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Decision 96-03-020 March 13, 1996

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion Into Competition for Local Exchange Service.	R.95-04-043 (Filed April 26, 1995)
Order Instituting Investigation on the Commission's Own Motion into Competition for Local Exchange Service.	I.95-04-044 (Filed April 26, 1995)

(See Appendix A for appearances.)

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O P I N I O N

I. Introduction

By this decision, we institute the resale of local exchange service by competitive local carriers (CLCs) within the market territories of Pacific Bell (Pacific) and GTE California (GTEC) effective March 31, 1996. Pacific and GTEC will be required to offer a broad range of services for resale. We adopt wholesale rates for these services that reflect avoided retail costs. For Pacific and GTEC, adopted wholesale rates will generally reflect a 17% and a 12% reduction, respectively, below current retail rates (with certain exceptions noted in the order below). The interim rules adopted in this decision also cover the issues designated for evidentiary hearings in Phase II of this proceeding, namely, local exchange carrier (LEC) and CLC retail pricing flexibility policies, rating area consistency, and recovery of the costs of implementing local exchange competition.

Consistent with our adopted timetable for progressing toward a fully competitive telecommunications market, today's decision will enable the competitive resale of the basic exchange service of Pacific and GTEC to commence effective March 31, 1996. Today's decision will help us meet the requirement of Public Utilities (PU) Code § 709.5 that we "ensure that competition in telecommunications markets is fair and that the state's universal service policy is observed." Meeting this mandate involves the close coordination of this rulemaking and investigation with companion proceedings including Open Access and Network Architecture Development (OANAD), Universal Service, and the New Regulatory Framework (NRF). The rules adopted in today's decision are interim in nature and designed to be modified, as we progress past various milestones in this as well as in companion proceedings.

In the meantime, the measures we adopt for interim purposes are based on the best information available to us today. In the interests of maintaining California's leadership in creating a competitive telecommunications market, we have adopted a schedule that initiates resale competition now even though the pathway toward a fully competitive market will require additional work. Accordingly, throughout this decision, we lay out remaining tasks to be completed in this as well as other proceedings in order to make progress toward a fully competitive market.

As we discuss below, although the rules we adopt are intended to ultimately lead to a fully competitive market, the incumbent LECs will likely not lose their market power overnight. Accordingly, at least during the initial transition to a competitive marketplace, our interim rules must retain certain restrictions on the LECs in recognition of their market dominance. We intend to continue monitoring the progress of competition on an ongoing basis and will consider modifying regulations for either the LECs or the CLCs when justified to allow the forces of competition to work. It would be irresponsible, however, to prematurely remove regulatory safeguards which are in place to ensure that carriers cannot abuse their market power to the detriment of the public interest.

II. Procedural Background

By issuance of Decision (D.) 94-12-053, we formally adopted a procedural plan to open all telecommunications markets within California to competition by January 1, 1997. As part of that plan, we instituted R.95-04-043/I.95-04-044 on April 26, 1995 in which interim rules were proposed for local exchange competition within the service territories of Pacific and GTEC. The proposed rules included provisions for interim number portability (INP).

In July 1995, we issued D.95-07-054 which set forth our initial rules for the competitive provision of local exchange service within the territories of Pacific and GTEC. As prescribed by D.95-07-054, entry into the local exchange service market for facilities-based CLCs was authorized to begin January 1, 1996 and for CLC resellers of local exchange service by March 1, 1996. D.95-07-054 also identified issues for which evidentiary hearings would be held, and directed the administrative law judge (ALJ) to schedule them.

By ruling dated August 18, 1995, the assigned ALJ adopted a procedural schedule establishing three phases for the proceeding. The ALJ's adopted schedule called for INP issues to be divided between Phase I and Phase II of the proceeding.

Phase I was designated to cover issues relating to the institution of facilities-based competition effective January 1, 1996. We adopted additional interim rules on December 20, 1995, in D.95-12-056 governing interconnection and related matters in Phase I. In D.95-12-057, we concurrently approved an initial group of CLC petitions to engage in facilities-based competition. Phase II was designated to cover hearing issues relating to institution of bundled resale competition to become effective March 1, 1996, as well as LEC/CLC retail pricing flexibility, NXX rating area consistency, and implementation costs.[1] In addition to the issues which were designated for evidentiary hearings, Phase II was also designated to address the remaining rulemaking issues which were set forth in the proposed interim rules issued

1 The issues of interim number portability pricing and franchise impacts, originally Phase II issues, were rescheduled to be decided in separate decisions. On January 8, 1996, a proposed ALJ Decision was released addressing interim number portability pricing. A decision on franchise impacts issues is scheduled for Commission action in the spring of 1996.

