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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 Incorporated and Pacific Bell.

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.

FILED
PUBLIC UTILITIES COMMISSION
MARCH 26, 1998
SAN FRANCISCO OFFICE
RULEMAKING 98-03-040

ORIGINAL
Application 98-02-003
(Filed February 2, 1998)

**ORDER INSTITUTING RULEMAKING AND
CONSOLIDATING APPLICATION 98-02-003**

Summary

In this order, we initiate a proceeding to conduct the third triennial review of the New Regulatory Framework (NRF) applicable to Pacific Bell (Pacific) and GTE California Incorporated (GTEC). Further, to avoid the proliferation of open dockets and expedite matters, we will consolidate Application (A.) 98-02-003, which was filed by Pacific and sought review of the NRF, with the rulemaking we begin today.

The NRF was first adopted by the Commission with the issuance of Decision (D.) 89-10-031 and applied to Pacific and GTEC. Citizens Telephone Company (Citizens) and Roseville Telephone Company (Roseville) have operated under their versions of the NRF since 1996 and 1997, respectively. Citizens last year separately filed A.97-10-021 seeking NRF review, as was required by the decision in its last general rate case which also placed this

company under the NRF.¹ Roseville is scheduled to file its first NRF review proceeding in October 1998 in accordance with its last general rate case decision, D.96-12-074, which also placed Roseville under the NRF.² We will not bring their NRF reviews into this proceeding since the issues for Pacific and GTEC, while related to Citizens and Roseville, are sufficiently different due to the relative maturity of Pacific's and GTEC's NRF programs. We expect that Citizens and Roseville may well benefit in their future NRF reviews from the matters considered in this proceeding. Thus, we will concentrate in this proceeding on the 1998 NRF review for Pacific and GTEC.

Background

Nearly nine years ago, the Commission placed California's two largest incumbent local exchange companies (LECs), Pacific and GTEC, under a form of incentive-based regulation called the NRF. The decision adopting the NRF, D.89-10-031, was issued at the conclusion of Phase II of Investigation (I.) 87-11-033, our investigation into alternative regulatory frameworks for local exchange carriers. This order generally balanced the interests of ratepayers and shareholders by: 1) providing Pacific and GTEC with the opportunity to earn rates of return above and below a market-based return while setting a sharing mechanism, a ceiling, and a floor on those earnings;³ 2) permitting each company to manage its own expenses and plant investment while requiring extensive

¹ *Re. Citizens Utilities Company of California*, 62 CPUC2d 244, 320 (1995).

² D.96-12-074, mimeo at p. 146.

³ *Re. Alternative Regulatory Frameworks for Local Exchange Carriers*, 33 CPUC2d 43, 135, 138-141 (1989).

monitoring reports and pre-approval of fiber deployment;⁴ 3) granting Pacific and GTEC increasing pricing flexibility dependent upon the level of competition for a particular service;⁵ and 4) adjusting prices of services based on a price-cap formula that offset inflation with productivity and allowed the recovery of costs beyond the control of the utilities' management.⁶

In D.89-10-031, the Commission also ordered that the NRF be revisited every three years, and called for the utilities to file an application no later than May 1, 1992, to set the forum for the Commission's first triennial review.⁷ Hence, GTEC and Pacific filed A.92-05-002 and A.92-05-004, respectively. The Commission's first triennial review resulted in two significant orders, D.93-09-038 and D.94-06-011. D.93-09-038 adopted two partial settlements between GTEC and the intervenors in its application that, among other things, allowed GTEC to remove the sharing band in exchange for agreeing to certain productivity adjustments to its price cap formula through 1996.⁸ D.94-06-011 removed Pacific's earnings ceiling and replaced it with a sharing band that permitted the company to keep 70% of its earnings and refund 30% to its ratepayers, and also adopted a productivity factor for Pacific applicable until the next NRF review.⁹

⁴ *Id.*, at 149-150.

⁵ *Id.*, at 125.

⁶ *Id.*, at 136-137.

⁷ *Id.*, at 236.

⁸ *Re. GTE California, Inc.*, 50 CPUC2d 684, 689 (1993).

⁹ *Re. GTE California, Inc.*, 55 CPUC2d 1, 33 (1994).

