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MAIL DATE
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Decision 99-02-087 February 18, 1999

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Rulemaking on the Commission's Own Motion into the Third Triennial Review of the Regulatory Framework Adopted in Decision 89-10-031 for GTE California, Inc. and Pacific Bell.	R.98-03-040 (Filed March 26, 1998)
In the Matter of the Application of Pacific Bell (U 1001 C) for a Third Triennial Review of the Regulatory Framework Adopted in Decision 89-10-031.	A. 98-02-003 (Filed February 2, 1998)

ORDER DENYING REHEARING OF DECISION NO. 98-10-026

I. SUMMARY

This order denies the application for rehearing of Decision (D.) 98-10-026 (the "Decision") filed by The Utility Reform Network ("TURN"). As we explain below, D.98-10-026 properly concluded that the suspension of the inflation minus productivity portion of the price cap formula should be continued. The application's allegations have no merit and do not demonstrate legal error.

II. BACKGROUND

TURN filed an Application for Rehearing of D.98-10-026 on November 12, 1998. D.98-10-026 resolves the third triennial review of the operations of the incentive-based regulatory framework adopted in D.89-10-031[1] for Pacific Bell ("Pacific") and GTE California Incorporated ("GTEC").

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[1] Re Alternative Regulatory Frameworks for Local Exchange Carriers [D.89-10-031 (1989) 33 Cal.P.U.C.2d 43.]

In D.98-10-026 the Commission modifies some elements of the new regulatory framework ("NRF") of Pacific and GTEC and continues others. D.98-10-026 continues the suspension of the inflation (I) minus productivity plus stretch ("I-X")[2] portion of the price adjustment formula.[3] The Commission was not sufficiently persuaded by any party, to either permanently eliminate or reinstate the inflation minus productivity plus stretch portion of the price adjustment formula.

In its Application for Rehearing TURN asserts that the Commission continues the suspension of I-X on the basis that competition is sufficient to justify as a surrogate for NRF regulation. (TURN Application at 2.) TURN argues that the Decision's reliance on evidence on the level of competition to continue the suspension of I-X is (1) directly contrary to the Commission's April 13, 1998 Scoping Memo and Ruling of Assigned Commissioner ("Scoping Memo"), which TURN alleges, prohibited parties from presenting evidence on the level of competition facing Pacific and GTEC; (2) violates the due process rights of the parties; and (3) violates PU Code section 1757 because the Commission failed to regularly pursue its authority. (TURN Application at 2-6.)

Responses to the applications were filed by Pacific and GTEC. Both Pacific and GTEC oppose TURN's Application. Pacific and GTEC argue that the

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[2] "Productivity factor" is the percentage estimate of the amount by which the utility is expected to increase its productivity during a year and, consequently, decrease its cost of service. It thus reflects a decrease in rates. Productivity factor is often expressed as an offset to an inflation adjustment, which typically increases rates. Productivity factor adjustments were established by D.89-10-031 as part of the New Regulatory Framework (NRF) adopted for GTEC and Pacific Bell. (Re Alternative Regulatory Frameworks for Local Exchange Carriers, 33 CPUC2d 43, 158 (1989).)

[3] The price adjustment formula is R(t) = R(t-1) * (1 + I-X) +/-Z, where R(t) is the rate to be set for the current year, R(t-1) is the rate in the prior year, I is inflation (initially measured by the gross national product price index or GNPPI, and later changed to the gross domestic product price index (GDPPI), X is a productivity and stretch adjustment (based on the difference in productivity growth between the national telecommunications market and the national economy, plus a stretch factor), and Z is other exogenous adjustments found reasonable and necessary. Price changes beyond those allowed by the annual price formula require separate Commission approval.

Commission does not rely on a finding that competition is sufficient to act as a surrogate for NRF regulation in continuing the suspension of I-X, but instead, provides other support for continuing the suspension of I-X. (Pacific Response at 2-9; GTEC Response at 3-5.) In addition, Pacific and GTEC assert that TURN distorts the plain meaning of the Scoping Memo, which did not prohibit all evidence of competition. (Pacific Application at 2; GTEC Response at 1-3.)

III. DISCUSSION

The Commission properly concluded that the suspension of the inflation minus productivity portion of the price cap formula should be continued.