April 26, 1995 but which were not resolved in our Phase I decision (D.95-12-056). As determined in D.95-07-054, these rulemaking issues were addressed by written comment only and were not the subject of evidentiary hearings. In this decision, we shall address the issue of resale restrictions which was subject to written comments because of its close linkage to resale rates which was designated as a hearing issue.[2] We addressed the remaining Phase II nonhearing issues in a decision on February 23, 1996.

Phase II evidentiary hearings were held from October 23 through November 21, 1995. Testimony on Phase II issues was served on October 9, 1995, by Pacific, GTEC, the Commission's Division of Ratepayer Advocates (DRA), MCI Telecommunications Corp. (MCI), AT&T Communications of California, Inc. (AT&T), Citizens Utilities (Citizens), Public Advocates,[3] LDDS World Com (LDDS); California Cable Television Association (CCTA); Teleport Communications Group (TCG) and Toward Utility Rate Normalization (TURN). The California Telecommunications Coalition (Coalition) filed a single brief in support of its members' positions. In the case of wholesale rate issues, separate briefs were filed by various Coalition members. The members of the Coalition joining in the brief in addition to those serving testimony include California Association of Long Distance Telephone Companies; California Payphone Association; Time Warner AxS of California, L.P. Opening briefs were filed

2 Various parties filed written comments on resale issues and/or briefs who did not offer testimony. We have reviewed all parties' filed comments, and briefs and taken them into account as appropriate.

3 Public Advocates represents the Southern Christian Leadership Conference, National Council of La Raza, Korean Youth and Community Center, Filipinos for Affirmative Action, and Filipino Civil Rights Advocates.

December 11, 1995, and reply briefs were filed December 18, 1995. This decision disposes of all Phase II hearing issues.

III. Competitive Resale of Local Exchange Service

A. Introduction

In D.95-07-054, we stated that resale of basic services by the LECs is key to creating a truly competitive local exchange market,[4] and required Pacific and GTEC to provide basic service for resale by March 1, 1996. To implement this requirement, we solicited input regarding the following topics: (1) The appropriate interim rate for wholesale bundled local exchange services and (2) How to reconcile rates other than existing retail rates with the Commission's imputation policies expressed in IRD.

B. Parties' Positions

Pacific

On an interim basis, Pacific proposes reselling basic access service priced at the current retail rate for its 1MB basic business service, or $10.32/month. Pacific believes the $10.32 rate will allow Pacific to recover its costs, is low enough to attract entry by resellers, and complies with the Commission's order that the NRF LECs must offer resale of basic service by March 1, 1996.

Pacific would tariff "basic service" for resale as an access line, with no packaged local usage. The resale access line (1RL) would be available throughout Pacific's territory, could be purchased as a single line or multi-line group, and could be resold by the CLC to either business or residential customers. Included with the 1RL would be the telephone number, dial tone, touch-tone, a copy of white and yellow pages, the ability to place/receive

4 D.95-07-054, mimeo, p. 31.

calls, the ability to place 10XXX calls, and access to 911, operator, 800, and 900 services. Pacific would also include with its 1RL a listing in the white pages, yellow pages, and Pacific's 411 data base. Custom calling features would be available through Pacific's already approved wholesale tariff and could be packaged with 1RL by resellers. Also, blocking of 900 and 976 calls would be provided free to the residential customers of resellers. Excluded from 1RL basic service would be local usage, which Pacific would sell separately, billed at its current retail rates.

Pacific proposes that existing resale restrictions on any of its local exchange services be maintained. Pacific argues that CLCs will have ample opportunity to compete in the resale market through the 1 RL tariff offering without the lifting of resale restrictions on all LEC local exchange services. Pacific believes that the lifting of resale restrictions will cause resellers to arbitrage subsidized services and will undermine the LECs' ability to earn a fair return. Pacific is particularly concerned that large IECs will be able to offer customers "one-stop shopping" whereby all the customer's traffic could be carried by the IEC. Pacific believes that the IECs intend to use the lure of cheap resale rates for local exchange service to also capture the more lucrative toll market. To mitigate the risk that IECs will be able to take away a significant share of Pacific's toll customers, Pacific proposes restricting CLCs and IECs who have over 5% of the presubscribed access lines from jointly marketing interLATA services and resold local services obtained from the LEC. Without this restriction, Pacific states it would be at a competitive disadvantage due to its inability to package inter- and intraLATA services. Pacific's proposed joint marketing restriction would remain in place until Pacific was permitted into the interLATA market. GTEC proposes that no CLC should be allowed to bundle interLATA services with intraLATA services as long as GTEC is excluded from doing the same.

