shall remain under seal at the Commission for a period of one year from the date of this ruling, and during that period should not be made accessible or disclosed to anyone other than Commission staff except on the further order or ruling of the Commission, the Assigned Commissioner, the assigned ALJ, or the ALJ then designated as Law and Motion Judge.

2. If any party believes that further protection of the exhibits and briefs submitted under seal is needed after one year, it may file a motion stating the justification for further withholding the exhibits from public inspection, or for such other relief as the Commission rules may then provide. This motion should be filed no later than one month before the expiration of this protective order.

3. The motions of Pacific, FBC, MCI, Sprint, and TURN requesting to file under seal an unredacted copy of their briefs should be granted.

4. Our goals in adopting a rate reduction offset should be to (1) target the services parties demonstrate contain implicit subsidies; (2) ensure the rate reductions we adopt result in sustainable prices; and (3) reduce the rates within these services in a manner which benefits the broadest base of customers.

5. Recognizing the limitations of the cost data available in this proceeding, we should rely on the relative magnitude of the measurements, not the precise calculations, and we should not use the revenue/cost measurements to equalize margins between services or to reduce the price of any service too close to its existing price floor.

6. We should reduce prices and/or price ceilings for all five of the services identified as providing implicit subsidies in order to achieve our goals.

7. In D.96-10-066, we found that the need for sustainable prices was a primary reason for establishing the CHCF-B.

8. We should not reduce any service near the price floors the Commission has previously determined are sufficient to prevent anti-competitive behavior.

9. We should not adopt the EPRM as a permanent rate offset for Pacific.

10. Pacific's rate reduction offset proposal does not meet our goals.

11. We should not adopt the specific price reductions proposed by Pacific.

12. Toll provides a relatively larger contribution than does access.

13. We should apply all toll reductions to Pacific's basic MTS for residential and business customers.

14. In applying price reductions to toll, it is reasonable to effectively eliminate the volume discount provision of Pacific's residential and business MTS tariffs.

15. We should reduce the price ceiling for Category II services.

16. It is reasonable to provide the funds to support residential MTS toll parity from revenues that would otherwise go to price reductions for custom calling services.

17. We should not apply price reductions to the NIC.

18. We should apply the largest price reductions to toll because it has the highest contribution margin and has historically provided the largest implicit subsidy for universal service.

19. The price reductions adopted for local exchange and ZUM are reasonable and should not discourage new competitive entrants.

20. The price reductions set forth in Appendix C are reasonable and should be adopted.

21. Sufficient procedures for the CHCF-B fund are in place for the Commission to implement a permanent rate reduction offset for Pacific.

22. If the CHCF-B is not activated prior to Pacific implementing its permanent rate reduction offset, Pacific may apply to be compensated for the time value of money in a manner consistent with that set forth in D.98-01-023 as modified by D.98-04-068.

23. We should not reject Pacific's study of toll elasticity for not accounting for a toll bypass market.

24. Pacific should file tariffs to implement the price reductions adopted in Appendix C by compliance letter filing within 15 days of this decision. This compliance filing should be limited to current tariffs only, modified to reflect the authorizations of this decision; no other tariff modifications may be presented as part of this compliance filing. The tariffs filed should be effective no earlier than 15 days after filing and no later than 60 days after filing and shall have an effective date of the first calendar day of a month.

25. Pacific should file revised tariff sheets to reflect the adopted increments to its Schedule A-2, Rule 33- Billing Surcharges, shown in Appendix D.

26. Pacific should reconcile its $305.2 million estimate with its approved draw from the CHCF-B for the 12-month period immediately preceding the date rates are effective. If the adjustment resulting from Pacific's reconciliation of its $305.2 million estimate to its approved draw from the CHCF-B is within 10% of $305.2 million, Pacific should file by compliance letter to recover or refund the difference through a change to local usage and ZUM prices. If the adjustment is greater than 10% of $305.2 million, Pacific's advice letter filing should be subject to protest.

27. We should not adopt an annual true-up mechanism.

28. This proceeding should use current data to set the elasticity factors.

29. We should not reject Pacific's study for using an aggregated elasticity factor.

30. It is a reasonable result for the switched access elasticity measure to be higher than the toll elasticity.

31. It is a reasonable result for the elasticity measures in this proceeding to be lower than those adopted in IRD.

32. The price data used in Pacific's elasticity studies do not lead to an under-estimation of elasticity.

33. We should adopt an elasticity of -.20 for toll and -.24 for switched access for this proceeding. We should adopt Pacific's general method of calculating its projected demand with a correction for Pacific's initial inclusion of the EPRM.

34. Elasticity should be reexamined in future proceedings in light of current data and more sophisticated studies, and should address at least the questions set forth in Section III.C.6 of this decision.

