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Decision 98-10-026 October 8, 1998

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.	Rulemaking 98-03-040 (Filed March 26, 1998)

(See Appendix A for List of Appearances.)

29985

TABLE OF CONTENTS

Page

FINAL OPINION 2
1. Summary 2
2. Background 3
2.1. The New Regulatory Framework 3
2.2. 1992 Review 5
2.3. 1995 Review 6
2.4. 1998 Review 6
2.4.1. Scoping Memo and Categorization 7
2.4.2. Comments, Reply Comments, Evidence, Motions for Hearing, Closing Argument, and Draft Decision 7
2.4.3. Intervenor Compensation 9
2.4.4. Final Decision 9
3. Five Issues for Review 9
4. Price Cap Index 10
4.1. Positions of Parties 10
4.2. Discussion 12
4.2.1. Continued Suspension of Inflation Minus Productivity Plus Stretch 12
4.2.2. Arguments for Elimination or Reinstatement 15
4.2.3. Application of AT&T Model for Relaxation of Regulation 21
4.2.4. Conclusion 27
5. Sharing and Earnings Reports 27
5.1. Positions of Parties 27
5.2. Discussion 30
5.2.1. Suspend Sharing 30
5.2.2. Arguments for Retention of Sharing 37
5.2.3. Audit 44
5.2.4. ORA Alternatives 46
5.2.5. Conclusion and Future of Sharing 48
6. Depreciation Review and Approval of Depreciation Changes 50
6.1. Positions of Parties 50
6.2. Discussion 51
6.2.1. Stranded Costs 53
6.2.2. Equal Life Group 55
6.2.3. Annual Depreciation Report 56
6.2.4. Adverse Consequence by Application 57
6.2.5. Other Proposals 58

TABLE OF CONTENTS (Continued)

Pages

7. Z Factors ... 58
7.1. Position of Parties ... 58
7.2. Discussion ... 59
7.2.1. Eliminate New Z Factors ... 59
7.2.2. Limited Exogenous (LE) Factor Mechanism ... 61
7.2.3. Criteria ... 63
7.2.4. Phase Out of Existing Z Factors ... 65
7.2.4.1. Post Retirement Benefits Other Than Pensions ... 65
7.2.4.2. Other Items for Phased Out Z Factor ... 67
7.2.4.3. List of Z Factors To Be Phased Out ... 67
7.2.5. Other Considerations ... 68
8. Cap On Basic Residential Services Through 2001 ... 69
8.1. Positions of Parties ... 69
8.2. Discussion ... 70
8.2.1. Consideration of Arguments for Removal of Cap or Freeze for Three Years ... 72
8.2.2. Pacific Bell Residential Cap ... 75
9. Other Issues And Next NRF Review ... 75
10. Eligibility to File Request for Intervenor Compensation ... 78
11. Competition ... 79
Findings of Fact ... 81
Conclusions of Law ... 89
APPENDIX A: Service List

FINAL OPINION

1. Summary

This decision modifies some elements of the new regulatory framework (NRF) regulation of Pacific Bell (Pacific) and GTE California, Incorporated (GTE), but continues others. It continues suspension of the inflation (I) minus productivity plus stretch (X) portion of the price adjustment formula. It suspends sharing effective January 1, 1999, but continues the reporting of earnings. It permanently eliminates annual depreciation reviews and approvals effective January 1, 1999. It phases out existing Z factor adjustments; eliminates new Z factor adjustments; and continues streamlined advice letter consideration of a very limited set of exogenous costs by a new, limited exogenous (LE) cost mechanism. It continues residential rate caps just as all rate caps and floors are continued, subject to change by future Commission decision. It orders that any application filed pursuant to Ordering Paragraph 7 of D.96-09-089 ("franchise impact claim") contain certain information on applicant's efforts to mitigate any alleged reserve deficiency. Except as changed herein, it continues current rules and procedures for the consideration of changes to Category 1 rates, and Category 2 ceilings or floors. It invites parties and the public to serve information by September 1, 2000 to facilitate Commission issuance of the next NRF Order Instituting Rulemaking (OIR). Finally, it finds that The Utility Reform Network (TURN), the Greenlining Institute (GI) and the Latino Issues Forum (LIF) may file requests for intervenor compensation within 60 days, and orders that any such requests comply with the preliminary ruling of the Administrative Law Judge (ALJ). The proceeding is closed.

2. Background

2.1. The New Regulatory Framework

For many decades, Pacific and GTE were regulated under cost of service, or rate of return, regulation. Under that regulation, the Commission set rates based on a review of each utility's costs, investments, necessary return and corresponding revenue requirement needs.

In November 1987, the Commission undertook an investigation of alternatives to cost of service regulation for Pacific and GTE "that might better serve California under current conditions."[1] (Order Instituting Investigation (OII or I.) 87-11-033.) The Commission partitioned the investigation into three phases.

Phase I considered pricing flexibility for services subject to limited competition. As a result, Pacific and GTE were granted limited downward pricing flexibility for vertical services, CentraNet/Centrex features, and high speed digital private line services. Further, the intraLATA high speed digital private line service market was opened to competition.[2] (See D.88-08-059 (29 CPUC2d 11) and D.88-09-059 (29 CPUC2d 376).)

Phase II considered alternatives to cost of service regulation, and resulted in the Commission adopting incentive-based regulation known as the NRF. (Decision (D.) 89-10-031, 33 CPUC2d 43.) The NRF joined new financial incentives, streamlined regulation, and safeguards for both shareholders and

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[1] Notice of En Banc Hearing, dated August 11, 1987, page 1, cited in Exhibit 8 at page 8.

[2] California is divided into ten Local Access and Transport Areas (LATAs) of various sizes, each containing numerous local telephone exchanges. "InterLATA" describes services, revenues, and functions that relate to telecommunications originating in one LATA and terminating an another. "IntraLATA" describes services, revenues, and functions that relate to telecommunications originating and terminating within a single LATA.

ratepayers, with Commission monitoring to promote the Commission's regulatory goals.[3]

The NRF includes several features. Rates are adjusted annually based on a formula that offsets cost increases from inflation by cost decreases from productivity gains and a stretch factor, while also allowing recovery of costs beyond the control of utility management (i.e., exogenous, or Z, factors).[4] Pacific and GTE are given the opportunity to earn rates of return above market-based returns, within limits. An earnings sharing mechanism is employed with market-based, benchmark, ceiling and floor rates of return.[5] Additionally, Pacific and GTE may petition for reconsideration of the adopted inflation or productivity factors if their earnings fall to the floor or below for two years in a row.

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[3] 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 and footnote 2 at 411; also see D89-11-031, 33 CPUC2d 43, 92-115.)

[4] 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.

[5] The sharing formula established several rates of return: a market-based rate of return (initially set at 11.50%), a benchmark rate of return 150 basis points higher than the market-based rate of return, a cap (ceiling) rate of return 500 basis points higher than the market-based rate of return, and a floor rate of return 325 basis points below the market-based rate of return. A utility retained 100% of earnings between the market-based and benchmark rates of return, shared 50% of earnings between the benchmark and ceiling rates of return, and returned to ratepayers 100% of earnings over the ceiling rate of return.

Further, services are classified into three categories: Category 1 for basic monopoly services, Category 2 for discretionary or partially competitive services, and Category 3 for fully competitive services. Prices for Category 1 services are fixed, and are subject to annual change by application of the price adjustment formula. Category 2 prices are subject to flexibility within ceilings and floors. Price floors are based on direct embedded costs, and are increased each year by inflation, unless a new cost study justifies a different floor. Price ceilings change annually by the price cap formula. Category 3 prices are subject to the maximum pricing flexibility allowed by law. Monitoring reports are also required. Finally, the Commission ordered that the NRF be reviewed every three years.

Phase III considered implementation issues. The Phase III Implementation Rate Design order reset price levels for most incumbent local exchange carrier (ILEC) services to be more reflective of costs, opened the intraLATA toll market to competition on a 10xxx basis effective January 1, 1995, and moved a number of services, including intraLATA toll services, to Category 2. (D.94-09-065, 56 CPUC2d 117.)

2.2. 1992 Review

The first triennial review resulted in two significant orders. First, D.93-09-038 (50 CPUC2d 684) adopted two partial settlements. Among other things, GTE's 50% sharing band was removed in exchange for a one time rate adjustment and increased productivity factors in its price adjustment formula through 1996. Second, D.94-06-011 (55 CPUC2d 1) changed the earnings sharing distribution for Pacific. Pacific was allowed to retain 70% of its earnings above the ceiling rate of return, with the remaining 30% returned to ratepayers. D.94-06-011 also adopted an increased productivity factor for Pacific, replaced the GNPPI with the GDPPI for measuring inflation, and reduced the rate of return level for sharing.

2.3. 1995 Review

The second triennial review (I.95-05-047) resulted in the Commission setting the productivity factor in the price adjustment formula equal to the inflation factor (GDPPI). (D.95-12-052, 63 CPUC2d 377.) This essentially suspended the I-X term within the formula, and effectively froze rates for Pacific and GTE until 1998, except for Z factor adjustments.[6]

2.4. 1998 Review

On December 19, 1997, GTE filed a motion in I.95-05-047 seeking postponement until 1999 of the Commission's third triennial NRF review for GTE. On February 2, 1998, Pacific filed an application for its third triennial NRF review. (Application (A.) 98-02-003.) Pacific proposed the proceeding be categorized as quasi-legislative (QL). The Commission preliminarily categorized the proceeding as QL.[7]

On March 26, 1998, the Commission adopted Order Instituting Rulemaking (OIR or R.) 98-03-040. R.98-03-040 preliminarily identified five issues for review, named Pacific and GTE as respondents, consolidated R.98-03-040 with A.98-02-003, directed the ALJ in I.95-05-047 to deny GTE's motion to postpone consideration of its NRF until 1999, and categorized R.98-03-040 as QL. Responses to the OIR were filed by Pacific, GTE, the Office of Ratepayer Advocates (ORA), TURN, AT&T Communications of California, Inc. (AT&T), the California Cable Television Association (CCTA), MCI Telecommunications Corporation (MCI), Teleport Communications Group, Inc.,

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[6] GTE's 1993 settlement agreement (adopted in D.93-09-038 (50 CPUC2d 684)) was allowed to expire in 1996, thereby setting productivity plus stretch equal to inflation for GTE only for 1997 and 1998.

[7] Resolution ALJ-176-2986, reported in the Daily Calendar, February 6, 1998, page 32.

and Sprint Communications Company (Sprint). (Rule 6(c)(2) of the Commission's Rules of Practice and Procedure (Rules).) All parties, with the exception of respondents, objected to the preliminary determination of category.

2.4.1. Scoping Memo and Categorization

On April 13, 1998, the Assigned Commissioner filed and served a Scoping Memo and Ruling. The Scoping Memo and Ruling set five issues for review, categorized the consolidated proceeding as QL, addressed the responses in opposition to the Commission's preliminary categorization, determined no hearing was needed, found that Article 2.5 of the Rules ceased to apply, set the schedule, named Commissioner Jessie J. Knight, Jr. as the Presiding Officer, adopted the service list, and adopted Rule 7.1 for the reporting of ex parte communications.

On April 23, 1998, TURN, AT&T, and CCTA filed an appeal of the categorization stated in the Scoping Memo. (Rule 6.4(a).) On April 28, 1998, Pacific filed a response in support of the QL categorization. On May 4, 1998, GTE filed a response in support of the QL categorization. On May 21, 1998, the Commission changed the categorization to ratesetting, waived Rule 6.5(b) if the Assigned Commissioner later determined a hearing was needed,[8] and dismissed A.98-02-003. (D. 98-05-061.)

2.4.2. Comments, Reply Comments, Evidence, Motions for Hearing, Closing Argument, and Draft Decision

Consistent with the adopted schedule, parties served comments on May 29, 1998. On June 19, 1998, parties served reply comments.

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[8] Rule 6.5(b) requires the assigned Commissioner to place any assigned Commissioner's ruling changing the Commission's preliminary determination of the need for hearing on the Commission's Consent Agenda for approval.

On June 19, 1998, Pacific, GTE and TURN filed objections to the receipt of portions of the comments of other parties as evidence. On June 23, 1998, Pacific, GTE, Joint Commenters,[9] and TURN filed responses to the objections of receipt of portions of their comments as evidence. Also on June 23, 1998, Pacific and TURN filed objections to the receipt of portions of the reply comments of other parties as evidence; Joint Commenters filed a motion to strike portions of Pacific's Comments, or in the alternate, for evidentiary hearings; and TURN filed a motion for hearings regarding reply comments and for briefing in lieu of hearings. On June 25, 1998, Pacific filed responses to the motions of Joint Commenters and TURN.

Closing argument was held on June 26, 1998. Motions for hearing were withdrawn. By ruling dated June 29, 1998, TURN's motion for briefing in lieu of hearings was granted in part, and parties were given seven days to file briefs on the relationship and relevance, if any, of Commission regulation of AT&T from 1984 through 1998 to NRF issues under consideration here. Briefs were filed on July 6, 1998 by Pacific, GTE, Joint Commenters, ORA and TURN.

On July 2, 1998, Joint Commenters filed an opposition to Pacific's motion to strike portions of their reply comments, and Pacific filed a response to TURN's objections to receipt of reply comments. On July 3, 1998, ORA filed its response to objections of TURN and GTE regarding objections and motions to strike.

No hearing was held. On July 31, 1998, motion for en banc oral argument was filed by TURN, and comments concerning en banc

[9] Joint Commenters are AT&T, CCTA and MCI.

presentation were filed by Pacific and GTE. By rulings dated August 31, 1998, motion for en banc presentation was denied, objections to receipt of comments and reply comments were overruled, comments and reply comments were received as evidence, and the proceeding was submitted for decision.

On September 4, 1998, the draft decision of Commissioner Knight was issued for comment. Comments were filed and served on September 18, 1998, and reply comments were filed and served on September 23, 1998. We have reviewed the comments and reply comments, and made changes to the draft decision where appropriate.

2.4.3. Intervenor Compensation

On April 23, 1998, the GI and LIF filed a joint Notice of Intent (NOI) to seek intervenor compensation. (Public Utilities (PU) Code Section 1801 et seq.) On May 20, 1998, TURN filed an NOI to claim intervenor compensation. No statements responding to the notices were filed. On June 19, 1998, after consultation with the Presiding Officer and Assigned Commissioner, the ALJ filed a preliminary ruling on the NOIs. The preliminary ruling found TURN eligible to later file a claim for compensation, addressed matters raised by the NOI of GI/LIF, and directed TURN and GI/LIF to address specific issues in any subsequent compensation request.

2.4.4. Final Decision

This final decision is timely issued. It is issued well before the 18-month time period set forth in Senate Bill 960, Section 1 (Ch. 856, Stats. 1996).

3. Five Issues for Review

The scope of this 1998 NRF review, established in the Scoping Memo and Ruling, is to address five issues:

1. Should the currently suspended GDPPI minus X price cap formula for adjusting rates be permanently eliminated for Pacific and GTE?

2. Should the Commission eliminate as to Pacific and GTE (a) sharing of earnings above specified levels (i.e., Pacific's benchmark, GTE's ceiling), (b) earnings floors, (c) earnings caps, (d) benchmark and market-based rates of return, (e) "trigger" mechanisms, and (f) periodic earnings reviews?

3. Should the annual depreciation review and approval of depreciation rate changes for Pacific and GTE be eliminated?

4. Should the criteria for Z factor recovery be modified for Pacific and GTE, and if so, how? Should Z factor adjustments be completely eliminated?

5. Should the cap on the price of Pacific's and GTE's basic residential services be continued through 2001? Should the cap be applied at the existing level, or should it be subject to adjustment consistent with the outcome in pending proceedings?

The issues and decisions are interrelated. Nonetheless, we address each issue in turn.

4. Price Cap Index

The first issue is:

> Should the currently suspended GDPPI minus X price cap formula for adjusting rates be permanently eliminated for Pacific and GTE?

4.1. Positions of Parties

Pacific, GTE and the California Manufacturer's Association (CMA) recommend permanently eliminating the GDPPI minus X price cap formula. Pacific asserts that elimination of the price adjustment formula in no way precludes the Commission from exercising its existing authority to regulate prices, price ceilings and price floors for services in Categories 1 and 2, where,

and to the extent, necessary. Pacific also says that the price cap formula is a "blunt instrument," and can lead to inefficient pricing and economically inefficient results by treating all services the same, thereby making customers worse off. According to Pacific, permanently eliminating the price formula removes negative, but retains positive, efficiency incentives.

GTE maintains that the price formula is unnecessary because a market oriented system forces productivity gains through to customers. According to GTE, the price cap formula forces ILECs to suffer "double jeopardy," whereby the market requires rate decreases of otherwise over-priced services while prices already set below cost for other services are reduced further by application of the formula. GTE concludes that Commission suspension of the formula in 1995 was proper, and it should now be permanently eliminated. CMA argues that the price formula should be abandoned in favor of pure price regulation.