In addition, D.94-06-011 provided guidance on how the Commission would engage in the next NRF review. Having estimated that the application process had added approximately nine months to the proceeding's schedule, the Commission decided that "[t]hrough an [Order Instituting Investigation], early on the Commission can engage in the necessary examination of those rapidly changing issues that are integral to the framework and the future."⁸ Thus, as part of the Telecommunications Roadmap adopted in D.94-12-053,⁹ the Commission opened I.95-05-047 into the second triennial review of the NRF on May 24, 1995.

We concluded our policy review in the second triennial review with D.95-12-052. This decision essentially froze Pacific's and GTEC's rates until 1998 by setting the productivity factor in the price cap formula equal to the inflation factor.¹⁰ However, the utilities were still subject to the Z-factor adjustment for costs generally outside their control. Later, on May 8, 1996, the Commission issued D.96-05-036 which stated that "[t]he issues of recategorization, Z-factors, and [NRF] monitoring requirements will be addressed in the 1998 Triennial NRF review or, if the Commission resources allow, in 1997."¹¹ The delay arose from the Commission's engagement in several proceedings, such as R.95-01-020, the Universal Service rulemaking, and the costing phase of R.93-04-003, the Open Access and Network Architecture Development (OANAD) rulemaking, which

⁸ *Id.*, at 57.

⁹ *Re. Alternative Regulatory Frameworks for Local Exchange Carriers*, 58 CPUC2d 392, 395-396 (1994).

¹⁰ D.95-12-052, mimeo at p. 49, 51, O.P. 4 at 96.

¹¹ D.96-05-036, mimeo at p. 12.

preempted the allocation of scarce resources to the 1995 NRF Review. The second triennial NRF review docket remained open for the sole purpose of receipt of and approval of an audit plan from the Division of Ratepayer Advocates.¹⁴

Nevertheless, the Commission in D.96-05-036 signaled that it intended to engage in the 1998 NRF Review as soon as practicable, stating that the third triennial review would begin in 1997 if at all possible.

The 1998 NRF Review

On December 19, 1997, GTEC filed a motion in I.95-05-047 seeking postponement of the Commission's third triennial NRF Review until 1999 as to potential changes and modifications to the framework that would apply solely to GTEC. GTEC supported its motion by differentiating its market position and regulatory program from other NRF LECs. Both the Office of Ratepayer Advocates and The Utility Reform Network opposed the Commission's institution of separate NRF reviews for Pacific and GTEC and, in fact, proposed that the Commission delay the 1998 NRF Review for both companies. The California Telecommunications Coalition joined in this request.¹⁵ Pacific filed in opposition of the delay and in support of GTEC's request that the two utilities be treated separately as to the third triennial review of the NRF.

On February 2, 1998, Pacific filed A.98-02-003 to begin the third triennial review of the NRF. In that application, Pacific requested that the Commission

¹⁴ *Id.* at 13. The Division of Ratepayer Advocates is now called the Office of Ratepayer Advocates.

¹⁵ The California Telecommunications Coalition membership includes AT&T Communications of California, MCI Telecommunications Corp., Sprint Communications Company L. P., Teleport Communications Group, the California Cable Television Association, Nextlink, and the Utility Reform Network.

conduct the 1998 NRF Review in two phases, with the first phase resulting "in structural changes to the regulatory framework applicable to Pacific to become effective on January 1, 1999."¹⁶ In Phase I, Pacific asks for relief from what it terms the remaining vestiges of rate-of-return regulation, e.g., the earnings cap and floor, the requirement that the Commission approve its depreciation rates, and the inflation and productivity adjustments in the price cap formula. Under Pacific's proposed procedural schedule, a second phase would apply to other carriers also operating under the NRF, and would consider what current pricing rules are appropriate for 1999 and beyond.¹⁷

As we indicated in D.96-05-036, our last order in the 1995 NRF Review, we are anxious to begin the third triennial review as soon as possible (even in 1997 if resources had allowed). The parties' protestations to the contrary, we believe that we are now in a good position to start the next NRF Review. Having instituted rules for competitive entry into the territories of the large and mid-sized California LECs, implemented an intrastate universal service program, recently adopted costs for Pacific in the OANAD docket, and almost completed the recalculation of the wholesale margin for total-service resale, there is simply no reason to delay the start of the 1998 NRF Review any further. We will not neglect to complete all other relevant pieces of the Telecommunications Roadmap, but recognize that we must keep our whole regulatory program moving forward, including those pieces of the program that affect the incumbent LECs.