35. We should not adopt elasticity factors for GTEC in this proceeding.

36. Pacific should within ten days from the effective date of this decision calculate the non-recurring and recurring the industry settlement effects of the price changes adopted by this decision and serve a draft copy of its results and supporting workpapers on the Commission's Telecommunications Division and all affected small LECs. Should Pacific deem its workpapers to be proprietary, it should provide each of the affected small LECs their respective workpapers that support the LEC's settlement revenue impacts. Within 25 days of the effective date of this decision, Pacific shall file by advice letter subject to protest the industry settlement effects for all affected small LECs. The small LECs may reflect their respective settlement revenue impacts, including the one-time 1998 impacts, in their annual CHCF-A filings on October 1, 1998.

ORDER

IT IS ORDERED that:

1. The motions of Pacific Bell (Pacific), Facilities-Based Carriers, MCI Telecommunications Corporation, Sprint Communications Company L.P., and The Utility Reform Network requesting to file under seal unredacted copies of their briefs are granted.

2. The exhibits and briefs submitted under seal in this proceeding shall remain under seal at the Commission for a period of one year from the date of this ruling, and during that period shall not be made accessible or disclosed to anyone other than Commission staff except on the further order or ruling of the Commission, the Assigned Commissioner, the assigned Administrative Law Judge (ALJ), or the ALJ then designated as Law and Motion Judge.

3. If any party believes that further protection of the exhibits and briefs submitted under seal is needed after one year, it may file a motion stating the justification for further withholding the exhibits from public inspection, or for such other relief as the Commission rules may then provide. This motion shall be filed no later than one month before the expiration of this protective order.

4. The price changes set forth in Appendix C are adopted.

5. Pacific shall file tariffs to implement the price reductions adopted in Appendix C by compliance letter filing within 15 days of this decision. This compliance filing must be limited to current tariffs only, modified to reflect the authorizations of this decision; no other tariff modifications may be presented as part of this compliance filing. The tariffs filed shall be effective no earlier than 15 days after filing and no later than 60 days after filing and must have an effective date of the first calendar day of a month.

6. Pacific shall file revised tariff sheets to reflect the adopted increments to its Schedule A-2, Rule 33 Surcredits, shown in Appendix D.

7. Pacific shall reconcile its $305.2 million estimate with its approved draw from the California High Cost Fund (CHCF-B) for the 12-month period immediately preceding the date rates are effective. If the adjustment resulting from Pacific's reconciliation of its $305.2 million estimate to its approved draw from the CHCF-B is within 10% of $305.2 million, Pacific shall file by compliance advice letter to recover or refund the difference through a change to local usage and zoned usage measurement prices. If the adjustment is greater than 10% of $305.2 million, Pacific's advice letter filing will be subject to protest.

8. We adopt an elasticity of -.20 for toll and -.24 for switched access for this proceeding. We adopt Pacific's general method of calculating its projected demand with a correction for Pacific's initial inclusion of the equal percentage reduction.

9. We do not adopt elasticity factors for GTE California, Inc. in this proceeding.

10. Pacific shall within ten days from the effective date of this decision calculate the non-recurring and recurring industry settlement effects of the price changes adopted by this decision and serve a draft copy of its results and supporting workpapers on the Commission's Telecommunications Division and all affected small LECs. Should Pacific deem its workpapers to be proprietary, it should then provide each of the affected small LECs their respective workpapers that support the LEC's settlement revenue impacts. Within 25 days of the effective date of this decision, Pacific shall file by advice letter subject to protest the industry settlement effects for all affected small LECs and/or provide Extended Area Service. The small LECs may reflect their respective settlement revenue impacts in their annual CHCF-A filings on October 1, 1998.

11. Any incremental difference between the estimated settlement revenue impact of $4,800,000 at Appendix B and Pacific's advice letter filing should be included in Pacific's reconciliation of its $305.2 million estimate with its approved draw.

12. This proceeding is closed.

This order is effective today.

Dated July 2, 1998, at San Francisco, California.