Pacific intends for all services provided in conjunction with its resale service to be priced at "compensatory rates." In practice, this would mean that usage would be resold at currently tariffed or "retail" rates; Directory Assistance would be resold on a per-call, retail basis, without the allowances Pacific is required to give its own retail customers; and Operator service would be charged on a per-call basis. Tariffed volume discounts would not be available for toll resold to customers since Pacific states that its billing system cannot track toll usage resold to specific end users of the reseller.

On a longer-term basis, Pacific proposes pricing its wholesale service based on geographically deaveraged TSLRIC. Pacific strongly opposes setting wholesale prices "below cost," arguing that to do so would be inconsistent with economically efficient pricing; would be confiscatory and financially harmful to Pacific; and would be inconsistent with the Commission's own policy that rates be set at or above cost. Pacific recommends that all LEC services, including resold basic service, be priced above cost in order to cover joint and common costs such as overhead costs.

Pacific states that applying standard imputation rules to subsidized service will result in negative contribution, where the price floor of the retail service after imputation may be lower that its incremental cost. Pacific believes this issue can be solved through universal service funding that is made available to all providers.

<u>GTEC</u>

GTEC recommends a resale pricing policy that it calls the "efficient component pricing rule" (ECPR). Under ECPR, GTEC's resale price would equal GTEC's average incremental cost, including all pertinent incremental opportunity costs. Among the opportunity costs included in GTEC's ECPR are the profits (i.e., contribution) that GTEC loses by being forced to sell services to its rivals who use the purchased inputs to take away business from GTEC. For

example, competitors might package their own toll service with basic exchange service purchased from GTEC, causing GTEC to lose the contribution embedded in the toll service it previously provided.

GTEC justifies its ECPR on several grounds. First, the Commission adopted a "contribution formula" in the IRD decision which GTEC views as similar to its ECPR formula. Second, GTEC states that a competitor in a competitive market will charge a price for an input to recover the same level of contribution which the competitor would have received if it had used the input to sell the final product itself. Third, ECPR is economically efficient since it reflects GTEC's economic costs. Finally, GTEC argues ECPR is fair since it preserves the level of contribution irrespective of whether GTEC sells the product wholesale to the CLCs or retail to the end user.

GTEC proposes a basic exchange wholesale rate of $25.92/month which could be resold by the CLC to either business or residential customers. GTEC says this rate reflects ECPR since it is the sum of the LRIC for basic business service plus a contribution to margin, and excludes all costs associated with LEC retail activities. Included in the wholesale price is the contribution from anticipated losses in intraLATA toll if a CLC provides its own intraLATA toll services via 10XXX. However, if the CLC end user uses GTEC's intraLATA toll service, GTEC will provide a credit to the CLC, based on 9 cents per intraLATA toll MOU, not to exceed $7/month per pre-subscribed line, which results in a wholesale basic exchange rate as low as $18.92/month. The intent of the credit is avoid double recovery of contribution to margin from toll services.

<u>**The Coalition**</u>

The Coalition argues that all existing resale restrictions should be lifted if viable resale competition is to

occur. The Coalition proposes that at least the following services not be restricted:

1. Residential 1FR and 1MR service[5]
2. All vertical features
3. Pacific's CENTREX and GTEC's CENTRANET services
4. ISDN, both primary rate interface (PRI) and basic rate interface (BRI)
5. All bulk-purchase intraLATA toll offerings, whether they be tariffed or offered pursuant to contract
6. All private line services[6]

The members of the Coalition do not have a consensus position on issue of wholesale rates of LEC services. Instead, the following members of the Coalition presented separate positions on this topic. We shall review each position below.

<u>AT&T and MCI (AT&T/MCI)</u>

AT&T/MCI recommend that the Commission adopt interim wholesale rates equal to the LECs' current tariffed rates less "retail costs" the LECs avoid by selling the services wholesale to CLCs. According to AT&T/MCI, the retail costs that LECs avoid by selling wholesale to CLCs amount to 28% of Pacific's tariffed rates and 24% of GTEC's tariffed rates. These across-the-board percentages were the result of an analysis performed by AT&T

5 The Coalition agrees, however, that the existing restriction on selling 1FR service to business customers is appropriate if the Commission believes that 1FR rates are below cost.