The United States Department of Defense and All Other Federal Executive Agencies (DOD/FEA) and ORA recommend against permanently eliminating the price adjustment formula. DOD/FEA contend that the price cap formula should be retained but applied only to those services over which Pacific and GTE retain market power. ORA argues that price cap regulation is still needed in the transition to a fully competitive market. Alternatively, if the Commission eliminates sharing, ORA says a price cap formula with a more aggressive productivity factor should be instituted. If the Commission eliminates both sharing and the price formula, ORA says the Commission should institute a rate rebalancing proceeding to protect ratepayers from unwarranted rate increases without corresponding rate reductions.

Joint Commenters and TURN recommend reactivating the price cap formula. Joint Commenters oppose any changes to NRF until Pacific and GTE

face far more competition than now, and, before relaxing NRF, recommend first applying the same tests to Pacific and GTE that the Commission applied to AT&T before relaxing regulation of AT&T. Joint Commenters contend that the price cap formula provides ratepayers the benefits of efficiency savings, and is the only way the Commission can ensure rates are just and reasonable. Moreover, Joint Commenters say the productivity factor provides the only incentive for Pacific and GTE to invest prudently.

TURN says the price formula is needed as long as Pacific and GTE retain monopoly power. TURN argues that as long as markets are not sufficiently competitive to discipline prices, a productivity offset is needed to ensure reasonable rates and prevent anti-competitive cross-subsidies. Sprint argues that elimination of the price cap formula should not mean elimination of existing price caps, but existing price caps must remain in place.

4.2. Discussion

4.2.1. Continued Suspension of Inflation Minus Productivity Plus Stretch

Good arguments are made by all parties. We are not sufficiently persuaded by any party, however, to either permanently eliminate or reinstate the inflation minus productivity plus stretch portion of the price adjustment formula. Rather, we continue its suspension and continue observing price levels and rates of return. We expect to permanently eliminate I-X during the next NRF review if no problems emerge which reinstatement of I-X would have cured, or could cure, or unless clear and convincing reasons support its continued suspension or reinstatement. We expect permanent elimination as part of the evolution of our regulation in response to the continued evolution of the market. Moreover, permanent elimination will remove regulatory risk, and provide desirable certainty.

We suspended I-X in 1995 saying:

> "Effective competition' is not a prerequisite for modifying the price cap formula. The threshold question is whether competition has increased to such a point as to cause us to reconsider the continued application of the price cap formula to Category I and Category II services. At this time, there is more than enough evidence to support modification of price cap regulation and suspension of the Price Cap formula. The fact that the LECs face more competition in the toll markets today and that once the remaining local markets are opened, the degree of competition will further increase, are strong indicators of the movement towards a more competitive market. Modification of price cap regulation through suspension of the price cap formula is necessary." (D.95-12-052, mimeo., pages 48-9.)

Effective competition is still not a prerequisite for modifying the price cap formula, or for continuing the suspension of I-X. No party convinces us that market conditions, or changes in market conditions, justify a change in policy. Moreover, no 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.

Our assessment of the market in 1995 convinced us to suspend I-X. Additional events since 1995 demonstrate that significant market changes continue to occur. For example:

1. The Commission authorized facilities-based competition in the local exchange market in late 1995 (D.95-12-056, 63 CPUC2d 700).

2. The Commission authorized resale competition in the local exchange market in early 1996 (D.96-02-072; D.96-03-020).
3. Congress passed the Telecommunications Act of 1996, designed to open all telecommunications markets to competition, including local exchange services.
4. The Commission has authorized, as of May 1998, certificates of public convenience and necessity (CPCN) for over 150 competitive local exchange carriers (CLCs).
5. The Commission has approved, as of August 1998, over 100 interconnection agreements between CLCs, Pacific and GTE.

ORA and TURN assert that local competition has not developed as fast as anticipated in D.95-12-052, and this fact should cause us to reconsider the suspension of I-X. They point out, for example, that full panel hearings were held in 1997 and 1998 to explore the degree to which local competition has developed. (R.95-04-043.) Some parties there argued that resale competition in the local exchange market is unsuccessful, and some CLCs have withdrawn from the resale market. ORA and TURN claim that substantial entry barriers remain for facilities-based carriers. ORA says Section 271 of the Telecommunications Act of 1996 requires the regional Bell Operating Companies (RBOCs), including Pacific, to meet certain conditions before they may enter the interLATA market (e.g., they must satisfy a 14-point checklist, demonstrating that they have opened their local markets to competition). No RBOC has yet met these requirements, according to ORA.

These concerns overlook the fact that the issue here is how we will adjust Category 1 rates and Category 2 price ceilings. That is, these rates are for services which are already in markets that are less than fully competitive. The

issue is how we will regulate rates for monopoly and partially competitive services offered by Pacific and GTE.

Nevertheless, we suspend, but do not eliminate, I-X because we agree with ORA that price cap regulation is still needed in the transition to a fully competitive market. At the same time, we agree with Pacific that reinstating I-X would be a step backwards, and could cause Pacific financial harm (discussed below). For these reasons, and the reasons explained more below, we conclude that the suspension of I-X should continue.

4.2.2. Arguments for Elimination or Reinstatement

In reaching today's decision, we also give careful consideration to the specific arguments of those advocating elimination or retention of I-X. For example, Pacific argues that I-X is a "blunt instrument" uniformly applied to all prices, causing below cost prices to be priced further below cost. Because of this, Pacific concludes that I-X should be permanently eliminated because it leads to inefficient pricing and resource allocation.

To the contrary, as ORA points out, the NRF mechanism has never prevented Pacific and GTE from applying for unique adjustments in their prices, based on costs and different competitive pressures. More importantly, as TURN and others point out, there is nothing that prevents future application of I-X from being nonuniform, either based on future arguments to be made at that time, or as the result of a subsequent OIR/OII.[10]

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[10] TURN observed that the Commission would soon conclude a proceeding which addresses the issue of how to distribute rate reductions (A.97-03-004, the Universal Service rate reduction case). TURN points out that an improved method for distributing reductions may result (e.g., targeting reductions to services with prices that have the highest margins above cost). The lessons learned there could be similarly applicable here, if at some point we unsuspend I-X. We note that the rate reduction proceeding is now concluded. (D.98-07-033.) We adopted $305.2 million in price

Footnote continued on next page

We also reject the double jeopardy argument of GTE, used to support its advocacy of permanently eliminating I-X. To the extent there is such a problem, it is a problem of the distribution of rate decreases. There is nothing about NRF that requires a double jeopardy result, and, even if so construed, there is nothing that necessitates continuation of that result.

Joint Commenters and others contend that suspension of I-X has cost ratepayers more than $500 million over the years 1996 through 1998, and will cost ratepayers more than $700 million from 1999 through 2001. ORA estimates that Pacific's ratepayers have lost nearly $1.4 billion from 1996-98 (with X set equal to I, compared to X set equal to 6.5%, the latter rate having been adopted in a recent Federal Communications Commission (FCC) decision, according to ORA). ORA believes Pacific's ratepayers may loose similar amounts in the future. ORA says GTE's ratepayers have also lost about $240 million over the years 1996-98, and may loose another $240 million in the next three years. Joint Commenters and ORA contend that I-X must be retained, if not reinstated.

Accepting ORA's numbers, Pacific says that an X of 6.5% with a cumulative rate reduction of approximately $1.4 billion over three years would reduce Pacific's rate of return by about 400 basis points. Pacific asserts that the cumulative rate reduction over 5 years would be approximately $3.5 billion, reducing rate of return over 700 basis points. Pacific contends that in the fourth year the rate reduction would be about half of Pacific's 1997 operating income.

TURN points out that a high X provides ratepayers more money to spend and invest. As CMA observes, however, a high X results in less

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ceiling reductions for Pacific. The reductions were targeted to services that contained implicit subsidies, with rate reductions resulting in sustainable prices and benefiting the broadest base of customers.

money for Pacific to invest in California's telecommunications infrastructure. Moreover, Pacific's comments show that at a sufficiently high X, the NRF financial stability goal is jeopardized.

Thus, the estimates of savings to ratepayers, or harm to Pacific, are interesting, and show the possible importance of this decision, but are not probative. The greater X is relative to I, the more savings to ratepayers, and the less revenue (and potentially less operating income) to Pacific and GTE. The lower X is relative to I, the less savings to ratepayers, and the more revenue (and potentially more operating income) to Pacific and GTE. The issue here, however, is to establish and apply a regulatory structure that meets the Commission's goals for the NRF, balances competing interests, and produces rates that are just and reasonable. Suspension of I-X was found to have met those criteria in D.95-12-052, and suspension continues to meet those criteria.

We also soundly reject ORA's contention that eliminating I-X effectively recategorizes all Category 1 and 2 services into Category 3. This was not true when I-X was temporarily eliminated (i.e., suspended) by D.95-12-052, and nothing has changed to make it true now. Moreover, neither suspension nor elimination of I-X removes rate caps, floors or ceilings on Category 1 and 2 services, nor in any way eliminates the Commission's authority over caps, floors or ceilings in Categories 1 and 2.

TURN argues that elimination of I-X will allow Pacific and GTE to accumulate a monetary "war chest," which they will use to gain an unfair competitive advantage through cross-subsidization. According to TURN, Pacific and GTE will use their market power to set prices higher than would otherwise occur in a competitive market, or fail to lower prices that should be lowered. TURN contends this will produce additional revenue that will be used to support

rate reductions for competitive services, or fund low rate special contracts routinely provided large business customers, to fend off competition.

To the contrary, this was not true in 1995 when we suspended I-X, and nothing has changed to make it true today. D.95-12-052 found that suspending I-X resulted in just and reasonable rates. The same is true today.

Further, we have no reason to believe war chests are accumulating. For example, rates of return in 1996 and 1997 do not show an accumulating war chest.[11] We monitor for cross-subsidies and have found none. We will investigate when reasonable allegations are made, and, if substantiated, will eliminate any improper cross-subsidies.

Moreover, the Commission sets Category 1 rates. Pacific and GTE can neither independently raise a Category 1 rate, nor refuse to lower a Category 1 rate when ordered to do so by the Commission. Pacific and GTE cannot thereby use market power to manipulate Category 1 rates and accumulate a war chest.

The Commission sets Category 2 ceiling and floor rates. Category 2 services are discretionary or partially competitive. We

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[11] Pacific's rates of return in 1996 and 1997 were 10.55% and 6.49% respectively, at a time the NRF sharing threshold (benchmark rate of return) was 11.5%. (Exhibit 1, Attachment 2.) GTE's rates of return in 1996 and1997 were 11.17% and 12.10%, respectively, when GTE's ceiling was 15.5%. (Exhibit 8, attached Exhibit A.) In their comments on the draft decision, MCI, Sprint and AT&T allege that these rates of return are untested, and have not be subject to scrutiny or cross-examination. To the contrary, 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 were made. The rate of return data was received as evidence by ruling on August 31, 1998.

design Category 2 floor rates to prevent cross-subsidies. Pacific and GTE cannot charge prices below the floor rates, using other revenue to cross-subsidize below cost rates to gain a competitive advantage, nor can they charge above the ceiling rates. Similarly, Pacific and GTE cannot use Category 2 prices that are not reduced as much as TURN believes they should be reduced to subsidize other Category 2 rates by setting those rates below the floor because the Commission sets the floor to prevent cross-subsidies. Pacific and GTE have discretion to set Category 2 rates between the rate ceilings and floors, but, as noted above, we see no evidence in rates of return of accumulating war chests, and we are not convinced the Category 2 pricing flexibility provides any real opportunity to accrue war chests.

Category 3 rates are given the maximum pricing flexibility allowed by law because markets for Category 3 services are competitive. Competitive markets prevent firms from charging above cost. Should Pacific and GTE price below cost for Category 3 services they will lose money since by definition the markets are too competitive to result in Pacific and GTE forcing their competitors out of business. Plus, anti-competitive pricing, such as predatory pricing, is unlawful under state and federal anti-trust laws.

We also reject TURN's argument that I-X must be reactivated to fulfill the recommendation in the Infrastructure Report that rates for basic telecommunications services be indexed to bring down the cost of telephone service for the average Californian.[12] Setting X equal to I is a form of indexing. It

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[12] The Commission's Report to the Governor entitled "Enhancing California's Competitive Strength: A Strategy For Telecommunications Infrastructure" (November 1993), page 51, as cited by TURN in Reply Comments, page 8. Hereinafter, "Infrastructure Report."

results in lowering the cost of telephone service for the average Californian by keeping rates from increasing at the rate of inflation. Rates decline in real terms when inflation is any number greater than zero. As Pacific correctly points out, suspension of I-X provides real savings to all ratepayers, and brings down the cost of telephone service for all Californians.

Joint Commenters contend that the price formula must be reinstated to provide ratepayers the benefits of efficiency savings, and that a reinstated price formula is the only way to ensure just and reasonable rates. To the contrary, setting X equal to I provides efficiency savings to ratepayers (i.e., the productivity plus stretch factor captures efficiency savings equal to the rate of inflation). It thereby provides reductions in real prices. As found in D.95-12-052, suspension of I-X results in just and reasonable rates and nothing has changed that result.

Joint Commenters argue that the productivity factor provides the only incentive for Pacific and GTE to invest prudently and spend wisely. According to Joint Commenters, competitive markets require firms to pass the benefits of efficiencies to customers through better services at lower rates. Joint Commenters say Pacific and GTE do not face this pressure, and the Commission wisely adopted an external productivity factor to establish such incentives artificially.

To the contrary, investment and operating decisions are based on financial analysis of future returns using such tools as net present value, internal rate of return, and benefit/cost ratios. An X that is too high (compared to the realized X in the market) may harm investment and wise spending as prices are reduced below those which would otherwise prevail in a competitive market. For example, the higher one sets X, the lower the rates. At a high X a utility may find its prices dropping faster than its costs, resulting in decreasing

profits, and rejection of investment and operating decisions that would otherwise be cost-effective. Similarly, competitors may be harmed to the extent prices are forced below costs, reducing their ability to compete. Thus, while a high X may give Pacific and GTE an incentive to try to meet that X, at the same time it may have the opposite effect on financial analyses used to make productivity enhancing decisions.

On the other hand, other factors provide an incentive for Pacific and GTE to invest prudently and spend wisely, such as the potential to earn higher returns. Thus, we are not persuaded by Joint Commenters that X provides the only incentive for Pacific and GTE to invest and spend wisely, while a high X may actually distort financial analyses and prevent implementation of operating and investment decisions that would be made at a lower X.

We are also not persuaded by DOD/FEA to reactivate I-X, and apply I-X, as DOD/FEA recommends, only to those services over which Pacific and GTE have market power. By definition, Pacific and GTE retain market power in Category 1, and the Category 2 market is only partially competitive. That has not changed since 1995, when we decided to suspend I-X. The same reasons that justified the suspension in 1995 continue to justify suspension now.

4.2.3. Application of AT&T Model for Relaxation of Regulation

Joint Commenters contend that we should here use the same tests for modification of NRF that we used in deciding when and how to change the regulation of AT&T between 1984 and 1998 (wherein we eventually recategorized AT&T from a dominant to a nondominant carrier, and exempted AT&T from rate of return regulation). Joint Commenters say we there examined

eight criteria, using a method called the observation approach.[13] We developed a full evidentiary record, according to Joint Commenters, and must do no less here. Joint Commenters assert that Pacific and GTE should be required to produce evidence showing fading or no market power using the eight criteria before the Commission considers, or grants, additional regulatory flexibility. We are not persuaded.

We are not considering here whether to convert Pacific and GTE to nondominant status. We are not considering elimination of rate of return regulation. Indeed, under NRF, we already regulate by incentive-based, not rate of return, regulation.

D.87-07-017 (24 CPUC2d 541) invited AT&T to file an application to change the way it was regulated, directing the use of one of two approaches: the prediction approach, or the observation approach. AT&T selected the observation approach. As we described that approach:

> "Under the Observation Approach, the effects of regulatory flexibility would be measured rather than predicted. Limited flexibility would be granted initially and the results closely monitored to assess actual marketplace responses and any benefits or costs to ratepayers." (24 CPUC 541, 545-6.)

The recommendation of Joint Commenters essentially seeks to here apply the observation approach as a hurdle which must be overcome before NRF may be modified. That is, Joint Commenters would require that the tests

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[13] The eight criteria are: (1) determination of the relevant market, (2) the carrier's market share in that market, (3) the earnings of the carrier and its competitors, (4) facilities ownership by competitors of the carrier, (5) ease of market entry and exit, (6) the size and growth potential of the carrier's competitors, (7) the existence of technical barriers to competition, and (8) service options and customer satisfaction with the carrier's services. (D.87-07-017, 24 CPUC 541, 554-65.)

used in the observation method be satisfied before, rather than after, flexibility is granted. That, however, is not the mechanism used with AT&T. Rather, flexibility was "granted initially," and the results monitored.