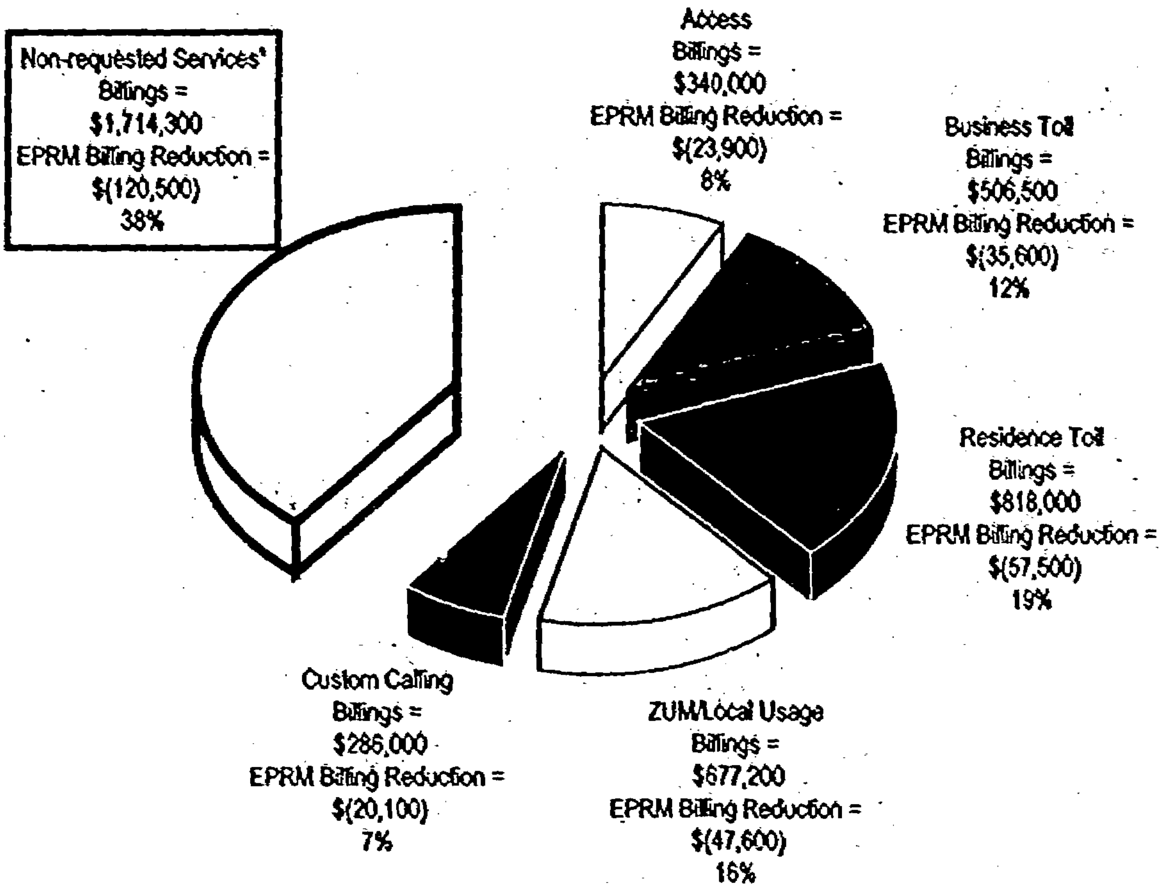
RICHARD A. BILAS
President
P. GREGORY CONLON
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
Commissioners

I will file a partial dissent.

/s/ JOSIAH L. NEEPER
Commissioner

Appendix A

Pacific Bell
Total Proposed Universal Service Surcredit Billing Base = $ 4,342,000,000**
($000)



* Services for Which No Reductions Were Requested include: Business Recurring, Special Access, C.O. Features, Business Service Connects, Directory Assistance, and Other Incidental Revenues. (Source: Pacific Bell's December, 1996, MR4 Report.)

** As calculated from Pacific Bell's Advice Letter 18608B

(END OF APPENDIX A)

Appendix B

Adopted Rates
Pacific Bell Rate Rebalancing Summary

	Service	Incremental Billings ($000)
1	MTS	(152,700)
2	Switched Access	(60,000)
3	Custom Calling Services	(7,100)
4	Local/Zone Usage Measurement (ZUM)	(80,500)
5	Total Billings	(300,300)
6	Implementation Stimulation Costs	(9,700)
7	Settlements *	4,800
8	Total Revenue Effects of Price Changes	(305,200)
9	Pacific Bell's Total Estimated USF Subsidy	305,200

* Access Settlements Effect = $ 1,469,100
Toll Settlements Effect = $ 3,352,300
Does not include EAS settlement effects.

(END OF APPENDIX B)