¹⁶ A.98-02-003 at p. 2.

¹⁷ *Id.*, at pp. 4-6.

We also point out that, through our periodic review of the NRF, we have assured that our regulatory framework matches well with the evolving telecommunications marketplace and reflects our experiences to date with incentive-based regulation. We do not agree that consideration of changes to the NRF should await further developments in our effort to bring competition to California's telecommunications market. We instituted the NRF to transition to full-fledged competition. That does not mean that the NRF must be kept intact through the passage of time, thus ignoring industry shifts. Industry activity, as well as regulatory decisions at the state and federal levels have drastically modified the telecommunications marketplace since we instituted the NRF in 1989 and last conducted the review exercise in 1995.

In today's order, we also direct the Administrative Law Judge (ALJ) to whom I.95-05-047 is assigned to issue a ruling denying GTEC's motion to postpone consideration of the 1998 NRF Review until next year. Many circumstances have changed since our last review involving GTEC, including the passage of the 1996 Federal Telecommunications Act, the institution of a universal service fund that applies to GTEC, and the implementation of intra-Local Access and Transport Area (LATA) equal access within GTEC's territory. All these changes argue for the need by the Commission to start the 1998 NRF Review for GTEC now, not next year.

Lastly, we will not carry out the 1998 NRF Review employing the procedural vehicle suggested by Pacific, i.e., A.98-02-003. Although the Commission's procedural instruction at the conclusion of the 1992 NRF Review was for an investigation to be initiated, that instruction was limited to the 1995 NRF Review only." In that decision we discussed the Commission's preference

" 55 CPUC 2d 63.

for investigations over company-driven applications. We hereby affirm that "the application process wastes a substantial amount of time in a NRF review...We wish to immediately focus the parties and get the maximum amount of participation from those interested parties..." in the 1998 NRF Review. The rulemaking²⁰ we adopt today, by setting forth the issues in which we are interested and making Pacific and GTEC respondents, will be more efficient, maximize the parties' and the Commission's resources, and be completed in a more timely fashion. Pacific's application is hereby consolidated with the new dockets we open today. Both proceedings will remain open to explore the issues described in the preliminary scoping memo below. Other issues relevant to the third triennial NRF Review, such as those mentioned by Pacific as appropriate for its proposed Phase II, will be explored in a separate generic proceeding to be opened later.

Preliminary Scoping Memo

This rulemaking shall be conducted in accordance with Article 2.5 of the Commission's Rules of Practice and Procedure.²¹ As required by Rules 6(c)(1) and

¹⁹ *Id.*, at 57.

²⁰ Senate Bill (SB) 960, which now governs procedure and categorization of our proceedings, sets forth different procedures and rules for rulemaking versus investigation. Therefore, we will employ a rulemaking format without an accompanying investigation, in order to simplify SB 960 compliance and to avoid confusion over conflicting rules.

²¹ The Rules of Practice and Procedure are posted in the Commission's web site at www.cpuc.ca.gov. Article 2.5 of the Commission's Rules implements many of the reforms contained in SB 960.

6(c)(2) of Article 2.5, this order includes a preliminary scoping memo²² as set forth below. In addition, this order sets the schedule, and assigns the presiding officer.

1. Scope of Proceeding

The issues to be considered in this consolidated proceeding are:

1. Should the Commission eliminate as to Pacific and GTEC (a) sharing of earnings above specified levels (i.e., Pacific's benchmark, GTEC's ceiling), (b) earnings floors, (c) earnings caps, (d) benchmark and market-based rates of return, (e) "trigger" mechanisms, and (f) periodic earnings reviews?
2. Should the annual depreciation review and approval of depreciation rate changes for Pacific and GTEC be eliminated?
3. Should the currently suspended GDPPI minus X price cap formula for adjusting rates be permanently eliminated for Pacific and GTEC?
4. Should the criteria for Z factor recovery be modified for Pacific and GTEC and, if so, how? Should Z factor adjustments be completely eliminated?
5. Should the cap on the price of Pacific's and GTEC's basic residential services be continued through 2001?