In this limited way, our approach here and the observation approach are similar. That is, as explained with each issue as appropriate, limited regulatory changes are made, with results to be observed. Should observations reveal it may be necessary, we will consider reversing the decisions we make herein as warranted. Alternatively, observations may justify further relaxation or eventual elimination of NRF.

In other ways, the observation approach, and the tests used therein, are fundamentally different than our approach with NRF. For example, D.88-12-091 (30 CPUC2d 384) granted AT&T authority to increase or decrease its rates up to 15% above or below reference rates (based on the rates in its last general rate case), and instituted a monitoring program. While these elements for AT&T may bear some general similarities to pricing flexibility and monitoring under NRF, AT&T was neither then, nor later, subjected to other critical NRF elements, such as sharing, earnings caps, earnings floors, annual price cap indexing, productivity factors, stretch factors, annual reviews of depreciation rates, and Z factor adjustments, despite our concerns about AT&T's market power. Indeed, in adopting upward as well as downward pricing flexibility, we granted AT&T greater flexibility than the more limited downward flexibility available even now to Pacific and GTE for Category 2 services.[14]

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[14] AT&T points out several ways in which, it argues, AT&T was subject to a more stringent regulatory regime than that of NRF. For example, AT&T says it was limited to four rate changes per year within rate bands, while Pacific and GTE can change Category 2 rates an unlimited number of times. (AT&T Brief, page 4.) AT&T is correct that there are differences between how we regulated under the observation approach

Footnote continued on next page

D.93-02-010 (48 CPUC2d 31) provided AT&T additional pricing flexibility after considering the eight criteria in D.87-07-017. We did not, however, address the kinds of regulatory questions at issue here. In fact, the reforms being considered for Pacific and GTE here would have no effect on our continuing to set the prices for Category 1 services, and the caps and floors for Category 2 services.

D.97-08-060 granted AT&T's request for nondominant status after further assessment of the eight market power criteria. Again, however, the non-dominant status and authority granted AT&T has no comparison to the regulatory issues under consideration here. In short, the regulatory structures were, and are, different; the NRF components under consideration here did not apply to AT&T; and we decline to use exactly the same analysis to consider modifications to NRF that we used when considering modifications to our regulation of AT&T.

Furthermore, as GTE points out, we have several times considered and rejected applying elements of the observation approach to NRF, and elements of NRF to the observation approach.[15] We continue to decline the application of elements of the observation approach to NRF. Moreover, the

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and how we regulated, and now regulate, under NRF. On balance, however, AT&T enjoyed generally greater flexibility than do Pacific and GTE.

[15] For example, we could have, but did not, adopt the observation approach when we first adopted NRF in D.89-10-031. Nonetheless, even after we adopted the observation approach for AT&T, the Division of Ratepayer Advocates (DRA) recommended a version of NRF (including an overall price cap, a price cap adjustment mechanism with a productivity factor, a sharing mechanism and an overall earnings cap) for AT&T. (See A.90-07-015.) We agreed with AT&T that DRA's proposal was a retreat from the observation approach and declined its adoption. (D.93-02-010; 48 CPUC2d 31, 60.) In D.96-03-020, we declined to adopt a recommendation that any request for NRF pricing flexibility be judged using the market power criteria of the observation approach. (Mimeo., pp. 51-9.)

observation tests are designed to test conversion to nondominant status. The issues here are how we continue to regulate services that are in monopoly or only partially competitive markets. In addition, strict application of the observation approach would result in immediate elimination of sharing and the price index (which were never applied to AT&T). Thus, the two approaches are sufficiently different that the same measures used to execute the observation approach do not apply here.

Joint Commenters argue that failing to use the eight criteria in the observation approach not only violates Commission precedent, but short-changes California consumers, who will be the victims of the remaining monopoly power of Pacific and GTE. TURN argues that the AT&T model must be applied here since the fundamental factor to be considered is the extent of Pacific's and GTE's market power. TURN says the AT&T cases stand for the proposition that regulation should only be relaxed as market power is lost.

To the contrary, to the extent there is a precedent, it is to allow increments of greater flexibility with monitoring. We do that here. Moreover, the decisions we make here (including not only to continue the suspension of I-X, but suspend sharing, as discussed below) do not allow Pacific and GTE to exercise monopoly power. Rather, we continue to regulate Category 1 and 2 rates, ceilings and floors. We continue to monitor for cross-subsidies. We continue to observe rates of return. When we next review NRF we may reverse the policies adopted herein if observations warrant. We are persuaded for all the reasons stated in this decision, however, that the changes we order today will not provide an opportunity for monopoly abuse.

TURN argues that we did not grant AT&T pricing flexibility in 1989 until AT&T had lost 30% of the long distance market. To be consistent with our treatment of AT&T, TURN says we should here allow no relaxation of NRF.

To the contrary, NRF already provides pricing flexibility for some services independent of the market share of Pacific and GTE, and no proposal is before us to reverse that. Moreover, our decisions here are consistent with our view of the state of the intraLATA telecommunications market in California in 1998 compared to that of the interLATA market in 1989, and we continue monitoring to ensure that dominance of the markets, if any, is not abused. Furthermore, we do not here grant either Pacific or GTE any greater pricing flexibility.

TURN contends that we should be even more cautious in relaxing NRF than we were in relaxing regulation of AT&T because of the higher barriers to entry, and heightened universal service implications, in the intraLATA market. We do not necessarily disagree, and consider these factors as we make our decision today. For example, barriers to entry are no higher, and universal service no less a factor, now than in 1995, when we first suspended I-X. Parties make no reasonable allegations of changes in these factors which convince us to do anything other than continue the suspension of I-X.

In large part, the strong reactions of Joint Commenters and others to the recommendations of Pacific and GTE (i.e., to request removal of all NRF pricing restrictions and eliminate sharing) seem to be because they first interpreted the recommendations to effectively be deregulation. Joint Commenters and others argue that a thorough and complete evidentiary record, including data on the eight tests used in the observation method, is therefore necessary.

As clarified through reply comments and at oral argument, however, Pacific and GTE do not recommend deregulation. Moreover, we authorize no such modifications of NRF. Therefore, the record development

recommended by Joint Commenters and others is unnecessary, and would be an unwise use of scarce resources of parties and the Commission.

4.2.4. Conclusion

Therefore, on balance, for all the reasons stated above, our decision to suspend the I-X portion of the price adjustment formula was reasonable in 1995, and remains so today. We expect I-X to be permanently eliminated during the next NRF review absent compelling reasons for its continued suspension or reinstatement.

5. Sharing and Earnings Reports

The second issue is:

> Should the Commission eliminate as to Pacific and GTE (a) sharing of earnings above specified levels (i.e., Pacific's benchmark, GTE's ceiling), (b) earnings floors, (c) earnings caps, (d) benchmark and market-based rates of return, (e) "trigger" mechanisms, and (f) periodic earnings reviews?

5.1. Positions of Parties

Pacific, GTE and CMA recommend that all remaining aspects of rate of return regulation be eliminated. Specifically, they propose elimination of sharing, earnings caps and floors, the benchmark and market-based rates of return, the "trigger" mechanism, and periodic earnings review. According to Pacific, rather than regulate earnings, the Commission should protect customers by regulating prices where, and only to the extent, necessary, allowing market forces to discipline the market wherever possible. Pacific, GTE and CMA contend that earnings regulation distorts incentives for efficiency, investment and innovation because the financial rewards for good performance are diluted. CMA asserts this may jeopardize California's potential to lead the country in information technology and telecommunications services. According to Pacific, this also leaves customers at risk because customers must "share" when earnings

are below the floor. Pacific says elimination of earnings/rate of return regulation puts the full responsibility for Pacific's performance on Pacific's shareholders, where it belongs. Sharing puts an asymmetric burden on Pacific and GTE not placed on their competitors, according to Pacific and GTE, and eliminating the vestiges of rate of return regulation will promote efficiency by discontinuing the debates about how much profit they are earning and should earn, as well as reduce the need for monitoring of investments, rate base and profitability.

GTE specifically comments that it is no longer required to share earnings above a benchmark rate of return, pursuant to D.93-09-038 (1993 NRF settlement). Rather, GTE says that its earnings are capped at a ceiling, beyond which earnings are not shared with, but must be given to, ratepayers. Pursuant to the 1993 NRF settlement, GTE says it is no longer subject to benchmark and market-based rates of return, trigger mechanisms, and earnings reviews.

Joint Commenters, ORA, TURN and DOD/FEA recommend against eliminating these features of NRF until markets are competitive. Joint Commenters contend that the Commission has applied a series of eight criteria that a dominant carrier must meet before emerging from rate of return regulation. Joint Commenters believe Pacific and GTE do not qualify under these criteria for any further relaxation of Commission regulation, including any relaxation of earnings reviews, caps, trigger mechanisms and sharing. According to Joint Commenters, the Commission must remain vigilant, given the persistence of Pacific's and GTE's monopoly power, to ensure that regulatory flexibility already accorded Pacific and GTE does not result in monopoly profits, predatory prices for relatively more competitive services, and monopoly overcharges for services facing little or no competition. Joint Commenters contend it is premature to allow regulatory flexibility for Pacific and GTEC that

AT&T achieved only after facing 13 years of vigorous competition and losing over half its market share.

ORA says the Commission should continue to rely on sharing and reporting until irreversible competition exists in local exchange service, in order to ensure ratepayers continue to pay just and reasonable rates. NRF was designed to achieve several regulatory goals, which remain important today. Prematurely abandoning sharing will be detrimental to those goals, according to ORA. ORA proposes, however, that the existing NRF be modified in two ways: (1) sharing should apply to basic exchange services in Category 2, and (2) the sharing band should be modified so ratepayers share 50% of earnings between the market-based rate of return and a new ceiling, with shareholders retaining 100% over the new ceiling. If the Commission eliminates sharing, ORA recommends the replacement be pure price regulation, with an aggressive productivity factor to ensure achieving the Commission's regulatory goals.

TURN says the rate of return scheme in the NRF must be retained absent a finding that Pacific and GTE face effective competition. Rate of return monitoring with sharing is necessary to prevent price gouging in the event Pacific and GTE fail to pass through efficiency gains to ratepayers. Sharing will become more critical if the Commission eliminates the productivity factor, as there is no other means for the cost savings from efficiency gains to be passed through to ratepayers when Pacific and GTE retain market power, according to TURN. TURN says franchise impact recovery must be ruled out in the event the Commission eliminates all limits on rate of return. TURN asserts that sharing does not reduce the incentives for efficiency, investment and innovation, and there is no evidence that the pace of innovation is lagging or that Pacific and GTE are having trouble attracting investment capital. DOD/FEA asserts all aspects of

the original NRF should be applied to those services over which Pacific and GTE retain market power.

5.2. *Discussion*

5.2.1. Suspend Sharing

We are largely, but not completely, persuaded to eliminate sharing. As a result, we suspend sharing, including the component and related elements of earnings floors; earnings caps; market-based, benchmark, and ceiling rates of return; and trigger mechanism. We expect to permanently eliminate sharing, with all component and related elements, during the next NRF review if no problems emerge which sharing would have cured, or could cure, or unless clear and convincing reasons support its continued suspension or reinstatement. We expect permanent elimination as part of the evolution of our regulation in response to continued changes in the market. Moreover, permanent elimination will remove regulatory risk, and provide desirable certainty to the market.

We suspend sharing because of the serious risk that sharing distorts operating and investment decisions. We recognized this risk in D.89-10-031:

> "We find attractive many aspects of a pure price cap model for establishing revenue levels...The utility and its shareholders would be completely at risk for their operational decisions...Further, the pure price cap model avoids a host of regulatory complexities as well as the reduction in efficiency incentives which accompany a sharing mechanism...While Pacific, GTEC, and DRA attempt to minimize any negative impacts of sharing, we are persuaded by other parties' arguments that a sharing mechanism reduces...the strong efficiency incentives in a pure price cap model..." (33 CPUC2d 43, 133-34.)

Nonetheless, we also said that a price adjustment formula with sharing "is more likely to be sustainable," and that "indexing with a sharing mechanism is preferable, at least in the short term, to a pure price cap model." (33 CPUC2d 43, 134.) We concluded that "[i]n light of accompanying reductions in efficiency incentives...we wish to reevaluate the need for a sharing mechanism as part of the 1992 review." (Id.)

In the 1992 review, we improved sharing so that NRF companies would be motivated to enhance their performance and enter sharing. We said, however, that:

> "Ultimately, we recognize that the presence of any sharing mechanism may distort company behavior and create confusion over the goals of the incentive framework...It soon may be appropriate to completely remove the conflicted message." (55 CPUC2d 1, 32-33.)

Pacific, GTE and CMA convince us that we must now, at a minimum, suspend sharing, with the objective of elimination during the next NRF review (if conditions continue to warrant its elimination). Dramatic changes are underway as a result of passage of the Telecommunications Act of 1996, our opening of local exchange markets to facilities-based and resale competition, our authorizing CPCNs for over 150 CLCs, our authorizing over 100 interconnection agreements, and, as CMA points out, rapid changes in technology.[16] The California telecommunications markets are now much different than they were at the time of our decisions in 1989 and 1994. These markets are among the most attractive in the world. With gross state product exceeding $1 trillion, California

[16] And we agree with Pacific when it says: "This technological dynamic is increasingly powerful because innovation is occurring at an accelerating pace, with no sign of abating." (Exhibit 3, page 7.)

is the seventh largest economy in the world, accounting for over 33% of the United States intraLATA traffic and nearly 20% of interLATA traffic.

We are convinced by parties advocating the elimination of sharing that sharing can distort operating and investment decisions. Sharing changes the forecast of present and future cash flows, and introduces greater uncertainty into the present and future stream of returns, thereby changing the analysis relative to an analysis without sharing.

While distortions to operating decisions are a vital concern, distortions to investment decisions are perhaps the more costly efficiency consequence of continued sharing, due to the long term effect of delaying or rejecting otherwise cost-effective investments. This is all the more important because Pacific's and GTE's infrastructure provides the foundation for not only their services, but those of many of their competitors and carrier customers, who rely upon the unbundled network elements, the resold telecommunications services and the modern access services of Pacific and GTE to provide their services. It is essential that Pacific and GTE be provided the correct economic incentives in order to have an advanced, competitive telecommunications marketplace and network.

Moreover, sharing is asymmetric. That is, potential competitors of Pacific and GTE make operating and investment decisions without profit constraints. The elimination of sharing gives Pacific and GTE the same incentives to reduce costs, introduce new services, and invest in new infrastructure, services and technologies already experienced by other California telecommunications firms. The result will be increased competitive pressures on Pacific and GTE, with consumers benefiting as competition is enhanced. It is imperative, with billions of dollars at stake in the emerging Information Age, that all firms, including Pacific and GTE, face the same financial analysis as they make

operating and investment decisions. It is imperative that our policies not skew the playing field for or against any potential player, including Pacific and GTE. To do otherwise compromises the efficiency of the competitive process itself.

CMA convincingly points out that we have "reached a critical juncture: the software exists to deliver tremendous services over the internet, but there is insufficient bandwidth to move this data rapidly through the network." (Exhibit 16, page 7.) According to CMA, one solution is digital subscriber line (DSL) technology, but, CMA says, that technology requires substantial investment. To provide the right economic incentives, and allow Pacific and GTE to participate equally, CMA strongly supports the elimination of sharing. We agree with CMA that sharing handicaps Pacific and GTE as they consider DSL and other options.

Further, as CMA says, the "disintegration" of the industry has created the opportunity for small, niche businesses to target specific needs, and for large players to package these new and traditional services into full menu offerings. Those handicapped by sharing face distorted incentives and risk falling hopelessly behind. We agree with CMA that "all customers suffer when a large competitor fails to aggressively pursue opportunities to provide service." (Exhibit 16, page 11.)

We also agree with CMA that customers have a strong desire for a single provider of bundled services. The Commission frustrates the satisfaction of that consumer desire when we apply policies that treat one provider differently from another, if we cause that provider to not offer a service as part of a package due to sharing-induced distortions.

Some parties allege that sharing may create an incentive to misallocate expenses and revenues in order to avoid sharing. While we have no

evidence this has occurred, suspension of sharing removes this incentive. Moreover, we will assess misallocation as part of an audit (discussed below).

It is also imperative that the Commission remove the risk of operating and investment decisions as much as possible from ratepayers, and place that risk squarely on shareholders where it belongs. Sharing in part burdens ratepayers with those risks. Suspension of sharing moves the risk back to shareholders. For example, GTE shares with (i.e., returns to) ratepayers 100% of its earnings above the rate of return ceiling. As such, the risk of poor management or investment is borne by ratepayers if the lack of return (because of poor management or an unsuccessful venture) keeps the return below sharing but would have put the return in the sharing range if the management had been good, or the venture successful. Ratepayers bear similar risk at the 50% and 30% sharing ranges for Pacific. The same is true at the rate of return floor. If poor operating or investment decisions push the rate of return below the floor, the utility may seek an increase in rates. In that way, ratepayers under our sharing mechanism bear the risk of poor decisions.