Appendix C

Present and Adopted Rates for Pacific Bell

Rate Element		Recurring Rate Current Ceiling	Recurring Rate Adopted Ceiling
Local Usage			
Local Usage - Business - Initial Minute	Day	$0.0333	$0.0293
	Evening	$0.0233	$0.0205
	Night/Weekend	$0.0133	$0.0117
Local Usage - Business - Additional Minute	Day	$0.0105	$0.0093
	Evening	$0.0073	$0.0064
	Night/Weekend	$0.0042	$0.0037
Local Usage - Residence - Initial Minute	Day	$0.0333	$0.0293
	Evening	$0.0233	$0.0205
	Night/Weekend	$0.0133	$0.0117
Local Usage - Residence - Additional Minute	Day	$0.0105	$0.0093
	Evening	$0.0073	$0.0064
	Night/Weekend	$0.0042	$0.0037
Zone Usage Measurement (ZUM)			
ZUM - Business - Initial Minute	Day	$0.0808	$0.0712
	Evening	$0.0565	$0.0498
	Night	$0.0323	$0.0285
ZUM - Business - Additional Minute	Day	$0.0181	$0.0159
	Evening	$0.0126	$0.0111
	Night	$0.0072	$0.0063
ZUM - Residence - Initial Minute	Day	$0.0808	$0.0712
	Evening	$0.0565	$0.0498
	Night	$0.0323	$0.0285
ZUM - Residence - Additional Minute	Day	$0.0181	$0.0159
	Evening	$0.0126	$0.0111
	Night	$0.0072	$0.0063
Switched Access Service			
Local Switching			
LS1 - Feature Groups A and B			
Call set-up, per call		$0.01438	$0.00916
Per MOU		$0.00315	$0.00201

Appendix C

Present and Adopted Rates for Pacific Bell

Rate Element	Recurring Rate Current Ceiling	Recurring Rate Adopted Ceiling
Switched Access Service (continued)		
LS2 - Feature Groups C, D,		
PVN Access, 800 and 900 Access		
Call set-up, per call	$0.01438	$0.00916
Per MOU	$0.00315	$0.00201
Custom Calling (Residential)		
Call Waiting	$3.50	$3.40
Call Forwarding	$3.50	$3.40
Busy Call Forwarding	$3.50	$3.40
3-Way Calling	$3.50	$3.40
Speed Dialing (8 codes)	$3.50	$3.40
Speed Dialing (30 codes)	$5.00	$4.90
Call Return	$3.50	$3.40
Call Screen	$3.50	$3.40
Priority Ringing	$3.50	$3.40
Repeat Dialing	$3.50	$3.40
Select Call Forwarding	$3.50	$3.40
Remote Access/Call Forwarding	$1.00	$1.00
Call Trace	$5.00	$4.90
Call Return (per use basis)*	$0.75	$0.75
Repeat Dialing (per use basis)*	$0.75	$0.75
Feature Packages		
Two Features	$3.50	$3.40
Three Features	$3.50	$3.40
Four or more Features	$3.50	$3.40

* (no effect on adopted rates due to rounding)

Rate Element	Current Ceiling	Adopted Ceiling
Custom Calling (Business)		
Call Waiting	$4.20	$4.10
Call Forwarding	$4.20	$4.10
Busy Call Forwarding	$4.20	$4.10
3-Way Calling	$4.20	$4.10
Speed Dialing (8 codes)	$4.20	$4.10
Speed Dialing (30 codes)	$6.00	$5.85
Call Return	$5.00	$4.90
Call Screen	$5.00	$4.90
Priority Ringing	$5.00	$4.90
Repeat Dialing	$5.00	$4.90
Select Call Forwarding	$5.00	$4.90
Remote Access/Call Forwarding	$1.50	$1.45

Appendix C

Present and Adopted Rates for Pacific Bell

Rate Element	Recurring Rate Current Ceiling	Recurring Rate Adopted Ceiling
Call Trace	$5.00	$4.90
Call Return (per use basis)*	$0.75	$0.75
Repeat Dialing (per use basis)*	$0.75	$0.75

*(no effect on adopted rates due to rounding)

Business MTS (DDD)	Mileage Band	Current Ceiling	Adopted Ceiling
Business MTS - Initial Min - Day	13 - 16	$0.1140	$0.0809
	17 - 20	$0.1140	$0.0809
	21 - 25	$0.1360	$0.0966
	26 - 30	$0.1360	$0.0966
	31 - 40	$0.1360	$0.0966
	41 - 50	$0.1470	$0.1044
	51 - 70	$0.1470	$0.1044
	71+	$0.1470	$0.1044
Business MTS - Initial Min - Eve	13 - 16	$0.0912	$0.0648
	17 - 20	$0.0912	$0.0648
	21 - 25	$0.1088	$0.0772
	26 - 30	$0.1088	$0.0772
	31 - 40	$0.1088	$0.0772
	41 - 50	$0.1176	$0.0835
	51 - 70	$0.1176	$0.0835
	71+	$0.1176	$0.0835
Business MTS - Initial Min - Night	13 - 16	$0.0684	$0.0486
	17 - 20	$0.0684	$0.0486
	21 - 25	$0.0816	$0.0579
	26 - 30	$0.0816	$0.0579
	31 - 40	$0.0816	$0.0579
	41 - 50	$0.0882	$0.0626
	51 - 70	$0.0882	$0.0626
	71+	$0.0882	$0.0626
Business MTS - Add'l Min - Day	13 - 16	$0.0700	$0.0497
	17 - 20	$0.0700	$0.0497
	21 - 25	$0.1140	$0.0809
	26 - 30	$0.1140	$0.0809
	31 - 40	$0.1140	$0.0809
	41 - 50	$0.1250	$0.0888
	51 - 70	$0.1250	$0.0888
	71+	$0.1360	$0.0966
Business MTS - Add'l Min - Eve	13 - 16	$0.0560	$0.0398
	17 - 20	$0.0560	$0.0398
	21 - 25	$0.0912	$0.0648
	26 - 30	$0.0912	$0.0648
	31 - 40	$0.0912	$0.0648
	41 - 50	$0.1000	$0.0710
	51 - 70	$0.1000	$0.0710
	71+	$0.1088	$0.0772