6 This includes digital (DS0, DS1 and DS3) and voice-grade private lines, fractional T1.5, basic rate digital services (2.4 - 64 Kbps), frame relay service, packet switched service, switched multi-megabit data service (SMDS), switched services, foreign exchange (FX) lines and off-premise extensions.

witness Selwyn (Exh. 45) using accounting data reported on Pacific's and GTEC's Form M's filed with the FCC. From this data, AT&T identified costs attributable to retailing functions such as billing and collection, sales and marketing, and processing end-user service orders. Once TSLRIC studies become available, AT&T/MCI support pricing LEC wholesale services at their TSLRIC with no additional mark-up.

AT&T/MCI believe that wholesale rates proposed by Pacific and GTEC generally exceed what the LECs charge to their own end users, thus making it extremely difficult for resellers to compete for customers. For instance, GTEC's proposed wholesale monthly rate of $25.92 (plus usage) exceeds GTEC's $10.00 for 1MR, $17.25 for 1FR, and $19.22 for 1MB. Similarly, Pacific's 1RL rate of $10.32/month (plus usage) exceeds Pacific's $6.00 for 1MR, and, in most circumstances probably exceeds Pacific's $11.25 for 1FR if usage charges are taken into account. These comparisons do not include the additional charges the CLCs will have to pay for services the LECs provide free to their own customers, such as the five free monthly directory assistance (DA) calls Pacific provides to its residential customers and two free DA calls Pacific provides to its business customers; nor do the comparisons include the mark-up the CLCs must add to recover their own internal costs.

AT&T/MCI also claim the LECs' proposed wholesale rates would allow the LECs to make more money from CLCs than from their own retail customers because the LECs would charge the CLCs at least as much as the LECs' own end users without incurring any of the retail-related costs. In addition, the LECs will continue to receive direct subsidies such as the EUCL charge and interstate carrier common line charge (CCL), while the CLCs would bear much of the associated costs.

AT&T/MCI claim that pricing LEC wholesale offerings at the same level as LEC retail offerings, without regard to avoidable retailing costs would create an anticompetitive price squeeze, and

would prohibit the CLCs from competing against the LECs on the basis of the retailing efficiencies. Conversely, if LEC wholesale pricing excludes avoidable retail costs, resellers will have an opportunity to substitute their retail functions for those otherwise provided by the incumbent LEC, and to pass on any efficiencies in the form of lower prices. AT&T/MCI claim that their proposed wholesale rates maintain current levels of contribution built into LEC retail prices, since the tariffed rate is only reduced by avoided retail costs, leaving intact any built-in contribution.

AT&T/MCI also state that the wholesale services the LECs will sell to the CLCs will be inferior to the service the LECs provide to their own end users in five different areas. Because of the inferior service, AT&T/MCI believe that CLCs will be at a competitive disadvantage, and recommend that the LECs be required to discount the wholesale service by 2% for each of the five identified deficiencies until the problems are resolved. The five areas of deficiencies are: (1) Pre-provisioning ordering; (2) service ordering and provisioning; (3) on-line access to local listing databases and line information databases; (4) trouble reporting and resolution; and (5) access to local usage data.[7]

AT&T/MCI recommend that the Commission allow the resale of LEC residential flat-rate (1FR) and measured-rate service (1MR). According to AT&T/MCI, even if residential rates are currently below cost, the LECs are no worse off by wholesaling 1FR and 1MR to CLCs since the wholesale rate subtracts only the LECs avoidable costs from the retail price. To the extent the Commission is concerned that lower priced residential services will be resold to

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7 For definitions of the deficiencies, see the Coalition's November 27, 1995 Phase II Reply Comments, pp. 14-15.

business customers, placing LECs at a disadvantage, AT&T/MCI believe that a narrow and temporary limitation can be imposed on the resale of residential services to business customers until cost-based rates can be set.

AT&T/MCI also recommend that resellers be allowed to purchase vertical features and intraLATA toll service at the tariff or contract rates Pacific and GTEC offer to their largest customers. AT&T/MCI state that the LECs have entered into hundreds of contracts with large end-users for vertical features and intraLATA toll services at prices below tariffed rates. AT&T/MCI believe that it would be discriminatory for the LECs to deny a CLC reseller, whose volumes may exceed those of large end-users, the same bulk-purchase prices offered to end users. AT&T/MCI state that CLC resellers should be able, as the LECs' large end users are, to receive toll discounts based upon a CLC's total toll usage which AT&T/MCI state can be tracked by the LECs' billing systems.

Finally, AT&T/MCI recommend that the LECs should be ordered to wholesale all of their services, including ISDN and Centrex. For those services for which Pacific and GTEC have contracting authority, they should be required to enter into contracts with reseller CLCs with comparable terms and conditions as those offered to the LECs' end users.