A. The Scoping Memo Did Not Ban Evidence Concerning Competition.

1. Background

The Scoping Memo provides that: "consideration of the issues herein does not at this time appear to require specific evidence on the level of competition. Rather, parties may argue in comments and reply comments that changes should be made without considering the level of competition and why that consideration is important. They may also argue that certain reforms to NRF should not occur until the Commission determines that sufficient competition exists or that certain competitive barriers are removed . . . " (Scoping Memo and Ruling, April 13, 1998, pp. 6-7.)

TURN avers that the Scoping Memo directed parties not to provide any specific evidence "detailed," "general," or otherwise about the level of competition facing ILECs. (TURN Application at 4.) Rather, TURN believes that the Scoping Memo guided parties to make arguments regarding why competition should be examined before making changes to NRF and if the Commission was convinced that competition is an issue then the Commission would analyze

whether sufficient evidence of competition exists to make changes to NRF. (TURN Application at 5.)

TURN argues that the Commission violates the Scoping Memo's ban on evidence about the level of competition facing ILECs by suspending the I-X portion of the price cap formula on the basis that competition is "sufficient to justify as a surrogate for NRF regulation." (TURN Application at 2.) TURN maintains that the Commission violates TURN's due process rights by citing to the number of certificates of public convenience and necessity issued to competitive local exchange carriers ("CLCs") and the number of interconnection agreements. (TURN Application at 7.) TURN contends that they would have provided evidence about competition if the Scoping Memo had not prohibited them from doing so and the Commission cannot mitigate its due process violation by regarding TURN's offer of proof as evidence on the level of competition. (TURN Application at 2-4; 7-8.) In addition, TURN states that in relying on evidence of competition, the Commission violates PU Code section 1757 by failing to regularly exercise its authority. (TURN Application at 3.)

Pacific and GTEC disagree with TURN, arguing that the Scoping Memo did not in fact, "ban" evidence concerning competition. (Pacific Response at 10; GTEC Response at 1-3.) Pacific argues the statement in the Scoping Memo was clearly limited to "specific evidence on the level of competition," which would include, as the Decision points out, "complicated and detailed specific evidence on the level of competition (e.g., calculations by expert witnesses on market structure, market share, market concentration ratios)."[4] Pacific believes that the Scoping Memo did not preclude comments regarding "obvious changes taking place in the telecommunications market but which provide no specific evidence of any particular level of competition." (Pacific Response at 11.) GTEC also argues

[4] D.98-10-026, mimeo, p. 80.

that nothing in the Scoping Memo required the Commission or the parties to ignore regulatory changes that have occurred since 1989 nor bar discussion of the subject of competition altogether. (GTEC Response at 2-3.) In fact, Pacific asserts that the Scoping Memo's observation that specific evidence regarding the level of competition was not needed proved correct and in fact was not relied upon in the Commission's decision to continue the suspension of I-X. (Pacific Response at 10.) Pacific also points out that the Commission stated that it was not persuaded by parties arguing that changes should not be made without considering the level of competition.

Moreover, Pacific contends that it is irrelevant whether TURN would have submitted evidence demonstrating that ILECs retain monopoly power because Pacific and GTEC retain power in Category 1 services and Category 2 services are only partially competitive and prices for those services would continue to be regulated. (Pacific Response at 3, 10.) In addition, GTEC states that the Commission determined that evidence regarding the specific level or existence of competition was not needed because the issues presented would not be impacted if competitive penetration in the local market was one percent or twenty percent and measures of specific levels of competition might have been contradictory or misleading. (GTEC Response at 2.) Pacific also argues that parties were invited to make arguments that changes to NRF should not be made until a sufficient amount of competition exists or until certain competitive barriers are removed, however, none of the parties' arguments were convincing. (Pacific Response at 11, citing to D.98-10-026, mimeo, p. 80.)