The sharing of risk and reward with ratepayers was reasonable when sharing was needed as a short term insurance mechanism against the risk of a poorly designed NRF, and to prevent facing "the possibility that there would later be a call for abandoning the framework in its entirety." (33 CPUC2d 43, 141.) Sharing, including application of the earnings floor, however, has not occurred in 8 years (1990-1997) of NRF for Pacific, and has not occurred since 1993 for GTE. Moreover, sharing has not been a significant source of controversy (i.e., no protested sharable earnings advice letter has been converted to an application for formal adjudication). That is, sharing has provided limited direct benefits in the form of lower rates, but comes at the cost of distorting the analyses used to make operating and investment decisions.

Experience has reduced, if not eliminated, the need for this insurance. In addition, as GTE points out, there has been no call to abandon NRF.

Given significant changes in the market, and our eight years of experience since sharing was instituted in 1989, it is now time to modify NRF so that shareholders bear the entire risk of operating and investment decisions. That goal is accomplished by the suspension of sharing.

To promote reasonable administration of this change, we suspend sharing effective January 1, 1999. That is, any sharing which might occur based on 1998 results of operations (reported by advice letters due April 1, 1999) will be for the full year of 1998, and will not be prorated for a partial year based on the effective date of this decision.

For all these reasons, we suspend, but do not eliminate, sharing effective January 1, 1999. We do not eliminate sharing because competition in the local exchange markets is still in its infancy. These markets are characterized by uncertainty and risk. We expect CLCs to provide increasing competition to Pacific and GTE over the next several years, but we need not eliminate sharing on that assumption. Rather, we suspend, but do not eliminate, sharing, and we will reinstate sharing if conditions warrant.

Another reason we suspend but do not eliminate sharing is that, as CMA points out, even without sharing, and with almost complete price freedom, potential competitors of Pacific and GTE to the small business and residential market "are reluctant to aggressively pursue this market." (Exhibit 16, page 13.) That is, the competition we expect in all markets, including small business and residential, is not certain. Pacific and GTE must be on an equal competitive footing as operating and investment decisions are made going forward, but we will evaluate during the next NRF review whether or not to permanently eliminate sharing.

ORA and others also point out that just because sharing has not occurred from 1990 through 1997 for Pacific does not mean that, if sharing is retained, it will not occur in the future. They are correct. Our judgment, however, is that sharing creates problems that must now be corrected, and that sharing should only be reinstated if rates of return become truly unreasonable. Thus, we suspend, but do not yet permanently eliminate, sharing.

We are also convinced by TURN that market power problems, if any, will not simply go away if we eliminate sharing and/or rate of return monitoring. Rather, they might only go undetected.

California telecommunications markets are poised for competition and dramatic change. That competition and change, however, has yet to fully materialize. While we are convinced, for the reasons stated above, that sharing poses serious risks of distorting operating and investment decisions, we are more cautious than to simply eliminate sharing. Rather, we suspend sharing, and continue observing rates of return.

Thus, we continue to require the annual earnings review filing on April 1 every year, as well as the other monitoring reports submitted by Pacific and GTE. Should rates of return become truly unreasonable, we will consider reinstating all aspects of sharing. For the purpose of reference only, Pacific and GTE should report the last adopted floor, market-based, benchmark, and ceiling rates of return with each report on April 1, as one measure to test whether rates of return are becoming unreasonable. At the same time, we note that the ability of Pacific and GTE to utilize market power remains constrained by the Category 1 and 2 limits on pricing.

Therefore, on balance, our judgment is that potential economic distortions at this stage of the changing California telecommunications markets are too serious to retain sharing as a form of insurance. The risk of bad operating

or investment decisions (including simple delay in making operating improvements and successful investments), or the risk of possibly excluding Pacific and GTE as participants on equal footing with competitors, is greater than the need to retain sharing as insurance. Moreover, given the rapid changes in technology and increased risk, it is no longer reasonable to force ratepayers to share in the risk of these decisions. Rather, the risk must now be fully placed on the shoulders of shareholders. Nonetheless, we only suspend, and do not eliminate, sharing because some small risks remain that market power problems will materialize, that competition will not evolve as expected, or that rates or return will become truly unreasonable. We therefore suspend sharing effective January 1, 1999, along with its component and related elements (earnings floors; earnings caps; market-based, benchmark, and ceiling rates of return; trigger mechanism). We do not suspend periodic earnings reviews, however, and we will continue monitoring rates of return. If no problems materialize in the next few years which sharing would have cured, we expect to permanently eliminate sharing and its component elements during the next NRF review.

5.2.2. Arguments for Retention of Sharing

In deciding to suspend sharing, we consider but reject several arguments of those advocating its retention. For example, ORA asserts that Pacific presents no evidence to substantiate the claim that its investment behavior has been distorted under the current NRF regime, or that its behavior will change once sharing is eliminated. Nor, according to ORA, does Pacific provide the Commission with any assurances that Pacific will make those investments crucial to promoting California's future economic development and technological progress if sharing is eliminated.

ORA may be correct. Pacific, however, need not demonstrate any bad behavior, nor pledge to behave "better," to convince us to eliminate

sharing. Rather, as we said in 1989, sharing reduces efficiency incentives otherwise contained in a pure price cap model. We reiterated our concern in 1994 that sharing distorts efficiency. We again stated our concern when we specifically recommended reforming NRF by eliminating sharing to remove the remaining incentives which distort investment decisions. (Infrastructure Report, pages 52-3.) At this stage of the evolution and development of California telecommunications markets, our principal concern is that the right economic incentives be in place, and Pacific and GTE be on equal competitive footing with competitors for the purpose of making operating and investment decisions. With those elements in place, we then rely on the profit motive for all competitors, including Pacific and GTE, to make the economic investments crucial to promoting California's future economic development and technological progress.

ORA says that there are many other factors besides sharing that may affect Pacific's decisions to invest in California. For example, ORA says Pacific is now a subsidiary of SBC Communications, Inc., and Pacific may no longer make investment decisions.

ORA is correct. We view this, however, as even more reason to ensure that the economic framework for making operating and investment decisions is correct. That is, executives competing in a global economy make crucial decisions affecting our future. Today we must make doubly sure that the economic incentives those executives face are without any potential distortions, thereby ensuring that California has at least an equal opportunity to enjoy the benefits of those decisions compared to other states and nations competing for those dollars.

TURN argues that advocates of the elimination of sharing provide no example of any product, service or network upgrade squelched because of the prospect of sharing. Moreover, TURN says there is no evidence of

Pacific or GTE having any trouble attracting sufficient capital, much less that sharing is the cause. Finally, TURN contends that Pacific and GTE have not shown that other states have moved ahead of California in network investment as a result of elimination of sharing in those states.

Whether TURN is or is not correct, no party needs to show any product, service or upgrade delayed or abandoned because of the prospect of sharing to convince us to suspend sharing. Rather, it is clear that sharing changes the forecast of present and future cash flows, and thereby changes the economic analysis and efficiency incentives in making operating and investment decisions. Similarly, we need no evidence of difficulty in attracting capital, nor the effect of sharing in other states, to decide to remove the distortions in economic analysis caused by sharing. Rather, what is at stake is simply too important to every Californian's future to continue with a system that has provided minimal tangible benefits (in the form of reduced rates by sharing) but contains palpable infirmities.

ORA and TURN contend that sharing must be retained to ensure that ratepayers pay just and reasonable rates. According to ORA, where a competitive market does not exist, sharing ensures that ratepayers are compensated via rate reductions when the price adjustment formula results in excess earnings to the utility.

To the contrary, the amount of competition is not a factor in our decision here since the Commission still retains its authority and responsibility to establish Category 1 rates, and Category 2 ceilings and floors, at just and reasonable levels. The mechanics of how we do that must now recognize current circumstances and markets, which are different than when sharing was instituted in 1989. Sharing was reasonable insurance when NRF was young. We must suspend sharing now based on changes in the market, the

importance of providing an undistorted basis for financial analysis, the need to provide correct economic incentives, the need to protect ratepayers from sharing in risky or bad operating and investment decisions, and the need to place the full risk of those decisions on shareholders. Given these considerations, the resulting rates will be no less just and reasonable with suspended sharing than rates with sharing.

D.95-12-052 found that rates resulting from a suspended I-X component of the price adjustment formula were reasonable. The I-X term has been suspended for three years, and there has been no sharing. We see no reason why rates resulting from this decision--with continued suspension of I-X and no sharing--will not be similarly just and reasonable. At the same time, we will continue to observe rates of return. Should it appear that sharing is needed to protect consumers from monopoly pricing, we will consider the reinstatement of sharing. This is consistent with how rates have always been made. That is, just and reasonable rates have always been determined based on all the factors before the Commission at the time. The Commission then continued to monitor results of operations, and, as was often the case in the past, initiated an OII or OIR to consider reducing rates when a utility's rate of return appeared excessive. That same model, which worked successfully for decades, will be used here.[17]

ORA and others assert that NRF is a surrogate for competition, and, in deciding whether and how to modify NRF, the Commission

[17] In comments on the draft decision, ORA contends that just and reasonable rates are not the result here, unlike with rates resulting from D.95-12-052, since sharing could have occurred after D.95-12-052, but will not occur after this decision even if otherwise justified. To the contrary, as explained above, we apply the same approach to ratemaking here that has worked successfully for decades in setting just and reasonable rates.

must first ascertain the amount of competition, in order to determine whether Pacific and GTE can exercise market power and manipulate prices. TURN asserts that sharing serves as a "backstop" constraint against the exercise of market power by Pacific and GTE. In fact, TURN says sharing must be retained absent a finding that Pacific and GTE face effective competition.

To the contrary, Category 1 and 2 services are sold in markets that are not fully competitive, and that has not changed since 1990. All regulation (including both rate of return and NRF regulation) is a surrogate for competition. If these markets were competitive, we would be considering the elimination of regulation, not its modification. What is at issue here is the regulation of services that are not sufficiently subject to the discipline of a fully competitive marketplace.

Sharing is not necessary as a backstop to constrain the exercise of market power. Rather, the Commission retains the authority and responsibility to set Category 1 and 2 prices, ceilings and floors at just and reasonable levels.

Category 1 prices are set by us to prevent monopoly utility abuses by the utility either overcharging or undercharging the customer. Those rates are set after considering the many competing goals that must be satisfied in making proper ratemaking decisions.

Category 2 ceilings are set to prevent monopoly abuses by overcharges. Category 2 floors are set to prevent monopoly abuses by cross-subsidization and predatory pricing. Within these bounds, Pacific and GTE can adjust Category 2 prices to respond to market conditions.

Thus, the issues under consideration here do not depend upon the amount of competition. Said differently, we need not assess the level of competition because we are considering regulation in markets that remain less

than fully competitive, and we do not eliminate price regulation as a result of this decision. Moreover, as noted above, sharing was an insurance mechanism against the possible risk of a poorly designed price adjustment formula to prevent a call for abandoning NRF altogether. The price adjustment formula has worked well for 8 years; sharing has never occurred for Pacific, and has not occurred since 1993 for GTE; and there has been no call to abandon NRF. Pacific and GTE cannot exercise monopoly power since the Commission will continue to have regulatory authority over Category 1 prices, and Category 2 ceilings and floors, and we will monitor for truly unreasonable results. Sharing compromises economic efficiency and should now be suspended.

TURN contends that sharing is even more critical if the Commission eliminates the annual price cap adjustments, arguing that without the automatic productivity offset, sharing becomes the only means of flowing through increased efficiencies to ratepayers in the event competition is insufficient. To the contrary, we do not eliminate the annual price adjustment formula. Rather, we continue to set X equal to I which, for the reasons stated above, is reasonable. Moreover, elimination of the distortion in the economic assessment of operating and investment decisions outweighs the near-term benefits of a few percentage point decrease in prices from a higher X. In the long run, the greater efficiencies we expect as a result of correcting these distortions will provide greater benefits to customers than a difficult to estimate X in a regulated price setting formula.

In response to Pacific's assertion that sharing must be eliminated to allow Pacific an opportunity to capture above normal returns on successful investments in order to counterbalance those that are unsuccessful, TURN says that Pacific has that opportunity now. According to TURN, three years ago Pacific was given authority to keep 70% of all earnings above the

ceiling rate of return. TURN says three years later Pacific has yet to reach the benchmark, let alone the sharing band, and there is no evidence that sharing has had any negative impact on earnings, or that eliminating sharing will significantly boost earnings.

To the contrary, we need no evidence that sharing has had any negative impact on earnings, or that eliminating sharing will boost earnings, to now correct distortions in economic analysis and efficiency incentives caused by sharing. We were concerned with that effect in D.89-10-031, but elected to include sharing rather than face calls for abandoning NRF altogether. That was a reasonable balance of interests then, but is a balance that is no longer necessary.

DOD/FEA argues that sharing is needed to prevent harm to either carriers or ratepayers, and cites in support what it describes as an unprecedented average interstate return of 15.52% in 1997 after the FCC eliminated sharing. DOD/FEA says ratepayers are ill-served by the elimination of sharing.

To the contrary, should returns indicate monopoly rent, such returns may be a powerful incentive for competitors to enter the market. At the same time, we are cautious and suspend, but do not eliminate, sharing so that we may reinstate sharing if truly excessive returns materialize and cause problems that sharing would cure.

Joint Commenters say the utilities' argument is backwards that sharing must be eliminated to provide them an incentive to invest. According to Joint Commenters, the current system (with sharing) provides incentives to spend and invest in California.

First, for example, Joint Commenters say that every dollar spent and invested becomes a dollar Pacific and GTE need not share with ratepayers. That is, because Pacific and GTE seek to avoid sharing, they have an

incentive to spend and invest, according to Joint Commenters. We think this argument is not backwards. Rather, this distortion—to the extent it may occur—is precisely the problem we seek to correct. We no longer believe it a necessary or reasonable balance to require ratepayers to share in this potential or actual risk in order to sustain NRF from challenge.

Second, Joint Commenters assert the Commission should not be in the business of providing investment incentives to any particular party or parties. We again agree. Regulation should be neutral regarding technology and parties. Correcting the distortionary effect sharing creates moves us closer, if not bringing us exactly, to that neutral position.

5.2.3. Audit

TURN argues that the absence of sharing from 1990 through 1997 may be a warning flag that Pacific is hiding profits, or falling behind the rest of the industry in productivity. TURN says the solution is not to abandon sharing but to carefully audit Pacific's earnings. In a similar vein, ORA asserts that the Commission should include compliance with cost allocation principles as part of the current NRF audit, to ensure that expenses and revenues have not been misallocated in the last eight years to avoid sharing.

The current audit to which ORA refers is an inspection of the books and records of Pacific and GTE pursuant to PU Code Section 314.5 ordered in D.94-06-011. (55 CPUC2d 1, 63, ordering paragraph 26.) In compliance with that order, the Division of Ratepayer Advocates (ORA's predecessor) filed a proposed audit plan. D. 96-05-038 considered the plan, provided additional guidance, and directed the filing of a revised plan. The revised ORA audit plan has recently been approved. We decline to either amend the scope of the approved audit plan, or order a second audit, for the following reasons.

First, Pacific and GTE have each year submitted sharable earnings advice letters pursuant to Rule 1 of the Commission's Rules of Practice and Procedure.[18] No party has ever brought reasonable allegations to our attention, including in this proceeding, that those reports contain false statements. Utilities have great incentive not to submit false reports, since doing so places them in jeopardy of severe fines and penalties. As such, we are confident that the earnings reports have not misled us by any artifice or false statement of fact.

Second, the NRF structure removes the Commission from detailed oversight of operations, streamlines regulation, gives utilities new financial incentives, and permits utilities to earn above normal rates of return. Consistent with this structure, we said of the sharing advice letters in D. 89-10-031: "[s]ince these filings will be reviewed primarily for accuracy, they should be much more straightforward than even an attrition filing." (33 CPUC2d 43, 152.)

Sharable earnings advice letters have been reviewed each year for accuracy. No inaccuracy has ever been found that warranted an audit. Moreover, sharable earnings advice letters have been subject to protest. No protest has ever resulted in the conversion of a sharable earnings advice letter to an application, for a more formal and thorough review. No review of, or protest to, a sharable earnings advice letter has ever lead to sharing when the utility first proposed no sharing. We have also monitored results through ongoing reports.

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[18] Rule 1 states: "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."

No advice letter has presented any particular facts to justify the time and expense of an audit.