Appendix C

Present and Adopted Rates for Pacific Bell

Rate Element	Mileage Band	Recurring Rate Current Ceiling	Recurring Rate Adopted Ceiling
Business MTS - Add'l Min - Night	13 - 16	$0.0420	$0.0298
	17 - 20	$0.0420	$0.0298
	21 - 25	$0.0684	$0.0486
	26 - 30	$0.0684	$0.0486
	31 - 40	$0.0684	$0.0486
	41 - 50	$0.0750	$0.0533
	51 - 70	$0.0750	$0.0533
	71+	$0.0816	$0.0579
Residence MTS (DDD)			
Residence MTS - Initial Min - Day	13 - 16	$0.1140	$0.0809
	17 - 20	$0.1140	$0.0809
	21 - 25	$0.1360	$0.0966
	26 - 30	$0.1360	$0.0966
	31 - 40	$0.1360	$0.0966
	41 - 50	$0.1470	$0.1044
	51 - 70	$0.1470	$0.1044
	71+	$0.1470	$0.1044
Residence MTS - Initial Min - Eve	13 - 16	$0.0912	$0.0648
	17 - 20	$0.0912	$0.0648
	21 - 25	$0.1088	$0.0772
	26 - 30	$0.1088	$0.0772
	31 - 40	$0.1088	$0.0772
	41 - 50	$0.1176	$0.0835
	51 - 70	$0.1176	$0.0835
	71+	$0.1176	$0.0835
Residence MTS - Initial Min - Night	13 - 16	$0.0684	$0.0486
	17 - 20	$0.0684	$0.0486
	21 - 25	$0.0816	$0.0579
	26 - 30	$0.0816	$0.0579
	31 - 40	$0.0816	$0.0579
	41 - 50	$0.0882	$0.0626
	51 - 70	$0.0882	$0.0626
	71+	$0.0882	$0.0626
Residence MTS - Add'l Min - Day	13 - 16	$0.0700	$0.0497
	17 - 20	$0.0700	$0.0497
	21 - 25	$0.1140	$0.0809
	26 - 30	$0.1140	$0.0809
	31 - 40	$0.1140	$0.0809
	41 - 50	$0.1250	$0.0888
	51 - 70	$0.1250	$0.0888
	71+	$0.1360	$0.0966
Residence MTS - Add'l Min - Eve	13 - 16	$0.0560	$0.0398
	17 - 20	$0.0560	$0.0398
	21 - 25	$0.0912	$0.0648
	26 - 30	$0.0912	$0.0648
	31 - 40	$0.0912	$0.0648
	41 - 50	$0.1000	$0.0710
	51 - 70	$0.1000	$0.0710

Appendix C

Present and Adopted Rates for Pacific Bell

Rate Element	Mileage Band	Recurring Rate: Current Ceiling	Recurring Rate: Adopted Ceiling
	71+	$0.1088	$0.0772
Residence MTS - Add'l Min - Night	13 - 16	$0.0420	$0.0298
	17 - 20	$0.0420	$0.0298
	21 - 25	$0.0684	$0.0486
	26 - 30	$0.0684	$0.0486
	31 - 40	$0.0684	$0.0486
	41 - 50	$0.0750	$0.0533
	51 - 70	$0.0750	$0.0533
	71+	$0.0816	$0.0579
Calling Card			
Calling Card - MTS - Initial Min - Day	0 - 12	$0.1556	$0.1105
	13 - 16	$0.1556	$0.1105
	17 - 20	$0.1556	$0.1105
	21 - 25	$0.1956	$0.1389
	26 - 30	$0.1956	$0.1389
	31 - 40	$0.1956	$0.1389
	41 - 50	$0.2256	$0.1602
	51 - 70	$0.2256	$0.1602
	71+	$0.2556	$0.1815
Calling Card - MTS - Initial Min - Eve	0 - 12	$0.1156	$0.0821
	13 - 16	$0.1156	$0.0821
	17 - 20	$0.1156	$0.0821
	21 - 25	$0.1656	$0.1176
	26 - 30	$0.1656	$0.1176
	31 - 40	$0.1656	$0.1176
	41 - 50	$0.1756	$0.1247
	51 - 70	$0.1756	$0.1247
	71+	$0.1856	$0.1318
Calling Card - MTS - Initial Min - Night	0 - 12	$0.0656	$0.0466
	13 - 16	$0.0656	$0.0466
	17 - 20	$0.0656	$0.0466
	21 - 25	$0.1056	$0.0750
	26 - 30	$0.1056	$0.0750
	31 - 40	$0.1056	$0.0750
	41 - 50	$0.1356	$0.0963
	51 - 70	$0.1356	$0.0963
	71+	$0.1656	$0.1176
Calling Card - MTS - Add'l Min - Day	0 - 12	$0.0656	$0.0466
	13 - 16	$0.0656	$0.0466
	17 - 20	$0.0656	$0.0466
	21 - 25	$0.1256	$0.0892
	26 - 30	$0.1256	$0.0892
	31 - 40	$0.1256	$0.0892
	41 - 50	$0.1456	$0.1034
	51 - 70	$0.1456	$0.1034
	71+	$0.1956	$0.1389