To provide basic information on these five issues, parties will include in their comments, along with anything else they offer, answers to the following: what effect on rates would there have been in the last 3 years, and what would the forecast of such effect be in the next 3 years, of the 5

²² Rule 5(m) defines "scoping memo" as an order or ruling describing the issues to be considered in a proceeding and the timetable for resolving the proceeding.

issues/proposals. Parties should comment upon what effect, if any, there would have been, and will there be, on rates by:

1. Replacement of the remaining vestiges of earnings/rate of return regulation with pure price regulation (e.g., how would rates have been any different, or will be any different);
2. Elimination of the annual depreciation review and approvals;
3. Elimination of the currently suspended GDPPI-X price cap formula and the Z-factor adjustments;
4. Modification of the Z factor criteria; and
5. Continuation of the cap on basic residential rates.

Pacific proposes its application be conducted in two phases, or the second phase be by separate proceeding. The latter approach will be used. That is, five issues will be addressed in a single phase, which is consolidated with this rulemaking into the same issues for GTEC. When the rulemaking is completed, it, along with A.98-02-003, will be closed. The Commission will issue a subsequent Order Instituting Rulemaking (OIR) to address the remaining issues.

Parties protesting Pacific's application state that the application is premature and should be deferred until 1999, when impediments to local competition may be reduced and competition may be more vigorous. We disagree and intend to adhere to the Commission's plan to review the NRF every three years.³³ Protestants do not convince us that we should deviate from that plan. Pacific's application is timely, but at the same time realistically limits review to issues that require immediate attention, while not requiring an

³³ 33 CPUC2d 203-204.

unreasonable use of the Commission's limited resources beyond that already committed in the Commission's business plan.

Protestants allege that the application is inconsistent with the public interest. To the contrary, it is vital to the public interest that NRF evolve simultaneously with the evolution of competition in telecommunications. Indeed, perhaps in some respects, NRF reform may promote the development of vigorous and effective competition. Whether or not applicant's specific NRF proposals, and the changes contemplated in the rulemaking and investigation, are just, reasonable, and timely will be decided after full consideration of the protests to A.98-02-003, as well as the comments, reply comments, and oral arguments in this proceeding.

Protestants generally argue for rejection of all of Pacific's proposals. This is not, however, reason to reject a fair and timely consideration of the issues delineated above. Rather, protestants will have a full opportunity to convince the Commission of their positions during the course of this consolidated proceeding.

Finally, protestants argue for inclusion of several additional issues, some of which were ordered by the Commission in previous decisions (e.g., service quality, audit results, impact of NRF on universal service, affordability, rate of return, marketing abuses, amount of local competition). While each of these issues is important, the Commission's limited resources prevent a comprehensive NRF review here. Some issues will be dealt with soon in other proceedings, e.g., the forthcoming OIR/OII into service quality. Other matters will be examined carefully in later facets of the 1998 NRF review.

2. Category of Consolidated Proceeding

This ruling preliminarily finds for the consolidated proceeding that this is a quasi-legislative proceeding, as described in Rule 5.

Protestants to Pacific's application argue that it must be categorized ratesetting. This application, however, when consolidated with the rulemaking, will examine a class of regulated entities. The class is California's large local exchange carriers. Therefore, the proceeding will "establish policy or rules (including generic ratemaking policy or rules) affecting a class of regulated entities, including those proceedings in which the Commission investigates rates or practices for...[a] class of entities within the industry." (Rule 5(d).) The consolidated proceeding is an exact match with the intent and letter of the Commission's categorization rules for the quasi-legislative category.

3. Need for Hearing

Protestants to A.98-02-003 have argued that evidentiary hearings are likely to be necessary, or are necessary, on factual assertions, e.g., the effect of the proposals, amount of local competition, impact of cross-subsidies caused by implementation of the proposals, implications of regulation in other jurisdictions, effect of eliminating ceilings and floors on franchise impact claims. According to these parties hearings would be needed whether or not new issues are added. We disagree and find that the issues in the consolidated proceeding do not require a hearing. Rather, the issues are policy matters, and this is a quasi-legislative proceeding. Evidentiary hearings will not be scheduled based on vague assertions by protestants to A.98-02-003 of the need for cross-examination. To the extent discovery is necessary, parties are encouraged to engage in discovery quickly, and recipients of discovery requests are ordered to cooperate.²¹ Cross-examination will not be allowed to be used for discovery.