Similarly here, no allegation has been raised in this proceeding to justify any special audit initiative. In particular, we decline to consider an audit for reasonableness of operations, which would essentially be the same as doing a general rate case review. The concept and purpose behind NRF is that we no longer do such reviews. We are not persuaded that we need to audit eight years of operations (or some portion thereof) for either reporting accuracy or reasonableness, beyond the audit ordered in D.94-06-011.

ORA now recommends the audit include compliance with cost allocation principles. To the extent this was not a factor in ORA's already submitted revised audit plan, ORA should have moved to amend its audit plan. We are not persuaded here to disturb the recently approved audit plan. Further, however, we do not understand ORA's proposal to be a change in its revised plan, and expect compliance with cost allocation principles to be part of the approved audit.

Thus, we decline the recommendations of TURN and ORA to undertake any special audit initiatives. Rather, we will pursue the audits ordered in D.94-06-011 and D.96-05-036.

5.2.4. ORA Alternatives

ORA recommends retaining, but modifying, sharing. ORA's proposals are largely moot since we suspend sharing. Nonetheless, we briefly address ORA's proposals.

The sharing scheme in D.89-10-031 directed that sharable earnings be allocated to Category 1 services. ORA recommends here that sharable earnings apply to basic exchange services now in Category 2, since the original intent was that these earnings benefit end users, with important services

for end users now in Category 2. ORA may be right. We will consider this recommendation, if renewed by ORA or another party at the appropriate time, should we later reinstate sharing. Until then, the suspension of sharing makes this proposal moot, and we will not address it further.

ORA also recommends that the sharing band should be modified so ratepayers share 50% of earnings above the market-based rate of return to a new ceiling, and shareholders retain all earnings above the new ceiling. This proposal is also moot given that we suspend sharing. Further, it would continue, if not make worse, the distortion in economic analysis that we here seek to correct. Firms make operating and investment decisions by examining the present value of the future stream of returns. Lowering the point at which sharing begins affects the stream of future earnings without any buffer to a benchmark rate of return. It thereby diminishes the expected returns and present value of those returns. This distorts the incentive to invest, and is contrary to our goal.

If the Commission eliminates sharing, ORA proposes the replacement be pure price cap regulation with an aggressive productivity factor. We suspend but do not eliminate sharing, making ORA's proposal at least partly moot. To the extent we expect this suspension to eventually lead to permanent elimination of sharing, and the suspension is similar to elimination, we have addressed the productivity factor above. We here find compelling reasons to set X equal to I (i.e., continue the suspension of I-X), and are not convinced by any reasons to do otherwise. Moreover, we are not persuaded by ORA that there is any reasonable link between the suspension of sharing to correct distortions in economic analysis and an increase in X.

ORA also recommends eliminating sharing (as well as the price cap formula and the trigger mechanism) for large business customers one

year after decisions are made in several proceedings: open access and network architecture development (OANAD; costing and pricing of unbundled network elements and operating support systems); local competition (implementation of cost recovery); permanent local number portability; collocation; equal access; and Pacific's Section 271 proceeding.[19] ORA recommends a longer time frame of perhaps three years after implementation of these decisions before elimination of sharing and other NRF safeguards for residential and small business customers. In support, ORA contends that the Commission must defer NRF changes until irreversible, effective competition can provide protections to ratepayers. ORA believes this will occur one, and perhaps three, years after completion of these other Commission proceedings.

Just as we did in D.95-12-052, we decline to tie NRF reform to milestones in other proceedings. As we said there, any step that complicates our regulatory process by further encumbrances is a step in the wrong direction, and inconsistent with our overall strategy to reduce regulation as markets open. While milestones may appear to offer a reasonable approach, the complexity and multiplicity of regulatory proceedings now underway continue to stretch the managerial capabilities of the Commission so seriously that we are uncertain the results of this apparently reasonable approach would prove reasonable in fact. (D.95-12-052, 63 CPUC2d 377, 401-2.) Rather, it is reasonable to examine the issues under consideration in this proceeding on their own merits.

5.2.5. Conclusion and Future of Sharing

Today's decision means we will not be proscriptive in the next few years about the earnings of Pacific and GTE. Rather, our role will be that of

[19] These issues are in R.93-04-003/I.93-04-002 (OANAD) and R.95-04-043/I.95-04-044 (local competition).

watching market behavior and monitoring for abuses. Among other things, the Commission will protect ratepayers, shareholders, Pacific, GTE, competitors and the market from abuse. We will react as necessary, but need not control rates of return within bands from year to year.

Our suspension of sharing includes the opportunity for Pacific and GTE to earn higher returns on successful operating and investment decisions, as well as lower returns if they make bad decisions, just as may their competitors. Should rates of return become truly unreasonable within the next few years, Pacific, GTE or the Commission may act.

That is, some parties state that utilities have a fiduciary duty to their owners which may include applying for rate relief in certain circumstances.[20] As such, if rates of return become unreasonably low, Pacific and/or GTE might be obligated to consider applying for rate relief. We caution that they should do this with great hesitation, however. They should be very hesitant because, in support of the elimination of sharing at high rates or return, they argue that the floor should be eliminated, and shareholders should take the full risk of variations in rate of return. We agree with, and adopt, this rationale in our suspension of sharing. Thus, we do not expect to see such application even if rates of return fall dramatically. If one is filed, we will look on such application with great skepticism given the fundamental reasons for adopting NRF, including the changes we authorize today.

[20] In certain circumstances, PB and GTE may file for a rate increase. (See, for example, Ordering Paragraphs 2 and 3 of D.95-12-052 (63 CPUC2d 377, 406), which indicate that Category 2 price caps are subject to increase upon Commission approval of a rate increase application.)

If such application is filed, applicant must clearly and convincingly address why the balancing of risks and rewards (by suspending sharing and thereby removing both the ceiling and the floor rates or return) should be disturbed by a rate increase to the benefit of the utility and its shareholders. Moreover, given the suspension of sharing, applicant will be held to a more demanding test than the earnings floor test in place before the suspension of sharing.

Similarly, if rates of return become truly excessive, we may issue an OII. We will be equally hesitant to engage in such investigation, however, but will do so if necessary.

Finally, ORA recommends that the $53 million reduction in GTE rates provided in the settlement approved by D.93-09-038 not be disturbed by our decision here. We agree. GTE is not authorized to increase rates by $53 million as a result of our suspension of sharing, or any other decision made herein. Said differently, this decision retains existing rates, with the $53 million reduction contained therein.

6. Depreciation Review and Approval of Depreciation Changes

The third issue is:

> Should the annual depreciation review and approval of depreciation rate changes for Pacific and GTE be eliminated?

6.1. Positions of Parties

Pacific, GTE, CMA, ORA and TURN recommend eliminating the annual depreciation review and approvals of depreciation rate changes. Pacific believes review and approval of depreciation decisions can inhibit investment, that the company should be at risk for depreciation decisions, and there is no purpose for depreciation reviews if sharing is eliminated. GTE says depreciation review and approvals are inconsistent with the management discretion granted

under the NRF. CMA asserts that depreciation rates should be dictated by the market, ensuring that shareholders, not ratepayers, bear all the risks of future investments, and "stranded costs" will not continue to mount.

ORA recommends that the straight line method, not equal life group (ELG), be used for depreciation. ORA says that extraordinary changes in depreciation expenses should not be allowed recovery through exogenous treatment of the resulting increase (i.e., by Z factor adjustment). On the other hand, if changes are sufficient to adversely impact the utility's earnings, ORA asserts that the depreciation expenses should be amortized over a period of not more than three years. Finally, ORA recommends an annual depreciation report for the purpose of monitoring technological advances and deployment. TURN joins with ORA in recommending elimination of the annual depreciation review and approval requirements, but recommends that Pacific and GTE not be allowed recovery for franchise impact claims.

Joint Commenters and DOD/FEA recommend retaining depreciation reviews and approvals. If the Commission adopts pure price cap regulation, Joint Commenters do not oppose elimination of this NRF requirement. If reviews and approvals are eliminated, Joint Commenters assert that the Commission must also rule out franchise impact claims. DOD/FEA say depreciation reviews and approvals need only be applied for categories of plant used in the provision of services over which Pacific and GTE maintain market power.

6.2. Discussion

For the reasons advanced by Pacific, GTE, CMA, ORA and TURN, we eliminate depreciation reviews and approvals. Depreciation reviews and approvals are largely necessary only in connection with sharing. As we said in D.89-10-031: "Because depreciation accruals will directly affect sharable

earnings, we believe that depreciation rates should be examined annually to ensure their continued reasonableness." (33 CPUC2d 43, 138.) That is, we needed to carefully examine depreciation rates because excessive depreciation charges could keep a utility's return below the benchmark or ceiling (and thereby avoid a rate reduction) or put a utility's return below the floor. Now, however, as Pacific says: "[w]hen earnings are not regulated, the need to calculate and control depreciation lives for telecommunications equipment disappears." (Exhibit 4, page 20.) Thus, suspension of sharing permits the parallel suspension of depreciation reviews and approvals.

We not only suspend, however, but permanently eliminate depreciation reviews and approvals. Depreciation reviews and approvals treat Pacific and GTE asymmetrically compared to their competitors. We agree with Pacific that the lack of competitive neutrality in depreciation regulation harms competition, consumers and incumbent firms. The harm results from possible negative effects on investment decisions, leaving consumers with higher prices and fewer services. The negative influence occurs when investment decisions are skewed by regulated depreciation rates (if not equivalent to market depreciation rates) used in economic analyses for some firms but not others. We also agree with GTE that this asymmetry subjects GTE and Pacific to administrative costs not required of CLCs, and is needless with the suspension of sharing. Thus, our concern about competitive neutrality, and desire to level the playing field wherever possible, persuades us to permanently eliminate depreciation reviews and approvals.

In addition, we agree with Pacific when it says:

> "Eliminating controls on depreciation rates also places this aspect of the financial responsibility for the success of investments squarely on the shareholders, where it rests in

unregulated, competitive markets. Customers are no longer subject to these risks..." (Exhibit 4, page 21.)

NRF provides Pacific and GTE with strong incentives to manage operations and investments efficiently, while making management and shareholders responsible for the corresponding risks and rewards. It also makes regulation more efficient, and reduces regulatory burdens and responsibilities on both utilities and the Commission. With the suspension of sharing, it is time to place the full responsibility on management and shareholders, along with the attendant risks and rewards, of decisions on depreciation rates and accruals.

In comments on the draft decision, MCI, Sprint and AT&T seek clarification of whether elimination of depreciation reviews and approvals applies to all plant, or just new plant. It applies to all plant.

Elimination of depreciation reviews and approvals will be effective January 1, 1999. This allows a smooth transition to this new policy, with a clear effective date for each utility to take responsibility for depreciation decisions.

6.2.1. Stranded Costs

We also agree with many commenters who say eliminating depreciation approvals will mitigate the stranded cost (or franchise impact) problem. As Pacific says: "If economic lives are used for depreciation purposes for the future, then new stranded investment problems will not arise and only those stemming from the historical under-depreciation of assets will exist." (Exhibit 6, page 8.)

With today's order, Pacific and GTE will set their own depreciation rates and accruals. They may use economic lives, or any other basis, with the attendant risks and rewards of that decision. As such, there will be no stranded cost problem for new plant investments, or depreciation rates, from January 1, 1999 forward. It is also for this reason we permanently eliminate, and

do not simply suspend, depreciation review and approvals, and thereby permanently foreclose any potential franchise impact claim covering investments and depreciation from this day forward.

We cannot, as TURN and others suggest, however, rule out any stranded cost claim for investments and depreciation up to January 1, 1999. The scope of this proceeding does not include resolution of historic stranded costs. Rather, Pacific and GTE may each file an application for consideration of past stranded costs as permitted by, and pursuant to the conditions in, D.96-09-089. Evaluation of any such claim will be undertaken in those applications, not here.

AT&T and others argue that permanent elimination of depreciation reviews and approvals—and granting Pacific and GTE complete discretion over existing depreciation expense streams and coordinating reserves—relieves the Commission and ratepayers of any responsibilities for stranded investment. That contention may or may not be correct, and, if relevant, parties may make that argument in protest to any application that might be filed pursuant to Ordering Paragraph 7 of D.96-09-089.

Pacific says:

> "In fact, regulatory reforms supported by Pacific in this proceeding (i.e., elimination of sharing, permanent elimination of GDPPI-X, and the elimination of depreciation review and approval) provide Pacific the opportunity to continuously evaluate mitigation of the reserve deficiency." (Exhibit 5, page 20.)

We essentially adopt the regulatory reforms supported by Pacific. Pacific will thereby have the opportunity to continuously evaluate mitigation of the reserve deficiency, and we expect Pacific to use every opportunity to do so. This is equally true for GTE. Therefore, any application

Pacific and GTE might file pursuant to Ordering Paragraph 7 of D.96-09-089 must contain information on Pacific's and GTE's continuous evaluation of measures to mitigate the reserve deficiency, including information on any and all efforts each utility has considered to mitigate the problem (whether or not implemented), the efforts that have been implemented, and the success of implemented measures.

6.2.2. Equal Life Group

ORA objects to Pacific using ELG, saying this will significantly increase depreciation expense. According to ORA, the Commission has authorized the straight line remaining life methodology since 1954, and changing the established methodology without detailed analysis and knowledge of the impact on ratepayers is unwise. ORA points out that the Commission authorized Pacific to use ELG for a subset of assets for only a brief time, and reversed that decision because of numerous problems and increased complexities. (D.88-11-055, 29 CPUC2d 618, 621.) ORA maintains that ELG will add an enormous burden and complexity on the Commission to estimate depreciation rates and accruals.

To the contrary, allowing Pacific to determine the basis for depreciating its assets should have no affect on ratepayers. As Pacific says: "...prices would be unaffected by the depreciation rates chosen by Pacific Bell..." (Exhibit 4, page 21.)

That is, whether or not Pacific now begins to use ELG, rates to ratepayers should not change as a result of our elimination of depreciation reviews and approvals. This is particularly the case because later herein we eliminate Z factor recovery for depreciation changes. Rather, Pacific's management and shareholders will take the risk of any change in depreciation methodology.

We eliminated the use of ELG in 1988 because of regulatory complexity. (E.g., Conclusion of Law 3 in D.88-11-055, 29 CPUC2d 618, 621.) That is not an issue for us now. For example, if ELG entails more complexity for Pacific, that will be a matter for Pacific to weigh in making its decision. Elimination of Commission depreciation reviews and approvals eliminates regulatory complexity for the Commission as a factor in this decision. If a utility's use of ELG results in increased burden on the Commission (because we may, in some circumstances we do not now foresee, still estimate depreciation rates and accruals), we accept this as an unintended consequence of this decision and as part of our changing role. That is, some increased burden on the Commission here may be a necessary tradeoff in shifting risk to management and shareholders of depreciation decisions.

6.2.3. Annual Depreciation Report

ORA asks that we order Pacific and GTE to submit an annual depreciation report to ORA (including such information as depreciation reserves, plant balances, depreciation rates and depreciation expenses) after the utilities first meet with ORA to determine the necessary information. Among other things, ORA asserts it needs this report "to continue monitoring technological advancements and deployment." (Exhibit 10, page 21.)

We decline to order a new depreciation report. We think there are better ways to monitor technological advances and deployment than to examine depreciation. Moreover, we will no longer review and approve depreciation schedules. Thus, we see no reason why we should order a new annual report to be submitted to ORA on depreciation. Rather, we believe the NRF reports now required of Pacific and GTE are adequate and reasonable.

We generally seek to reduce the regulatory burden on utilities and the Commission, and are not convinced by ORA that sufficient reason exists here for such report. Nonetheless, if ORA continues to believe the report is necessary, ORA may use its existing authority to secure the data from Pacific and GTE. ORA should meet with Pacific and GTE to identify the necessary information and develop a reporting format. If ORA develops a report and reporting format, but Pacific and GTE refuse to provide the data, ORA may bring the issue back to us in a future NRF review, or other appropriate proceeding, for an order. ORA must there propose a more specific report, with more specific reasons why such report is necessary and reasonable.

TURN asks that the annual report requested by ORA be made available to parties other than ORA. Since we decline to order the annual report, TURN's request is moot. If ORA uses its authority to request data or a report, TURN may request a copy from Pacific and GTE of any data responses or report submitted to ORA.

6.2.4. Adverse Consequence by Application

As a result of this decision, increases in depreciation rates will not increase rates to ratepayers, absent a truly compelling showing to the contrary. Should a truly adverse consequence result, we do not here modify previous orders regarding rate increase applications, and Pacific and GTE may file for relief by application to the extent there allowed. As applicant, of course, each utility incurs the burden of proof. Moreover, any such showing will need to be particularly compelling. It must be especially compelling because we have authorized lives close to the lives requested by Pacific and GTE since implementation of NRF in 1990, and, in some cases, have authorized even shorter lives. It must also be particularly compelling because of our decision here to shift the risks and rewards of such decisions to management and shareholders.