2. Discussion

The Commission properly concluded that the Scoping Memo did not prohibit all evidence on the level of competition. We find no merit in TURN's arguments. As stated in the Decision, the Scoping Memo provides that the issues

presented do not appear to require specific evidence on the level of competition, and therefore, guided parties' use of limited resources away from providing specific evidence on the level of competition. A plain reading of the text in question does not bar parties from providing all evidence on the level of competition such as evidence on the general nature of competition. Moreover, in Decision, the Commission observed that nearly all parties offered evidence on the general nature of competition and changes in the market. The Decision provides:

> "Parties were welcome, however, to offer evidence on the general nature of competition, and changes in the market. In fact, nearly all did . . . [I]t was all received as evidence, finding that the potentially objectionable comments and reply comments 'are all within the scope of this proceeding, address issues under consideration, and are responsive to opening comments.' (Ruling, August 31, 1998, page 2.)[5]

B. The Commission Provides Support For Its Decision To Continue The Suspension Of I-X.

1. Background

TURN states that without relying on evidence of competition, the Commission's conclusion that suspending I-X will result in just and reasonable rates in the next three years lacks support. (TURN Application at 2.) TURN contends that the Commission failed to regularly exercise its authority in violation of PU Code Section 1757.

In response to the Commission's statement that rates of return in 1996 and 1997 do not show an accumulating war chest, TURN avers that without auditing Pacific's and GTEC's operations, the Commission cannot assume that the suspension of I-X will result in reasonable rates. (TURN Application at 9.)

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[5] D.98-10-026, mimeo, p. 80.

TURN believes that Rule 1[6] is an effective deterrent only if the ILECs believe that the Commission is going to examine their operations through an audit and the fact that no party has brought reasonable allegations that Pacific and GTEC's sharable earnings advice letters contain false statements is not proof that rates are just and reasonable. (TURN Application at 10.)

Pacific responds that the Commission did not rely on a finding that competition is sufficient to act as a surrogate for NRF regulation in continuing the suspension of I-X. (Pacific Response at 2.) Pacific states that the Commission provides a number of reasons other than the level of competition for continuing to suspend I-X, such as the benefit to customers because it lowers the cost of telephone service by keeping rates from increasing at the rate of inflation.[7]

Both Pacific and GTEC believe that the Commission properly noted significant market changes that have occurred since 1995, and these changes provide no specific evidence of any particular level of competition. (Pacific Response at 8; GTEC Response at 1-3.) Pacific and GTEC also disagree with TURN that an audit is the only way to ensure that rates are just and reasonable. (Pacific Response at 7-8; GTEC Response at 4.) GTEC responds that TURN's argument is not based on any evidence and has been repeatedly rejected by the Commission. Furthermore, GTEC states that an audit to ensure that rates are just and reasonable would undermine regulatory policy that moves toward deregulation, reliance on market forces, and relaxed Commission oversight. (GTEC Response at 4.)

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[6] Rule 1 provides: "Any person who signs a pleading or brief, enters an appearance at a hearing, or transacts business with the Commission, by such act, represents that he or she is authorized to do so and agrees to apply with the laws of this State; to maintain the respect due to the Commission and its Administrative Law Judges; and never to mislead the Commission or its staff by an artifice or false statement of fact or law."

[7] D.98-10-026, mimeo, pp. 19-20.

2. Discussion

A review of the Decision supports the conclusion that neither evidence on the level of competition nor a finding that competition is sufficient to act as a surrogate for NRF regulation was material to the Commission's decision to continue the suspension of I-X. The Commission provided support for its determination to continue the suspension of I-X. Public Utilities Code section 1757 obligates the Commission to "regularly pursue its authority." Public Utilities Code section 1757 provides, in relevant part, "[t]he findings and conclusions of the commission on questions of fact shall be final and shall not be subject to review except as provided in this article. Such questions of fact shall include ultimate facts and findings and conclusions of the commission on reasonableness and discrimination."

We noted in the Decision that effective competition was not a prerequisite for modifying the price cap formula in 1995 and is not a prerequisite for continuing the suspension of I-X in this proceeding. (D.98-10-026, mimeo, p. 13.) The Commission acknowledged throughout the Decision that the continuation of the suspension of I-X was for services that are not fully competitive. For example, in the Decision, the Commission concluded that:

> "[N]o party convinces us that a detailed assessment of competition is needed before we make our decision here. In fact, as Pacific says, detailed information on competition and market share is not needed since suspension of I-X does not remove or change any rate caps, ceilings or floors for services in Categories 1 and 2. The Commission retains its full authority to regulate prices, price ceilings and price floors and these rates, ceilings and floors will not change unless subsequently authorized by us." (D.98-10-026, mimeo, p. 13, 81, FOF 5.)[8]

[8] *See also*, D.98-10-026, mimeo, pp. 14-15, 21, 85, FOF 34.