²¹ Discovery disputes are subject to the Commission's law and motion procedures. (Resolution ALJ-164, dated September 16, 1992.)

If, after review of the comments and reply comments, a party believes cross-examination is necessary, that party may move for leave to cross-examine another party. Motions must be specific, and identify the individual and precise comments or reply comments for which cross-examination is sought, the reason(s) why cross-examination is necessary and other techniques have failed, and an estimate of the amount of time believed necessary for cross-examination.

4. Schedule

The schedule for this consolidated proceeding is as follows:

March 26, 1998	Issuance of Rulemaking and Preliminary Scoping Memo; consolidation of Pacific's application with Rulemaking
April 3, 1998	Comments filed on this order, i.e., on the proper categorization, need for hearing, preliminary scoping memo, issues, and schedule
April 10, 1998	Scoping Memo issued
May 29, 1998	Comments filed and served
June 12, 1998	Reply Comments filed and served; motions for hearings filed
June 19, 1998	Oral Argument; Projected Submission Date
September 17, 1998	Commission Decision adopted

Parties shall use the same outline for their comments and reply comments. Comments and reply comments shall be by issue, and parties shall meet and agree upon a common subject heading within each issue. Disputes may be presented to the presiding officer, but shall be presented no later than April 20, 1998.

The procedures and schedule for the oral argument will be established by subsequent ruling.

The goal is to complete this proceeding by September 1998. In no event will resolution exceed eighteen months from the date of filing of the application or today's order, pursuant to SB 960, Section 13.

5. Presiding Officer

Commissioner Jessie J. Knight, Jr., is the presiding officer in this consolidated proceeding, and ALJ Burton W. Mattson is the assigned ALJ.

6. Service List

The official service list is attached to this order. Appearances include respondents to this OIR. Appearances also include protestants to Pacific's application, on the expectation that those protestants will be active parties in this proceeding. To remain as an appearance, protestants to Pacific's application included on the service list herein must file comments or reply comments. Such comments may incorporate by reference the protests already filed in A.98-02-003. Otherwise, protestants will be placed on the Information Only service list for the purpose of monitoring the proceeding.

Other persons may seek to be added to the service list in the category of appearance, state service, or information only. Persons seeking to become an appearance must file and serve a motion by April 3, 1998 moving for that status, and showing that they will be active parties (not just monitoring the proceeding) by their filing comments or reply comments. Persons seeking state service status need only file a document by April 3, 1998 requesting that status. Persons seeking information-only status may make that request by letter to the Commission's Process Office at any time. The scoping memo issued April 10, 1998 will make the final determination of parties, and will attach the final service list.

IT IS THEREFORE ORDERED that:

1. A rulemaking is instituted into the Third Triennial Review of the operations and safeguards of the incentive-based regulatory framework adopted in Decision (D.) 89-10-031 for Pacific Bell and GTE California Incorporated. Pursuant to Rules 6(c)(1) and 6(c)(2), persons may file a response to this order. Any response to this order shall be filed and served within eight days.

2. Application 98-02-003 of Pacific Bell for a Third Triennial Review of the Regulatory Framework Adopted in Decision 89-10-031 is consolidated with the rulemaking ordered in the paragraph above.

3. The scope of, and schedule for, this consolidated proceeding are as set forth in the body of this order. Parties shall use the same outline for comments and reply comments. Parties shall cooperate in responding to reasonable requests for discovery. Discovery disputes are subject to the Commission's law and motion procedures.

4. The categorization of this consolidated proceeding is quasi-legislative for purposes of Article 2.5.

5. The presiding officer is Commissioner Jessie J. Knight, Jr.

6. The Executive Director shall serve a copy of this OIR on the service lists in A.98-02-003 and I.95-05-047.

7. The official service list is attached to this order. Parties shall serve all filings on all parties listed on the service list, including those identified as "state service." Parties are not required to serve those individuals listed under "information only." The Commission will serve all rulings and orders on all individuals in all categories. Appearances to this proceeding are the respondent utilities and parties that filed protests to A.98-02-003. Protestants to A.98-02-003 will be required to file comments or reply comments in the consolidated docket

SERVICE LIST

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(End of Service List)