Therefore, we will be particularly skeptical of any such application. We suggest Pacific and GTE think thoroughly about such application before one is filed. If one is filed, we will give consideration to ORA's proposal, if renewed there, to amortize the effect over three years.

6.2.5. Other Proposals

We decline to adopt DOD/FEA's proposal to apply depreciation review and approval only to plant for services over which the utilities have market power. First, for the reasons stated above, we permanently eliminate depreciation review and approval. Second, to paraphrase GTE, it is not at all apparent how plant could be divided between services for which Pacific and GTE have market power, and services which are competitive. (Exhibit 9, page 18.) No allocation schemes can perfectly separate this plant, and we are not persuaded that this exercise would generate sufficient benefits to outweigh the costs and impreciseness of the results, as well as overcome all the other the reasons we reject depreciation reviews and approvals.

7. Z Factors

The fourth issue is:

> Should the criteria for Z factor recovery be modified for Pacific and GTE, and if so, how? Should Z factor adjustments be completely eliminated?

7.1. Position of Parties

Pacific, GTE and ORA basically recommend eliminating the Z factor mechanism. Except for some matters already authorized (e.g., expense limit increase authorized in D.91-04-066, merger refunds authorized in D.97-03-067), Pacific says the Commission should allow adjustments for cost recovery only on a case-by-case basis in separate proceedings limited to two situations: (1) a Commission or other government-mandated expenditure that Pacific would not

otherwise make in the normal course of business, or (2) an offsetting intrastate rate adjustment due to a jurisdictional cost shift that resulted in an interstate rate adjustment. GTE says Z factors are inconsistent with a market-based system. ORA recommends elimination of Z factors prospectively, with continued application of those already ordered by the Commission, or pending resolution, until they have expired.

CMA recommends retaining Z factors for government mandated and other exogenous costs, with recovery of those costs from services not sufficiently subject to market forces. Joint Commenters support continuation of Z factors, as refined in previous NRF reviews. Joint Commenters say this is the one element of the price cap mechanism that has consistently provided savings to ratepayers. If the Commission seeks to streamline the process, Joint Commenters recommend limiting future Z factor adjustments to those matters known and measurable at this time. TURN has no position on whether and how Z factor criteria should be modified, but urges the Commission to ensure that "pay back" rate decreases which are currently "in the pipeline" not be affected by this decision. TURN specifically cites ratepayers receiving the benefits of decreasing expense recovery for Post Retirement Benefits Other Than Pensions (PBOPs). DOD/FEA recommend retaining Z factors, but applying adjustments only to services over which Pacific and GTE retain market power.

7.2. Discussion

7.2.1. Eliminate New Z Factors

The Z factor adjustment was designed as a means for recovering exogenous costs (i.e., costs outside a utility management's control) in a routine, reasonably simple manner. Among other things, it was intended to satisfy the NRF goal of low cost, efficient regulation. Standards for Z factor eligibility were developed in D.89-10-031. (See 33 CPUC2d 43, 137-8.) We

established a comprehensive framework for streamlined Z factor analysis based on nine criteria in D.94-06-011. (See 55 CPUC2d 1, 36-41.)

Nonetheless, despite our best efforts to the contrary, many Z factors have been the subject of contention, and some Z factor adjustments await our decision. It is now time to further streamline and simplify NRF, promoting our goal of low cost, efficient regulation.

Therefore, we eliminate consideration of new Z factor adjustments effective immediately. We do this because we are persuaded by Pacific and others that, consistent with removing the upper and lower bounds on earnings, it is time to shift to shareholders more of the risk of cost changes previously recoverable by the Z factor. As Pacific says regarding its proposal to eliminate Z factors:

> "To the extent that it is appropriate to shift more business risks to shareholders, eliminating the Z factor mechanism is sound public policy." (Exhibit 1, page 20.)

> "If Pacific Bell desires no upper limits placed on its earnings, then it must be willing to accept more risk in other areas." (Exhibit 3, page 22.)

We also eliminate new Z factor recovery because it treats Pacific and GTE asymmetrically compared to their competitors. No competitor is so easily able to recover cost increases outside its control.

Moreover, we agree with ORA when it says:

> "...it is appropriate to simplify the regulatory process and reduce litigation and controversy for exogenous cost recovery within the Z factor framework in this transitional period to a competitive market." (Exhibit 10, page 32.)

Thus, elimination of new Z factor recovery shifts risks to shareholders, is consistent with our removing the upper and lower bounds on earnings, reduces asymmetry, simplifies the regulatory process, and is compatible with our promotion of competition, as we continue through this transitional period to a fully competitive market.

7.2.2. Limited Exogenous (LE) Factor Mechanism

Our elimination of new Z factor adjustments means we will no longer authorize recovery for exogenous cost changes, such as Commission-adopted Financial Accounting Standards Board accounting changes, changes in intraLATA toll pooling, or changes in federal or state tax laws. We will, however, allow continuation of a streamlined process for requests in two narrow areas: requests for recovery of cost increases or decreases resulting from (1) matters mandated by the Commission and (2) changes in total intrastate cost recovery resulting from changes between federal and state jurisdictions. These requests may be by advice letter on October 1 each year. To distinguish this process from the Z factor mechanism, we designate this as the LE (limited exogenous) factor mechanism.[21]

We allow these two exceptions because they remain potentially significant exogenous events outside utility management control. To further streamline the process, we limit rate changes for Commission-mandated cost changes (either increases or decreases) to only those costs for which an LE factor adjustment is authorized in the underlying Commission decision. That is, not every

[21] As explained later in this order, we continue Z factor treatment only for those items currently under consideration or implementation, until implementation is complete. For consistency, efficiency, and mitigation of the number of rate changes ordered per year, we retain use of the October 1 filing convention for LE factor adjustments.

Commission-mandated cost change will necessarily be reflected in rates, unless considered by the Commission at the time the program or event causing the cost change is authorized, and the change is therein approved for LE factor recovery. Moreover, in considering whether the cost will be allowed, we will consider whether the cost is unique to Pacific and/or GTE, or is a cost generally borne uniformly by all carriers in the industry.

We decline to adopt Pacific's recommendation to also include mandates of government entities other than the Commission. Competitors of Pacific and GTE are also subject to mandates of other government entities. Pacific and GTE need, and should have, no special protection relative to their competitors.

In comments on the draft decision, GTE alleges that an LE adjustment for Pacific and GTE is justified here because of asymmetry by government entities other than the Commission in treatment of Pacific and GTE compared to competitors. For example, GTE says rulings of the Federal Communications Commission or other federal entity concerning number portability obligations may disproportionately impact the incumbent local exchange carriers as a result of their incumbent status.

We are not persuaded that this justifies LE treatment. In its original comments on Z factor adjustments, GTE recommended that "all Z factor adjustments should be eliminated." (Exhibit 8, page 36.) In its reply comments, GTE did not support Pacific's exceptions, but said: "...'z' factors should be eliminated in a clean, sweep..." (Exhibit 9, page 27.) ORA similar recommended elimination of Z factors prospectively, and in its reply comments did not support Pacific's proposal for continuing adjustments in two areas.

We adopt a middle ground between the recommendations of Pacific, GTE and ORA. Moreover, we are not persuaded that the treatment by other entities, if different, is sufficiently significant to justify LE treatment for Pacific and GTE.

We also decline to adopt Pacific's exact language on the second LE factor (i.e., changes in total cost recovery). Pacific's proposal is unclear, and appears to be too narrow, limiting rate adjustments to those that "resulted in interstate rate adjustments." Pacific excludes, for example, potentially necessary rate adjustments resulting from changes in interstate cost allocations. We adopt a clearer, less narrow statement that provides for recovery of cost changes related to our jurisdiction (intrastate) due to changes in allowed cost recovery between federal and state regulators.

Finally, we authorize recovery by advice letter to promote low cost, efficient regulation. An application sets in motion more formal and complicated procedures that are unnecessary for what should be matters of limited, or no, controversy.

7.2.3. Criteria

Joint Commenters assert that the Commission should, in Phase II of this proceeding, "establish detailed criteria for determining whether to accept or reject any future cost change that conforms to Pacific's description of limited Z factors." (Exhibit 15, page 14.) Pacific seemingly recommends no criteria, but says the matter can be considered in whatever proceeding it appears (e.g., a pending proceeding, advice letter, application).

We decline to adopt Joint Commenters recommendation. A second phase is not contemplated for this proceeding, and this matter does not require examination in a subsequent proceeding.[22] Rather, our elimination of the Z factor mechanism, and replacement with an LE factor mechanism, is essentially a further narrowing and simplification of the existing process. As such, we neither need to establish new criteria, nor abandon existing criteria and allow any reason to be used in support of the filing. Rather, we will continue to apply the same nine criteria developed and adopted in D.94-06-011.[23]

Moreover, for Commission mandated costs, the moving utility must present an evaluation of the nine criteria in the underlying proceeding in which LE factor treatment will be authorized or rejected. To the extent actual costs may not be known at that time (or other criteria may not be satisfied but can reasonably be expected to be known at the time of the advice letter), the applying utility may request that criterion (or those criteria) be deferred and assessed with the advice letter.

[22] See, for example, R.98-03-040, mimeo, page 10: "When the rulemaking is completed, it...will be closed. The Commission will issue a subsequent Order Instituting Rulemaking (OIR) to address the remaining issues."

[23] The nine criteria are: (1) is the event creating the cost at issue exogenous; (2) did the event causing the cost occur after the NRF was adopted in late 1989; (3) is the cost clearly beyond management's control; (4) is the cost a normal cost of doing business, even if it is increased by an exogenous event; (5) does the event have a disproportionate impact on local exchange carriers; (6) is the cost caused by the event reflected in the economy-wide inflation factor (GDPPI) used in the annual NRF price cap proceeding; (7) does the event have a major impact on the utility's overall cost; (8) can actual costs be used to measure the financial impact of the event, or can the costs be determined with reasonable certainty and minimal controversy; and (9) are the proposed costs reasonable. (D.94-06-011, 55 CPUC2d 1, 36-41.)

7.2.4. Phase Out of Existing Z Factors

We also adopt the positions of Pacific, Joint Commenters, ORA and TURN to continue consideration of Z factors currently under review, and finish implementation of those now being implemented. We do this because prior Z factor treatment has increased rates in some instances, with offsetting rate decreases expected in later years.

Examples of adjustments for which implementation is not yet complete, as pointed out by Pacific, include (1) the one year remaining in the series of annual adjustments adopted in D.91-04-066 (i.e., the $200 to $500 expense limit increase, with a predetermined adjustment of $11.93 million scheduled to take effect January 1, 1999) and (2) completion of the merger refunds authorized in D.97-03-067.

7.2.4.1. Post Retirement Benefits Other Than Pensions

Other than previously scheduled adjustments, Pacific proposes excluding other adjustments it might have included in its October 1, 1998 price cap filing, such as costs associated with the accounting change for PBOPs. Joint Commenters, however, are concerned that PBOP decreases be reflected in rates.

In Reply Comments, Pacific clarifies that, under its proposal, cost recovery for PBOPs (currently $99.5 million annually) will be discontinued at the end of 1998. Pacific points out that, in addition to providing a $99.5 million rate reduction effective January 1, 1999, Pacific's Z factor proposal eliminates the need for the further proceedings on PBOPs contemplated in D. 97-12-079 and in Resolution T-16102. As Pacific says, this streamlines regulation and fosters regulatory efficiency. In its reply comments, ORA says the $99.5 million is currently in rates, and there is a pending issue of $115 million in overcollections.

GTE recommends no further Z factor recovery, with all recovery by application or other procedural vehicle. Thus, GTE proposes no further Z factor treatment for PBOPs.

We adopt the proposals of Pacific and GTE to discontinue PBOP recovery by Z factor at the end of 1998. Thus, Pacific should include in its 1998 price cap advice letter a proposed reduction in rates of $99.5 million annually, and GTE should include a proposed reduction of $24.025 million annually.[24] [25]

However, we do not rule on whether this decision eliminates the need for limited further consideration of PBOPs as Pacific asserts. Nor can we rule, as ORA would have it, that there is a pending issue of $115 million in overcollections. We also do not rule as to which issues, if any, should be included in the Forum OII or subsequent proceeding. Any issue regarding past Z-factor adjustments is beyond the scope of this proceeding. However, since we exclude new PBOP recovery for advice letters beginning with the ones due to be filed immediately after this decision, the need to determine the types of documents needed to facilitate analysis of PBOP requests for future Z-factor filings is moot. Hence, the matter need not be considered further.

[24] By letter from the Executive Director dated September 18, 1998, a joint Pacific and GTE request was granted, allowing deferral of their price cap advice letters otherwise due October 1, 1998. Pacific and GTE will file those advice letters within eight days of the mailing date of this order.

[25] Resolution No. T-15161 included $42,000,000 in rates. Resolution No. T-15821 reduced that recovery by $12,271,000. Resolution No. T-15977 further reduced the amount by $5,704,000, leaving net PBOP rate recovery of $24,025,000, which we now exclude.

7.2.4.2. *Other Items for Phased Out Z Factor*

Another Z factor not yet fully implemented is our treatment of other billing and collections. In Reply Comments, Pacific clarifies that the other billing and collection adjustment is a function of jurisdictional cost shifts. Consistent with both our limited continuation of adjustments by LE factor for jurisdictional cost changes, and continuation of pending Z factor items until completed, the other billing and collection adjustments will continue until implementation is complete.

Joint Commenters assert a residual 1998 GTE Z factor is a $12.656 million reduction for Customer Notification and Education Program (CNEP) costs. In Reply Comments, GTE states this is misleading since GTE simply eliminated the one-year positive Z factor adjustment authorized in 1997. Nonetheless, GTE should specifically exclude this $12.656 million in its October 1, 1998 advice letter (i.e., propose a rate reduction of $12.656 million annually), or provide an explanation. GTE should amend its advice letter to address this issue if it is not already addressed.

7.2.4.3. *List of Z Factors To Be Phased Out*

Therefore, we eliminate new, and phase out existing, Z factor adjustments. Phased out Z factors are allowed only for those in some stage of review, or for which implementation is not complete. Phased out Z factors should be included in price cap advice letter filings every October 1 until resolved or fully implemented, where, and to the extent, applicable to each company. Those Z factors are:

1. capital to expense shift ($200 to $500 expense limit increase)
2. merger refunds authorized in D.97-03-067
3. gain on sale of land
4. other billing and collections jurisdictional cost shift

5. results of the property tax OII (I.92-03-052)
6. PBOPs (i.e., $99.5 million Pacific reduction; $24.025 million GTE reduction)
7. CNEP costs (i.e., $12.656 million GTE reduction)

7.2.5. Other Considerations

In reaching our decision on Z factor treatment, we also consider but reject the arguments of those recommending its full retention. For example, Joint Commenters support retention of the Z factor mechanism, saying that in the past 6 years it has constituted the one element of the price formula that has consistently returned savings to customers. To the contrary, not only nominal but real rate reductions have occurred every year X was greater than I. Moreover, real rates were reduced every year X was set equal to I (i.e., I-X was suspended). In all cases, real savings have been provided to all Californians. Thus, the Z factor is not the only element to have consistently returned savings to customers.

DOD/FEA recommends retention of Z factor adjustments, but only for services over which Pacific and GTE retain market power. As addressed above regarding depreciation, allocations to particular services is not necessarily simple. Even if DOD/FEA's recommendation is understood to mean Z factor adjustments are only applied to services in Categories 1 and 2, however, we are not persuaded that continuing Z factor treatment without modification is reasonable. Rather, for all the reasons stated above, we find more reasonable the prospective elimination of Z factor adjustments, and replacement with very narrow and limited LE factor adjustments.

Finally, DOD/FEA says it makes no sense to replace the proven administrative simplicity of Z factor adjustments with a host of different procedures to accomplish the same task. To the contrary, our elimination of the Z factor mechanism prospectively, and adoption of a limited LE factor

mechanism, further streamlines the NRF process, better meets our low cost and efficient regulation goal, and elevates to application the more complicated requests which are not suited for advice letter treatment.

8. Cap On Basic Residential Services Through 2001

The last issue is:

> Should the cap on the price of Pacific's and GTE's basic residential services be continued through 2001? Should the cap be applied at the existing level, or should it be subject to adjustment consistent with the outcome in pending proceedings?

8.1. Positions of Parties

Pacific, ORA, TURN and GI/LIF recommend continuing the cap on basic residential services through 2001. Pacific recognizes that some adjustments to the cap may be warranted to resolve one or more pending matters.

ORA opposes any adjustments to the cap except as a result of sharing or the price cap formula. ORA asserts that any rate change resulting from the outcome of pending proceedings may frustrate NRF's commitment to universal service. ORA also states that the Commission should consider extending the cap on basic services to small business customers.