Appendix C

Present and Adopted Rates for Pacific Bell

Rate Element	Mileage Band	Recurring Rate Current Ceiling	Recurring Rate Adopted Ceiling
Calling Card - MTS - Add'l Min - Eve	0 - 12	$0.0456	$0.0324
	13 - 16	$0.0456	$0.0324
	17 - 20	$0.0456	$0.0324
	21 - 25	$0.1056	$0.0750
	26 - 30	$0.1056	$0.0750
	31 - 40	$0.1056	$0.0750
	41 - 50	$0.1156	$0.0821
	51 - 70	$0.1156	$0.0821
	71+	$0.1356	$0.0963
Calling Card - MTS - Add'l Min - Night	0 - 12	$0.0456	$0.0324
	13 - 16	$0.0456	$0.0324
	17 - 20	$0.0456	$0.0324
	21 - 25	$0.0756	$0.0537
	26 - 30	$0.0756	$0.0537
	31 - 40	$0.0756	$0.0537
	41 - 50	$0.0856	$0.0608
	51 - 70	$0.0856	$0.0608
	71+	$0.1356	$0.0963
Calling Card - Station	Svc Charge	$0.35	$0.25

Residence Direct Discount Plan (RDDP)

Discount: A discount of 15% is applicable on all Residence DDP charges in excess of $5 per month. Residence customers shall pay the lower of RDDP rates after direct discounts and Residence MTS rates, i.e., the same condition that currently applies to Pacific's Business Direct Discount Plan will also apply to Residence DDP.

(END OF APPENDIX C)

Appendix D

Pacific Bell
Adopted Billing Surcharge Increments

Schedule A-2 Rate Item Number	Recurring
1.A (Exchange):	-0.098%
1.B (Toll):	-0.480%
1.C (Access):	-0.510%

(END OF APPENDIX D)

APPENDIX E

************ SERVICE LIST *************

Last updated on 05-MAY-1998 by: SMJ
A9703004 LIST

****************** APPEARANCES ******************

Julian Chang
Attorney At Law
AT&T
795 FOLSOM STREET RM 670
SAN FRANCISCO CA 94107
(415) 442-3776
For: AT&T

Cheryl Hills
AT&T COMMUNICATIONS OF CALIFORNIA, INC
795 FOLSOM STREET
SAN FRANCISCO CA 94107
(415) 442-5550
For: AT&T communications of CA

Jeffrey F. Beck
JILLISA BRONFMAN
BECK & ACKERMAN
4 EMBARCADERO CENTER, SUITE 760
SAN FRANCISCO CA 94111
(415) 263-7300
For: EVANS, KERMAN, VOLCANO, SISKIYOU, PINNACLES TELEPHONE CO.

Stephen P. Bowen
KAREN N. POTKUL
Attorneys At Law
BLUMENFELD & COHEN
4 EMBARCADERO CENTER, SUITE 1170
SAN FRANCISCO CA 94111
(415) 394-7500
4185059@mcimail.com
For: MCI Telecommunications corp.