The Commission stated that Pacific and GTEC could not in fact use market power to manipulate prices for their advantage because it is the Commission, and not the LECs, that sets prices for Category 1 services and the ceiling and floor prices for Category 2 services. (D.98-10-026, mimeo, p. 18-19.) The Commission provided that it designed Category 2 floor rates to prevent cross-subsidies. (D.98-10-026, mimeo, p. 18-19.)

In the Decision, the Commission also observed significant market changes since 1995.[9] However, as Pacific and GTEC assert, the Commission did not continue the suspension of I-X based on these observations. Rather, the Commission found that the suspension of I-X meets the objectives of the Commission to establish and apply a regulatory structure that meets the Commission's goals for the NRF,[10] balances competing interests, and produces rates that are just and reasonable. (D.98-10-026, mimeo, p. 17.) Moreover, the Commission found that suspending I-X results in lowering the real cost of telephone service by keeping nominal rates from increasing at the rate of inflation (resulting in declining real rates when inflation is any number greater than zero); produces real savings to all ratepayers by bringing down the cost of telephone service for all Californians; and captures efficiency savings equal to the rate of inflation. (D.98-10-026, mimeo, p. 82, FOF 10-11.) The Commission also stated

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[9] Events since 1995, such as the following, demonstrate that significant market changes continue to occur: facilities-based competition in the local exchange market in late 1995; resale competition in the local exchange market in early 1996; Telecommunications Act of 1996 signed into law (designed to open all telecommunications markets to competition, including local exchange services); over 150 CLCs [competitive local exchange carriers] authorized to operate in California as of May 1998; and over 100 Commission-authorized interconnection agreements approved between Pacific, GTE and CLCs as of August 1998." (D.98-10-026, mimeo, p. 13-14, FOF 6.)

[10] The Commission's NRF regulatory goals are: (1) universal service; (2) economic efficiency, including both productive and pricing efficiency; (3) encouragement of technological advance; (4) financial and rate stability; (5) full utilization of the local exchange network; (6) avoidance of cross subsidies and anticompetitive behavior; and (7) low-cost, efficient regulation. (D.95-12-052, 63 CPUC2d 377, 381, 411, n.2; see also, D.89-10-031, 33 CPUC2d 43, 92-115.)

that an X factor that is too high "may harm investment and wise spending as prices are reduced below those which would otherwise prevail in a competitive market." (D.98-10-026, mimeo, p. 20.) Moreover, the Commission also concluded that other factors other than the productivity factor provide an incentive for Pacific and GTE[C] to invest prudently and spend wisely, such as the potential to earn higher returns." (D.98-10-026, mimeo, p. 21.)

The Commission properly noted that rates of return in 1996 and 1997 do not show an accumulating war chest[11] which could be used to gain an unfair advantage through cross-subsidization. The Commission also observed that evidence of Pacific's and GTEC's rates of return were uncontested.[12] In addition, the Commission noted that they monitor for cross-subsidies and found none and will investigate when reasonable allegations are made, and, if substantiated, will eliminate any improper cross-subsidies. (D.98-10-026, mimeo, p. 18.)

In addition, the Commission found in the Decision that an audit was not necessary because no allegation in this proceeding justified any special audit initiative. The Commission declined to consider an audit for reasonableness of operations, because it would essentially be the same as doing a general rate case review and the concept and purpose behind the NRF is that the Commission no longer does such reviews. (D.98-10-026, p. 46.) Moreover, the Commission noted

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11 Pacific's rates of return in1996 and 1997 were 10.55% and 6.49% respectively, at a time the NRF sharing threshold (benchmark rate of return) was 11.5%. (D.98-10-026, Exhibit 1, Attachment 2.) GTE's rates of return in 1996 and 1997 were 11.17% and 12.10%, respectively, when GTE's ceiling was 15.5%. (D.98-10-026, Exhibit 8, attached Exhibit A.)

12 In the Decision, the Commission provided that "motions for hearing were made on June 23, 1998. No motion was made for leave to test, scrutinize and cross-examine these rates of return. Objections to the receipt of comments and reply comments as evidence were filed according to the adopted schedule, but no objections to the receipt of this evidence was made. The rate of return data was received as evidence by a ruling on August 31, 1998." (D.98-10-026, mimeo, p. 18, n. 11.)

that each year, shareable earnings advice letters are reviewed for accuracy and no inaccuracy has ever been found that warranted an audit.[13]

C. There Was No Requirement That The Commission Undertake An Analysis Of Actual Productivity And Inflation Rates Before Deciding To Continue The Suspension Of I-X.