TURN believes price caps should be continued for all services, not just for basic residential services. TURN also recommends that price caps for basic residential services not be subject to any surcharges designed to cover local competition-related costs (e.g., franchise impacts) developed in other proceedings. TURN says the Commission should reaffirm its current general rule of not permitting rate increases above price cap levels.

Regarding rates for other residential services, TURN and GI/LIF believe it is not enough to cap only the basic monthly recurring residential service rates. Rather, they recommend that rates for other basic services also be

capped (e.g., directory listings, wire insurance, directory assistance) to prevent rate increases there that otherwise undo the benefit of a limited cap.

GTE objects to continuing the cap on basic residential service rates, asserting that a cap distorts efficiency incentives for competitors to serve this market. GTE believes the rate should be subject to adjustment consistent with the outcome in other proceedings.

CMA states it is premature to conclude that basic residential rates should be continued through 2001. Joint Commenters take no position on continuation of the current cap, but oppose a freeze of any rates under NRF.

DOD/FEA believe the basic residential price cap should be adjusted in a manner consistent with the outcome in pending proceedings and the NRF price adjustment mechanisms. DOD/FEA say that arbitrary freezing of any rates is economically inefficient and contrary to the public interest.

Sprint believes it is unnecessary and unwise to make a determination now as to whether basic residential rates, or other Category 1 rates, should continue to be priced at current levels for a fixed period of time. Rather, Sprint says if the price cap index formula is eliminated, price caps remain at current levels until changed by the Commission as a result of an application by Pacific or GTE.

8.2. Discussion

After thorough consideration of the positions of all parties, we are persuaded to continue existing caps on basic residential service rates for Pacific and GTE just as we continue all NRF rate caps. As TURN says: "[t]he price cap should be continued not just for basic residential services, but for all services." (Exhibit 12, page 23.) As discussed more below, no compelling arguments are made to justify modification of our existing policy on rate caps.

ORA recommends we consider extending the cap to small business customers. We adopt ORA's recommendation to the extent that we continue all NRF caps, ceilings and floors.

Similarly, TURN and GI/LIF recommend that price caps be extended to other residential services, so that a cap on the basic monthly recurring service charge services does not become illusory with rates for other related residential services raised to compensate for, or cross-subsidize, the basic rate cap. According to TURN and GI/LIF, these other services include service connection charges, directory listings, nonpublished listings, directory assistance, emergency assistance, busy-line verification, inside wire repair, calling card surcharges, plus person-to-person and other operator-assisted services. We adopt this recommendation to the extent we retain all existing NRF caps.

At the same time, we decline to apply the caps at existing levels through 2001, thereby freezing residential rates. Rather, the residential caps are subject to change based on the outcome of pending and future proceedings, just as are all caps. As GTE says:

> "There is simply no reason for the Commission at this point in time to tie its hands for the next three years, without knowing what changes will occur in the increasingly competitive marketplace or what proceedings may be brought before or opened by the Commission." (Exhibit 9, page 29.)

We also agree with GTE that freezing these rates would result in asymmetric treatment of Pacific and GTE compared to their competitors. We have opened the basic residential service markets to competition. Freezing residential rates for three years would be a market constraint inconsistent with the development of competitive markets. Moreover, freezing basic residential rates would either prejudge the outcome of pending and future proceedings, needlessly constrain our options for meeting all necessary goals in resolving

those matters, or require unacceptable delays of up to three years before fully implementing those decisions.

8.2.1. Consideration of Arguments for Removal of Cap or Freeze for Three Years

GTE recommends complete removal of the residential rate cap, contending it distorts efficiency incentives for competitors to serve the residential market. While we are highly concerned with promoting efficiency incentives, we do not remove the cap on any Category 1 or 2 service, and similarly do not do so here. Rather, we are not persuaded that special NRF treatment (i.e., removing the caps for one service and not others) should be carved out for residential ratepayers.

ORA recommends we cap basic residential rates, except for sharing or application of the price adjustment formula, and not adjust the cap for the outcome of other proceedings because, ORA says, further adjustments to the cap might frustrate our commitment to universal service. GI/LIF recommend we cap basic residential rates in furtherance of our commitment to universal service, and maintaining affordable, high quality service.

We decline to adopt these recommendations. Before making rate changes, we will continue to assess those changes for compatibility with all NRF goals, plus service quality, but will not here decide to cap rates in favor of one over other NRF goals, in favor of one over other rates potentially subject to change in other proceedings, or in favor of service quality in exclusion of other criteria.

In reply comments in further support of its recommendation, ORA says that adjusting the residential rate cap by decision in other proceedings may strain the universal lifeline telephone service (ULTS) fund as Pacific and

GTE seek to recover lost revenue. ORA says this may require an increase in the ULTS surcharge.

While ORA may be right, we are not persuaded this is sufficient reason to here exempt residential rates from reasonable adjustment by decision in other proceedings. Rather, when making an adjustment in another proceeding, we will consider the effect on the ULTS surcharge to the extent there relevant.

ORA asserts that failing to insulate residential and small business rates from the outcome of other proceedings is a step in the wrong direction. Rather, ORA says the Commission should not apply the outcome of pending proceedings to raise residential caps until competition arrives in these markets.

To the contrary, NRF is a transitional regulatory structure. We will not constrain our implementation of NRF, or proper resolution of other proceedings, during this transition. Neither will we constrain implementation of NRF until all services are recategorized to Category 3.

TURN recommends that basic residential rates not be subject to any surcharge designed to recover local competition-related costs (e.g., franchise impacts) adopted in other proceedings. We decline to adopt TURN's recommendation. Foreclosing consideration of a possible surcharge would either prejudge the outcome of pending and future proceedings; needlessly constrain our options for meeting all necessary goals in resolving those matters; require unacceptable delays of up to three years before fully implementing those decisions; or favor one NRF goal, or one class of customer, over others without full consideration of all factors.

TURN also asserts that residential basic exchange services are likely to be the last utility services to enjoy widespread and vigorous

competition, thereby justifying price cap protections that may not necessarily apply to other Category 1 and 2 services. We are not persuaded. NRF is largely designed to operate in Category 1 and 2 markets, which are by definition not fully competitive. Whether or not effective competition comes last to some residential markets, it does not follow that residential rates need to be provided unique protections beyond those already provided (e.g., universal service; reduced rates for low income households). Services over which utilities retain market power should generally be subject to the same degree of Commission oversight, and consumers of those services should generally enjoy the same degree of Commission protection. We are not presented here with sufficient reason to justify discrimination among classes of customers.

TURN recommends the Commission make clear that any requests to increase rates above capped levels will generally not succeed. In support, TURN says utilities know the current NRF program provides, as a general rule, that any request to raise rates above price caps will be automatically denied. Further, TURN argues that without this clarification, utilities will deluge the Commission with rate increase requests, consuming considerable resources of both the Commission and the parties, and threatening promotion of the Commission's goals (e.g., production and pricing efficiency, rate stability).

We decline to adopt TURN's recommendation. There is no general rule that applications are automatically denied. Moreover, we invite utilities to be candid with us when meeting on projected workload, and seek their comments on our Business Plan. We will manage their applications and our workload through the Business Plan.

GI/LIF ask the Commission to take official notice of other pending actions against Pacific which may affect disposition of the issues here.[26] We are not persuaded that the issues in these other matters have any bearing on the issues here, and GI/LIF do not clearly and convincingly present any link. We decline to burden this record with the records from other proceedings that are not relevant.

8.2.2. Pacific Bell Residential Cap

Lastly, in support of its position on this issue, Pacific states that it is willing to cap the price of its basic residential service through 2001, subject to adjustments that may be warranted to resolve pending matters. We endorse Pacific's proposal by our deciding to retain residential rate caps just as we retain all Category 1 and 2 caps, subject to reasonable adjustment based on the outcome in other proceedings. Thus, we do not expect to see Pacific file an application to increase its basic residential service rates before 2001, and will expect to see a particularly strong showing should Pacific file such application.

9. Other Issues And Next NRF Review

The Scoping Memo and Ruling states that the scope of this rulemaking is to address five identified issues and, when resolved, the rulemaking will be closed. It continues, saying the Commission will issue a subsequent OIR to address remaining issues. (Ruling, page 2.)

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[26] GI/LIF does not cite specific proceeding numbers, but references two matters: (1) Petition Of The Office Of Ratepayer Advocates For An Order That Pacific Bell Immediately Cease All Improper Practices At Its Residential Order Centers And For Other Appropriate Relief and, (2) Complaints for Unlawful Sales Policies and Practices filed against Pacific Bell by the Telecommunications International Union, Utility Consumers' Action Network and GI/LIF.

One such issue might be pricing flexibility.[27] We will give that issue thorough consideration during development of the Commission's next Business Plan. We encourage parties to state their position on whether or not the Commission should undertake that effort, and the priority for that effort relative to other proceedings, in their comments on the Business Plan.

We ordered that Pacific and GTE address in the 1998 triennial NRF proceeding the simplest possible method for ensuring recovery of PBOPs in Z factor filings. (D.97-12-079, Ordering Paragraph 1.) We here address Z factor PBOP expense reductions of $99.5 million and $24.025 million for Pacific and GTE, respectively; eliminate future PBOP recovery by Z factor; and direct resolution of remaining PBOP recovery issues in the Forum OII (I.90-02-047), consistent with our direction in Resolutions T-16102 and T-16103.

We ordered that the 1998 NRF review address the version of the GDPPI that is appropriate for use as an indicator of inflation, and the source from which the index can be readily obtained for future price cap filings. (Ordering Paragraph 4 of Resolution No. T-16102; Ordering Paragraph 5 of Resolution No. T-16103.) Continued suspension of the I-X term in the price cap formula, with the expectation that I-X will be permanently eliminated during the next NRF review, reduces the urgency of, but does not eliminate the need for, that inquiry. Rather, we must still address the appropriate GDPPI index, because we continue the requirement that price floors be adjusted for inflation by the annual filing of price cap advice letters. As we noted in Resolution No. T-16102, however, the differences between various GDPPI indices used in price cap filings have been

[27] Pacific included pricing flexibility as an issue for Phase II of its NRF application (A.98-02-003). In comments on the draft decision, GTE states the importance of an OIR into pricing flexibility before the next NRF triennial review.

minor. (Resolution No. T-16102, page 17.) The issue does not justify the issuance of an OIR. Therefore, we direct Pacific and GTE to work with Telecommunications Division staff to identify and recommend one GDPPI index for consistent use. We encourage Pacific, GTE and staff to include Roseville Telephone Company and Citizens Telecommunications Company of California, Inc. in that effort, with the objective of all NRF utilities agreeing to consistent use of one GDPPI index.

We also ordered that the issues of sharing, Z factors and NRF monitoring requirements be addressed in the 1998 NRF review. (D.96-05-036, mimeo., Ordering Paragraph 1, page 12.) We have here addressed sharing and Z factors. We have addressed, and decided to continue, monitoring of rates of return. We have addressed, and rejected, additional monitoring recommended by ORA (i.e., depreciation report). We are not persuaded that any further inquiry is necessary or reasonable of other NRF monitoring requirements.

Other candidate issues identified by parties include service quality, audit results, impact of NRF on universal service, affordability, rate of return, marketing abuses, and the amount of local competition. (R.98-03-040, page 11.) An OIR to examine service quality has already been issued. (R.98-06-029.) We have addressed the audit, universal service, and competition above. We see nothing further in these issues, or the remaining issues, to justify issuing an OII or another OIR.

Thus, we do not see any issues that require immediate attention by the rapid issuance of an OII or OIR. We invite parties to raise matters of their concern in comments on the Business Plan.

Just as we did with this rulemaking, we will initiate the 2001 NRF review by OIR. As we said in D.94-06-011, and as confirmed by our experience with A.98-02-003, the application process consumes time that can be better spent. This

is particularly true now, given the procedural requirements of SB 960. (PU Code Sections 1701.1 - 1701.4.) An OIR immediately focuses the parties, and gets the maximum amount of participation from parties without delay.

To facilitate drafting the OIR, parties and the public are invited to serve a document on the Commissioners, Executive Director, Director of the Telecommunications Division, Chief Administrative Law Judge, and the service list of this proceeding, by September 1, 2000.[28] The document should discuss anything relevant for the Commission's consideration in drafting the OIR, including proposed issues. Replies to the document should be served on the same persons and public commenters within 15 days.

10. Eligibility to File Request for Intervenor Compensation

On June 19, 1998, after consultation with the Presiding Officer and Assigned Commissioner, the ALJ filed a preliminary ruling on NOIs. The preliminary ruling found TURN eligible to later file a claim for compensation, addressed matters raised by the NOI of GI/LIF, and directed TURN and GI/LIF to address specific issues in any subsequent compensation request. We affirm the preliminary ruling.

PU Code Section 1804(c) provides that a customer found eligible for an award of compensation may file a request within 60 days following the final order of the Commission. This is the final order in this proceeding. Thus, TURN may file a request for an award within 60 days of today. In addition to any other requirement of the PU Code or Commission decision, the request, if made, must comply with the requirements stated in the preliminary ruling (e.g., full justification of hourly rates and numbers of hours; must address

[28] The document should be served, but not filed.

underrepresentation, fair determination and duplication consistent with D.98-04-059).

GI/LIF did not include a showing of significant financial hardship with its NOI. Nonetheless, GI/LIF may file a request for an award within 60 days of today. To be considered, any such request by GI/LIF must include a showing of significant financial hardship, must comply with all requirements of the PU Code and relevant Commission decisions, and must satisfy the requirements specified in the preliminary ruling (e.g., the request must make clear the type of customer each entity is (as defined in PU Code Section 1802(b)); the percentage of membership composed of residential ratepayers; if either is a representative of a group or organization, a copy of its articles of incorporation or bylaws, noting where in the document it is authorized to represent the interests of residential ratepayers; the showing of significant financial hardship must demonstrate hardship in a manner consistent with customer status as discussed in D.98-04-059; the request must fully justify proposed hourly rates and numbers of hours; the request must address underrepresentation, fair determination, and duplication consistent with D.98-04-059).

11. Competition

Several parties submitted comments and reply comments on the draft decision contending that they were foreclosed from presenting evidence on competition. Because of this, they recommend that the Commission's decision not rely on competition in finding facts and reaching conclusions.

We generally adopt those recommendations, and make changes accordingly herein. To the extent any reliance on competition remains, however, the following observations should be noted.

Despite their protestations to the contrary, parties were not, as they claim, prevented, prohibited, precluded or banned from addressing competition. The

Scoping Memo and Ruling limited the scope of the proceeding to five issues, and provided guidance on the best use of parties' and the Commission's limited resources. As such, the Scoping Memo said: "consideration of the issues herein does not at this time appear to require specific evidence on the level of competition." (Ruling, page 7.)

Thus, the Scoping Memo guided parties' use of limited resources away from providing complicated and detailed specific evidence on the level of competition (e.g., calculations by expert witnesses on market structure, market share, market concentration ratios). Parties were welcome, however, to offer evidence on the general nature of competition, and changes in the market. In fact, nearly all did. In turn, several parties objected to the receipt of those portions of the comments and/or reply comments of other parties as evidence. Most defended their evidence as within the scope, but argued that the evidence of others was outside the scope, of the proceeding. The objections were overruled, and none of the evidence was stricken. Rather, it 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.)

Further, some parties argued in comments and reply comments that changes should not be made without considering the level of competition. If they had convinced us, no changes would now be made until a subsequent proceeding undertook the necessary analysis, or parties were given the opportunity to comment on the taking of official notice of the level of competition from another proceeding. (See Ruling, pages 7-8.) In the end, parties did not convince us. Parties were not, however, prohibited from attempting to do so, and, in doing so, addressing competition.

Thus, the guidance in the Scoping Memo was reasonable. In turn, parties reasonably addressed competition, and the state of the market, without specific evidence on the level of competition but within the bounds suggested by the Scoping Memo, and that evidence was received.

Findings of Fact

1. On June 19, 1998, after consultation with the Presiding Officer and Assigned Commissioner, the ALJ filed a preliminary ruling which found TURN eligible to later file a claim for intervenor compensation, addressed matters raised by the NOI of GI/LIF, and directed TURN and GI/LIF to address specific issues in any subsequent compensation request.

2. Market conditions, or changes in market conditions, do not justify a change in suspension of I-X.

3. Effective competition is not a prerequisite for modifying, or continuing the suspension of, the price cap formula.

4. A detailed assessment of competition is not necessary to continue suspension of I-X.

5. Detailed information on competition and market share is not needed since continuing the suspension of I-X does not remove or change any rate caps, ceilings or floors for services in Categories 1 and 2.

6. Events since 1995, such as the following, demonstrate that significant market changes continue to occur: facilities-based competition in the local exchange market authorized in late 1995; resale competition in the local exchange market authorized 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 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.