Glenn Semow
Director, State Regulatory Affairs
CALIFORNIA CABLE TV ASSN
PO BOX 11080
4341 PIEDMONT AVENUE
OAKLAND CA 94611
(510) 428-2225

Barbara Snider
Attorney At Law
CITIZENS COMMUNICATIONS
7901 FREEPORT BLVD, SUITE 100
SACRAMENTO CA 95832
(916) 665-5335
bsnider@czn.com

Traci Bone
Deputy City Attorney
CITY/COUNTY OF SAN FRANCISCO
1390 MARKET STREET FIFTH FLOOR
SAN FRANCISCO CA 94102-5408
For: CITY AND COUNTY OF SAN FRANCISCO

E. Garth Black
MARK P SCHREIBER
COOPER, WHITE & COOPER
17TH FLOOR
201 CALIFORNIA STREET
SAN FRANCISCO CA 94111
(415) 433-1900
egbl@cwclaw.com
For: ROSEVILLE/CALAVERAS/CA-OREGON/DUCOR/FORESTHILL/HAPPY VALLEY/HORNITOS/PONDEROSA/SIE ETC

Richard Smith
Director, State Regulatory Affairs
COX CALIFORNIA TELECOM, INC.
2200 POWELL STREET, SUITE 865
EMERYVILLE CA 94608
(510) 923-6220

Joseph S Faber
Attorney At Law
DAVIS WRIGHT TREMAINE
SUITE 600
ONE EMBARCADERO CENTER
SAN FRANCISCO CA 94111
For: TELEPORT COMMUNICATIONS GROUP

Virginia Taylor
Attorney At Law
DEPARTMENT OF CONSUMER AFFAIRS
SUITE 3090
400 R STREET
SACRAMENTO CA 95814

************ SERVICE LIST ************

John L Clark
Attorney At Law
GOODIN MACBRIDE SQUERI SCHLOTZ & RITCHIE
SUITE 900
505 SANSOME STREET
SAN FRANCISCO CA 94111
(415) 392-7900
For: WORLDCOM, INC.

Thomas J. Macbride, Jr.
Counsel
GOODIN MACBRIDE SQUERI SCHLOTZ & RITCHIE
505 SANSOME STREET 9TH FLOOR
SAN FRANCISCO CA 94111
(415) 392-7900

Peter Hanschen
DOUGLAS ORVIS
Attorney At Law
GRAHAM & JAMES
1 MARITIME PLAZA, SUITE 300
SAN FRANCISCO CA 94111
(415) 954-0313
phanschen@gj.com
For: CALIFORNIA PAYPHONE ASSOCIATION

Elaine M. Lustig
ONDREA D HIDLEY
Attorney At Law
GTE CALIFORNIA INC.
ONE GTE PLACE, CA500LB
THOUSAND OAKS CA 91362-3811
(805) 372-7071
elaine.lustig@telops.gte.com

Janice L. Grau
Legal Division
RM. 5023
505 VAN NESS AVE
SAN FRANCISCO CA 94102
(415) 703-1960
jlg@cpuc.ca.gov

Bruce M. Holdridge
ICG TELECOM GROUP, INC.
180 GRAND AVENUE, STE. 1000
OAKLAND CA 94612
(510) 251-7033

Earl Nicholas Selby
Attorney At Law
LAW OFFICES OF EARL NICHOLAS SELBY
420 FLORENCE STREET
PALO ALTO CA 94301
(415) 323-0990
enselby@wenet.net
For: ICG TELECOM GROUP, INC.

Alfred C Pfeiffer Jr
Attorney At Law
MC CUTCHEN DOYLE BROWN & ENERSEN
SUITE 2500
THREE EMBARCADERO CENTER
SAN FRANCISCO CA 94111
For: AT&T Communications of CA.

William Harrelson
Attorney At Law
MCI TELECOMMUNICATIONS CORPORATION
201 SPEAR STREET, 9TH FLOOR
SAN FRANCISCO CA 94105

Martin A. Mattes
Attorney At Law
NOSSAMAN GUTHNER KNOX & ELLIOTT
50 CALIFORNIA STREET, 34TH FLOOR
SAN FRANCISCO CA 94111-4799
(415) 438-7273
mam@ngke.com

Gregory L Castle
COLLEEN O'GRADY
Attorneys At Law
PACIFIC BELL
16TH FLOOR
140 NEW MONTGOMERY STREET
SAN FRANCISCO CA 94105

Lee Burdick
Attorney At Law
PRIMA LEGAL SERVICES
SUITE 350
2317 BROADWAY
REDWOOD CITY CA 94063
(650) 261-0500
LBURDICK@PRIMALEGAL.COM
For: COX CALIFORNIA TELCOM, INC.