1. Background

TURN claims that by continuing the suspension of I-X, the Commission concludes that X equals or is relatively close to I, a conclusion which TURN maintains, is not based on any evidence in this proceeding. (TURN Application at 11-12.) TURN contends that in D.95-12-052, the Commission suspended I-X only after determining on the record that X was equal or close to I, however, in this proceeding, the Commission did no such analysis. (TURN Application at 11.) TURN alleges that because productivity and inflation change over time, the Commission cannot assume that they are equal based on the record of D.95-12-052. (TURN Application at 12.) Moreover, TURN argues that the Commission cannot make the finding that rates will be just and reasonable with the continued suspension of I-X because it did not permit parties to present evidence on this matter and there is no basis for the Commission's conclusion that Category 1 and 2 pricing rules alone will produce just and reasonable rates. (TURN Application at 8, 12). TURN avers that the fact that Pacific has not entered into the sharing band since NRF was adopted should be a "warning flag" to regulators that the company may be hiding profits or falling behind the rest of the industry in productivity. (TURN Application at 9-10.)

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[13] Moreover, shareable earnings advice letters have been subject to protest. No protest has ever resulted in the conversion of shareable earnings advice letter to an application, for a more formal and thorough review. No review of, or protest to, a shareable earnings advice letter has ever led to sharing when the utility first proposed no sharing. We have also monitored results through ongoing reports. No advice letter has ever presented any particular facts to justify the time and expense of an audit." (D.98-10-026, mimeo , pp. 45-46.)

Pacific and GTEC respond that the Commission is not required to analyze whether I equals or is relatively close to X. (Pacific Response at 12; GTEC Response at 5.) Both Pacific and GTEC acknowledge that although the effect of suspending I-X is that I equals X, it was not the Commission's objective in either this proceeding or in the D.95-12-052 proceeding to ensure that the actual rate of productivity and the actual rate of inflation matched. (Pacific Response at 12; GTEC Response at 5.) Pacific states that the Commission provides many reasons for the continued suspension of I-X as stated above, and the record demonstrates that Pacific's rates of return since the time I-X was initially suspended have not been unreasonably high. (Pacific Response at 12-13, citing to D.98-10-026, mimeo, p.18.) Moreover, GTEC argues that the suspension of I-X was justified in 1995 and the present because of the "competitive and regulatory landscape and not by any examination of inflation and productivity estimates." (GTEC Response at 5.) In addition, GTEC alleges that the Commission's objective in this inquiry was to determine whether the price cap formula should be continued or eliminated and not about the specific makeup of the formula itself and since no party convinced the Commission that I-X as a mechanism should either be reinstated or eliminated, the Commission should continue the status quo. (GTEC Response at 5.)

2. Discussion

TURN's arguments are without merit. The Commission was not required either in this proceeding or in D.95-12-052 to make a finding that I equals or is relatively close to X. Suspension of I-X was found to have met the Commission's goals for the NRF, balance competing interests, and produce rates that are just and reasonable.[14] Moreover, the record reveals that during the entire period under review, Pacific's and GTEC's rates of return fell within the range of

[14] D.98-10-026, mimeo, p. 17, 82, FOF 8.

outcomes the Commission determined to be acceptable. The Decision is consistent with the Public Utilities Code requirement that rates be just and reasonable.

The Commission provided adequate and relevant findings in support of continuing the suspension of I-X. There is evidence in the record to support the conclusion of the Commission who, acting as trier of fact, was required to decide between conflicting views. In Findings of Fact 2-12, 34-42, Conclusions of Law 1-2 and the text of the Decision, the Commission set forth the rationale and facts the Commission relied upon in reaching its decision. No legal error has been shown.

IV. CONCLUSION

No further discussion is required of applicant's allegations of error. Accordingly, upon reviewing each and every allegation of error raised by the applicant we conclude that sufficient grounds for rehearing of D.98-10-026 have not been shown.

THEREFORE, IT IS ORDERED that:

1. Rehearing of Decision 98-10-026 is denied.
2. This proceeding is closed.

This order is effective today.

Dated February 18, 1999, at San Francisco, California.

RICHARD A. BILAS
President
HENRY M. DUQUE
JOSIAH L. NEEPER
Commissioners