7. Price cap regulation is still needed until the transition to a fully competitive market is complete.

8. Continued suspension of I-X meets the Commission's NRF goals, balances competing interests, and produces rates that are just and reasonable.

9. Rates of return in 1996 and 1997 do not show that the elimination of I-X allowed Pacific and GTE to accumulate financial resources to gain unfair competitive advantage, and continuing regulation of Category 1 and 2 rates, ceilings and floors make unlikely the accumulation of those resources.

10. Setting X equal to I (i.e., 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), and produces real savings to all ratepayers by bringing down the cost of telephone service for all Californians.

11. Setting X equal to I captures efficiency savings equal to the rate of inflation.

12. X does not provide the only incentive for Pacific and GTE to invest and spend wisely, while an X that is too high may harm investment and wise spending.

13. We are not considering here whether to convert Pacific and GTE to nondominant status, nor are we considering elimination of rate regulation.

14. The observation approach initially granted pricing flexibility and monitored results.

15. Under the observation approach, AT&T was never subjected to such critical NRF elements as sharing, earnings caps, earnings floors, annual price cap indexing, productivity factors, stretch factors, annual reviews of depreciation rates, and Z factor adjustments, despite our concerns about AT&T's market power.

16. The observation approach and NRF are different regulatory structures, the NRF components under consideration here did not apply to AT&T, and the two approaches are sufficiently different that the same measures used to execute the observation approach do not apply here.

17. Barriers to entry are no higher and universal service is no less a factor now than in 1995 (when we first suspended I-X), and parties make no reasonable allegations of change in these factors which require any result different than continuing the suspension of I-X.

18. A sharing mechanism reduces the strong efficiency incentives in pure price cap regulation.

19. D.89-10-031 adopted sharing as insurance against the potential of a poorly operating NRF price adjustment formula, and as a way to increase the sustainability of the NRF price adjustment formula against challenge.

20. Dramatic changes in telecommunications markets are underway, including rapid changes in technology, with the technological dynamic occurring at an accelerating pace with no sign of abating.

21. Sharing distorts incentives for utilities to invest and be efficient.

22. Elimination of sharing places performance risk on shareholders.

23. Sharing changes the forecast of present and future cash flows, and introduces greater uncertainty into the present and future stream of returns, and thereby changes the economic analysis used in making operating and investment decisions.

24. Sharing results in asymmetric treatment between firms, since potential competitors of Pacific and GTE make operating and investment decisions without profit constraints, while Pacific and GTE have a sharing-imposed profit constraint.

25. Sharing compromises the efficiency of the competitive process itself.

26. Sharing has not occurred in the last 8 years for Pacific, has not occurred since 1993 for GTE, has provided minimal direct benefits in the form of lower rates, and has not been a significant source of controversy.

27. Experience with NRF since 1990 reduces, if not eliminates, the need for the insurance provided by sharing.

28. Given the billions of dollars at stake in the Information Age, the risk of bad operating or investment decisions (including simple delay), or the risk of possibly excluding Pacific and GTE as participants on equal footing with competitors, is greater than the need to retain sharing as insurance.

29. Given the rapid changes in technology and increased risks, it is no longer reasonable to force ratepayers to share in the risk of operating and investment decisions.

30. Because executives outside California (e.g., within SBC Communications, Inc.) competing in a global economy will make crucial operating and investment decisions affecting California's future, it is increasingly important that the economic analyses they assess, and incentives they face, are without any potential distortions, thereby ensuring that California has at least an equal opportunity to enjoy the benefits of those decisions compared to other states and nations competing for those dollars.

31. The mechanics of how the Commission establishes just and reasonable rates must now recognize that circumstances and markets are different than when sharing was instituted as insurance in 1989.

32. Sharing must be suspended based on changes in the market, the importance of providing an undistorted basis for financial analysis, the need to provide correct economic incentives, the need to protect ratepayers from sharing in risky or bad operating and investment decisions, and the need to place the full risk of those decisions on shareholders.

33. NRF without sharing results in just and reasonable rates.

34. The level of competition need not be assessed before making the changes adopted herein because the Commission continues to regulate rates for Category 1 services, and rate ceilings and floors for Category 2 services, and will continue to observe results through NRF monitoring reports for market abuses and reporting of rates of return.

35. No party alleges that the annual earnings advice letters filed by Pacific and GTE violate Rule 1.

36. NRF removes the Commission from detailed oversight of operations, streamlines regulation, gives utilities new financial incentives, and permits utilities to earn higher rates of return.

37. Earnings advice letters have been, and are, reviewed primarily for accuracy, and no inaccuracy has been found that warranted an audit.

38. No protest of a sharable earnings advice letter has resulted in the conversion of the advice letter to an application for more formal and thorough review.

39. No review of, or protest to, a sharable earnings advice letter has ever led to sharing when the utility first proposed no sharing.

40. No specific new allegations about earnings advice letters are presented here to justify an audit.

41. An audit for reasonableness would essentially be the same as doing a general rate case review, which is contrary to the concept and purpose of NRF.

42. Neither NRF experience since 1990, nor any contentions made in this proceeding, justify an audit of past sharable earnings advice letters to test either the reasonableness or accuracy of the results, beyond the audit to be conducted pursuant to D.94-06-011 and D.96-05-036.

43. The milestone approach (whereby decisions herein would be tied to the outcome of other proceedings) complicates our regulatory process, is inconsistent with our overall strategy to reduce regulation as markets open, and, while a seemingly reasonable approach, may not prove reasonable in fact since the complexity and multiplicity of regulatory proceedings now underway continue to stretch the managerial capabilities of the Commission.

44. The $53 million reduction already in GTE rates, as provided by settlement approved in D.93-09-038, is neither changed by suspension of sharing nor any other decision made in this NRF review.

45. Depreciation reviews and approvals are largely necessary only in connection with sharing.

46. Depreciation reviews and approvals treat Pacific and GTE asymmetrically compared to their competitors.

47. Harm to competition can occur when investment decisions are skewed as a result of some firms using regulated depreciation rates (if not equivalent to market depreciation rates) for analyses while other firms do not.

48. Depreciation reviews and approvals subject Pacific and GTE to administrative costs not required of their CLC competitors.

49. Eliminating depreciation reviews and approvals places financial responsibility for the success of investments on shareholders rather than ratepayers.

50. Without Commission depreciation reviews and approvals, Pacific and GTE will set their own depreciation rates and accruals, with the attendant risks and rewards of those decisions, and there will be no stranded cost problem for new investments or depreciation rates from today forward.

51. Eliminating, rather than suspending, depreciation reviews and approvals permanently forecloses any potential franchise impact claim covering investments and depreciation from today forward.

52. The scope of this proceeding does not include resolution of historic stranded costs.

53. Absent the grant of an application for recovery of truly extraordinary depreciation expenses, telecommunications rates to customers will be unaffected by the depreciation methodology and rates chosen by Pacific and GTE, with shareholders, not ratepayers, taking the risk of changes in depreciation methodology and rates.

54. The Commission generally seeks to reduce the regulatory burden on utilities and the Commission, and no compelling reason is presented here to justify a new depreciation report served on ORA by Pacific and GTE.

55. Consistent with removing the upper and lower bounds on earnings, elimination of Z factor recovery shifts more risk to shareholders.

56. Z factor recovery treats Pacific and GTE asymmetrically compared to their competitors.

57. Eliminating new Z factor recovery simplifies the regulatory process.

58. Potentially significant exogenous cost increases or decreases remain in the areas of (1) matters mandated by the Commission and (2) changes in total intrastate cost recovery resulting from changes between federal and state jurisdictions.

59. Advice letter recovery of LE costs promotes low cost, efficient regulation, whereas an application for LE factor recovery would set in motion a more formal and complicated process that is unnecessary for matters which should be of limited, or no, controversy.

60. Elimination of the Z factor mechanism, and replacement with an LE factor mechanism, is essentially a further narrowing and simplification of the existing process for considering exogenous cost recovery, and neither requires establishing new criteria, nor abandoning existing criteria, for the consideration of those requests.

61. Prior Z factor treatment has increased rates in some instances with offsetting rate decreases expected in later years.

62. Pacific proposes a PBOP expense reduction of $99.5 million annually effective January 1, 1999.

63. Z factors currently in review, or for which implementation is not complete, and which will be allowed phased out Z factor treatment, are: (1) $200 to $500 capital to expense shift; (2) merger refund; (3) gain on sale of land; (4) other billing and collections jurisdictional cost shift; (5) property tax OII; (6) PBOPs (i.e., $99.5 million Pacific reduction and $24.025 million GTE reduction); and (7) GTE CNEP costs (i.e., $12.656 million reduction).

64. Freezing basic residential rates would prejudge the outcome of pending and future proceedings; needlessly constrain Commission options for meeting all necessary goals in other proceedings; require unacceptable delays of up to three years before fully implementing other decisions; or favor one NRF goal, or one class of customer, over others without full consideration of all factors.

65. No issues require immediate issuance of an OII or OIR, and parties should address potential NRF issues in comments on the Business Plan.

Conclusions of Law

1. The I-X term of the price adjustment formula should continue to be suspended (i.e., the productivity plus stretch factor (X) should continue to be set equal to inflation (I)) until reinstated, permanently eliminated or otherwise modified as a result of the next, or a future, NRF review.

2. Permanent elimination of the I-X term should be considered during the next NRF review.

3. Sharing should be suspended based on changes in the market, the importance of providing an undistorted basis for financial analysis, the need to provide correct economic incentives, the need to protect ratepayers from sharing in risky or bad operating and investment decisions, and the need to place the full risk of those decisions on shareholders.

4. Sharing (including its component and related elements of earnings floors; earnings caps; market-based, benchmark and ceiling rates of return; trigger mechanism) should be suspended but should not be eliminated, while earnings reviews should continue (with the continued filing every April 1 of annual earnings reports) for the purpose of monitoring rates of return, until reinstated, permanently eliminated or otherwise modified as a result of the next or a future, NRF review.

5. Permanent elimination of sharing should be considered during the next NRF review.

6. The Commission should not adopt a milestone approach to modifying NRF, whereby decisions here are tied to the outcomes in other proceedings.

7. The $53 million reduction already in GTE rates, as provided by settlement approved in D.93-09-038, should remain in GTE rates.

8. Depreciation reviews and approvals should be permanently eliminated.

9. Given the continued suspension of I-X, suspension of sharing, and permanent elimination of depreciation reviews and approvals, Pacific and GTE should continuously evaluate mitigation of any reserve deficiency.

10. In any application filed to seek recovery of an alleged franchise impact claim (filed pursuant to Ordering Paragraph 7 of D.96-09-089), applicant should include information on its continuous evaluation of measures to mitigate the reserve deficiency, including any and all efforts considered to mitigate the problem (whether or not implemented), the efforts that have been implemented, and the success of implemented measures.

11. With the permanent elimination of Commission depreciation reviews and approvals, the Commission should not require the use of economic lives, ELG, or any other method of depreciation.

12. An application for recovery of truly extraordinary depreciation expenses would need to be particularly compelling because the Commission has authorized lives close to the lives requested by Pacific and GTE since implementation of NRF in 1990 (in some cases authorizing shorter lives), and because this decision shifts the risks and rewards of depreciation decisions to management and shareholders as Pacific and GTE have requested.

13. Consideration of Z factor adjustments currently under review should continue until the pending issues are decided and implementation completed, new Z factor adjustments should be eliminated, and a streamlined advice letter process for consideration of limited exogenous cost recovery in two narrow areas should be adopted.

14. Exogenous cost recovery in the LE factor mechanism should be limited to cost increases or decreases (1) resulting from matters mandated by the Commission and (2) as a result of changes in total intrastate cost recovery resulting from changes between federal state jurisdictions.

15. To further streamline the LE factor adjustment process, rate changes for Commission mandated cost changes should be limited to only those costs for which the change is authorized in the underlying Commission decision.

16. The criteria established in D.94-06-011 for Z factor recovery should apply to LE factor recovery.

17. Pacific's next price cap advice letter should include a reduction in rates of $99.5 million annually for PBOPs, and GTE's next price cap advice letter should include a reduction of $24.025 million annually for PBOPs and $12.656 million annually for CNEP costs, and, except for Pacific's $99.5 million reduction and GTE's $24.025 million reduction, both Pacific and GTE should discontinue seeking Z factor recovery for PBOPs beginning with their next advice letter filings.

18. The rate cap on Pacific's and GTE's basic residential services should be continued just as all NRF rate caps and floors are continued, subject to adjustment consistent with the outcome of other Commission proceedings.

19. NRF is a transitional regulatory structure and the Commission should not constrain its implementation of NRF, or proper resolution of other proceedings, by freezing residential rates.

20. An application by Pacific to increase its basic residential rates would need to be particularly compelling since we adopt Pacific's proposal to cap Pacific's basic residential service rates just as we retain all caps, subject to adjustment based on the outcome of other proceedings.

21. Rates resulting from the decisions made herein are just and reasonable.

22. No issues remain for consideration in this proceeding, and this proceeding should be closed.

23. No other NRF issues justify immediate issuance of another OIR or OII.

24. The next NRF review should be initiated by OIR.

25. To facilitate drafting the next NRF OIR, parties and the public should serve a document by September 1, 2000, discussing anything relevant for the Commission's consideration in drafting the OIR, and stating proposed issues, with replies to the document served within 15 days.

26. TURN and GI/LIF may each file a request for an award of intervenor compensation within 60 days of today.

27. This order should be effective immediately, allowing NRF program improvements adopted herein to be implemented without delay.

FINAL ORDER

IT IS ORDERED that:

1. The new regulatory framework (NRF) program, and the price adjustment formula, for Pacific Bell (Pacific) and GTE California, Incorporated (GTE) are amended as follows:

   a. The suspension of the inflation minus productivity plus stretch (I-X) component of the price adjustment formula ordered in Decision (D.) 95-12-052 (63 CPUC 2d 377) shall continue;

   b. Sharing shall be suspended (including, for the purpose of implementing sharing and as applicable to each utility, calculations relative to earnings floors; earnings caps; market-based, benchmark and ceiling rates of return; trigger mechanism) effective January 1, 1999;

   c. A price cap advice letter shall continue to be filed every April 1 for the purpose of reporting rates or return, including, only for the purpose of a reference, the floor, market-based, benchmark and ceiling rates of return last found reasonable for each company;

   d. Annual depreciation reviews and approvals shall be permanently eliminated effective January 1, 1999;

e. Z factor recovery shall be continued until fully implemented only for the following adjustments: (1) $200 to $500 capital to expense shift, (2) merger refund authorized in D. 97-03-067, (3) gain on sale of land, (4) other billing and collections jurisdictional cost shift, (5) results of Order Instituting Investigation 92-03-052 regarding property taxes, (6) a $99.5 million annual reduction in Pacific's rates for post retirement benefits other than pensions (PBOP) and a $24.025 million annual reduction in GTE's rates for PBOPs, and (7) a $12.656 million reduction in GTE's customer notification and education program costs;

f. All other Z factor recovery and adjustments shall be permanently eliminated effective immediately;

g. Advice letters shall be filed every October 1 requesting limited exogenous (LE) cost recovery for cost increases or decreases resulting from (1) items mandated by the Commission and (2) changes in total intrastate cost recovery resulting from changes between federal and state jurisdictions; alternatively, the advice letter shall state that there are no such adjustments;

h. LE factor recovery shall be allowed for Commission mandated cost changes only when authorized in the underlying Commission decision; and

i. Criteria for LE factor recovery shall be the criteria established for Z factor recovery in D.94-06-011.

2. Any application filed pursuant to Ordering Paragraph 7 of D.96-09-089 shall contain information on applicant's continuous evaluation of measures to mitigate the reserve deficiency, including any and all efforts considered to mitigate the problem (whether or not implemented), efforts that have been implemented, and the success of implemented measures.

3. Any other requests by Pacific and GTE to change rates for services in Category 1, or to change rate ceilings or rate floors for services in Category 2, shall continue to require Commission approval pursuant to applicable rules and procedures.

4. Parties and the public may serve a document to facilitate the development of the Commission's next Order Instituting Rulemaking (OIR) to review the NRF. The document shall be served no later than September 1, 2000 on the Commissioners, Executive Director, Director of the Telecommunications Division, Chief Administrative Law Judge, and the service list for this proceeding. The document shall discuss anything relevant for the Commission's consideration in drafting the OIR, and shall state proposed issues. Replies shall be served on the same persons and public commenters within 15 days of service of the document.

5. The Utility Reform Network, the Greenlining Institute and the Latino Issues Forum may file a request for an award of intervenor compensation. Such request, if made, shall be filed within 60 days of today. In addition to any other requirements of the Public Utilities Code or Commission decision, the request, if made, shall comply with the requirements stated in the June 19, 1998 Preliminary Ruling of the Administrative Law Judge.

6. This proceeding is closed.

This order is effective today.

Dated October 8, 1998, at Laguna Hills, California.

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

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