************ SERVICE LIST *************

Carol Matchett
Attorney At Law
SPRINT COMMUNICATIONS CO LP
1850 GATEWAY DIRVE 7TH FLOOR
SAN MATEO CA 94404-2467
(650) 513-2712
carol.l.matchett@mail.sprint.com

Glenn Stover
Attorney At Law
795 FOLSOM STREET, ROOM 670
SAN FRANCISCO CA 94107
For: AT&T

Paul Stein
THOMAS LONG
Attorney At Law
THE UTILITY REFORM NETWORK
SUITE 350
711 VAN NESS AVENUE
SAN FRANCISCO CA 94102
(415) 929-8870
pstein@turn.org

Eric A. Artman
Assistant Vice President
WORLDCOM, INC
REGULATORY AFFAIRS
225 BUSH STREET, 19TH FLOOR
SAN FRANCISCO CA 94104
(415) 743-4960
eric.artman@wcom.com

*************** STATE SERVICE *****************

Natalie Billingsley
Office or Ratepayer Advocates
RM. 4102
505 VAN NESS AVE
SAN FRANCISCO CA 94102
(415) 703-1368
nxb@cpuc.ca.gov

Kelly Boyd
Office or Ratepayer Advocates
RM. 4101
505 VAN NESS AVE
SAN FRANCISCO CA 94102
(415) 703-2520
keb@cpuc.ca.gov

Marc Kolb
Telecommunications Division
AREA 3-D
505 VAN NESS AVE
SAN FRANCISCO CA 94102
(415) 703-1575
mek@cpuc.ca.gov

Robert C. Lane
Executive Division
RM. 5204
505 VAN NESS AVE
SAN FRANCISCO CA 94102
(415) 703-2692
bob@cpuc.ca.gov

Norman C. Low
Telecommunications Division
AREA 3-E
505 VAN NESS AVE
SAN FRANCISCO CA 94102
(415) 703-1607
ncl@cpuc.ca.gov

Barbara Ortega
Executive Division
RM. 5109
107 S. BROADWAY, ROOM 5109
LOS ANGELES CA 90012
(213) 897-4158
bho@cpuc.ca.gov

James Simmons
Telecommunications Division
AREA 3-E
505 VAN NESS AVE
SAN FRANCISCO CA 94102
(415) 703-2883
jjs@cpuc.ca.gov

Christine M. Walwyn
Administrative Law Judge Division
RM. 5101
505 VAN NESS AVE
SAN FRANCISCO CA 94102
(415) 703-2301
cmw@cpuc.ca.gov

************** INFORMATION ONLY *************

Karen M. Potkul
Attorney At Law
NEXTLINK OF CALIFORNIA, LLC
1924 DEERE AVENUE RM 110
SANTA ANA CA 92705
(714) 756-1900

A.97-03-004
D.98-07-033

<u>Commissioner Josiah L. Neeper, Dissenting in part:</u>

I dissent in part, but only in part, from the Order adopted by the majority. I dissent to that part of the decision that directs interexchange carriers (IECs) to verify through a reporting requirement that the rate reductions applied to switched access service have been implemented and effective.

Underlying the desire to dictate how carriers should spend a savings that result from reduced access rate is an obsolescent philosophical vestige from a single-service provider era regulation that the regulator must ensure "pass-through" to customers. I believe such a requirement is unnecessary and unwarranted in a deregulated market such as the long distance telephony where rates have continued to come down as a result of competition and consequently.

The fact that there is intense competition in the long distance market with dynamic changes in market shares of carriers and rates are the main competitive tools is a good indicator that regulatory actions are not necessary to protect customers interest. In fact, it is precisely because the long distance market is competitive that we classified companies like AT&T, one of the largest long distance carriers, and over 500 others as non-dominant carrier freeing them from the shackles of numerous regulations. In August of last year when we classified AT&T as non dominant, we noted as one of the reasons for our action, its declining market share which had continued to slide over the years from a high of 70% in 1989 to about 55% in mid 1997 of last year. Similarly, AT&T's control of transmission capacity was only 20%; which means its competitors can readily absorb AT&T's entire customer base without adding capacity.

Events like these proved that the long distance market is competitive and thus subject to minimal regulation that forbears rate oversight and provides maximum flexibility in rate setting and changes. Having dismantled a monopoly era regulation in lieu of a laissez faire regulatory policy for this sector of the market, I find it quite perplexing that if somehow, coincidentally, an element of the cost of long distance service is to be offset through our regulation of a dominant carrier such as Pacific Bell, that we find a renewed interest to ensure that this offset must be "passed through" to consumers through a regulatory direction. The proposal is fallacious because, one, the Commission has no means of ensuring that the offset is passed on to consumers since IECs are free to lower and raise rates; and, two, if "passing through" the offset becomes an overriding concern, re-regulation of the industry will be necessary, which defies logic and the reality of the market.

Furthermore, the forewarning in the majority decision, which smacks of a threat, that this Commission may consider IECs' compliance with this direction in the switched access reform proceeding is antithetical to the principles of a competitive market.

This mix and match of a "reformed monopoly regulation" approach needs to be checked so that we do not create in the market unnecessary market distortion.

For all the above reasons, I will dissent in part.

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

San Francisco, California
July 2, 1998

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