Sprint Communications Company,
TCG; Time Warner AxS of California (TW); MFS
Intelenet of California (MFS)[8] and CCTA

According to Sprint, TCG, TW, CCTA, and MFS,[9] the ultimate success of local competition hinges on robust facilities-based competition. Once facilities-based competition is fully in place, they believe that resellers will be able to obtain discounts from the many competing facilities-based providers and offer vigorous competition to incumbent LECs. Sprint, TCG, TW, and MFS argue that setting LEC wholesale rates at large wholesale discounts below actual costs would give CLC resellers an unfair advantage and discourage investment by facilities-based CLCs, impeding the development of facilities-based competition.

Sprint, TCG, TW, and MFS oppose the interim discounted wholesale prices recommended by AT&T/MCI, arguing that AT&T/MCI have not properly supported their proposal. TCG adds that AT&T/MCIs' proposal to discount Pacific's and GTEC's wholesale rates by an additional 10% until certain interfaces are provided by the two LECs is arbitrary. Instead, TCG believes that the LEC interfaces should be made available at prices that reflect the cost of providing the interfaces. TCG notes that when AT&T and Sprint provide services to resellers, they do not discount the price of their wholesale offerings to compensate their resale customers for their lack of access to Sprint or AT&T internal databases.

8 Sprint, TCG, TW, CCTA, and MFS each filed separate briefs that stated similar positions on the issue of LEC resale rates.

9 MFS's brief included a discussion and recommendations regarding access to rights of way. That issue was set for written comment only pursuant to the ALJ Ruling of August 18, 1995, and will not be addressed by this decision.

To the extent LECs provide discounted service to reseller CLCs, TW and MFS believe the discounts should be negotiated between the LEC and CLC. If the Commission is determined to set a wholesale discount, TCG states that it should be no greater than the LEC's clearly demonstrated avoided cost. Finally, TCG recommends removal of all restrictions on the resale of residential flat rated service, except to restrict resale of residential services to nonresidential customers if the residential rates are not compensatory.

LDDS

LDDS recommends that LECs be required to offer a "wholesale local network platform" (WLNP) which it defines as an end-to-end network configuration that can be purchased and re-offered to customers. The WLNP would include the provision of local loops, switching, call termination, vertical services, interexchange access, and any other operational inputs necessary to make resold service appear seamless to the end user. Carriers purchasing the WLNP would be able to use the platform to provide innovative retail local services, offering both basic service and vertical features, and reselling access to IECs. The WLNP could also be combined with other services to create full service offerings in competition with the LECs' own offerings.

LDDS sees many benefits from requiring the LECs to offer a WLNP. First, full-service retail packages would be available from many providers, not just those who own local network facilities. Second, customers in areas in which investment in local facilities is uneconomic would have the same choices that would be available to customers in areas where such investment may be justified. Third, with WLNP, local resale competition could proceed immediately, everywhere, and for all customers without the need to await the construction of new local facilities. Fourth, WLNP would give IECs the same opportunity to provide local service to their customers over the existing LEC

network that LECs will have to provide long distance service to their customers over existing IEC networks. Finally, the availability of a WLNP would promote the construction of new local networks by allowing new entrants to develop a customer base and build facilities gradually where it is efficient to do so.

LDDS states that carriers purchasing from the WLNP should be able to resell it at any price they choose. LDDS believes that the LECs should be indifferent to this proposal as long as they receive full cost of the WLNP.

LDDS believes that LECs should be required to provide the necessary data to allow the WLNP users to bill IECs for access. If the current carrier access billing systems (CABS) do not permit the LECs to make the data available, then LDDS believes the LECs should make the necessary system modifications to make such data available. If the LEC demonstrates that it will take time to revise its CABS billing system, LDDS suggests on an interim basis, the LEC could adjust its charges to the CLC by a surrogate approximating the access revenues the LEC is receiving from that CLC's customers, based on the average usage per line.

LDDS believes that WLNP must be priced at TSLRIC as soon as possible so that competing carriers using the local network face the same underlying cost structure as do the LECs. Until TSLRIC cost studies can be completed, LDDS supports using the avoided cost approach proposed by AT&T/MCI.

LDDS finds fault with the concern of some parties that facilities-based competition will be delayed if wholesale local service is priced at rates lower than the LECs' retail rates. LDDS believes that the experience of the long distance industry belies this argument since discounted wholesale long distance service has existed concurrently with the construction of four nationwide and many regional IEC networks.

Citizens

Citizens opposes the wholesale prices proposed by Pacific and GTEC. Citizens believes that the proposed rates inappropriately include retail costs that are avoided when providing the services at wholesale. Citizens also opposes using AT&T's proposed across-the-board flat percentage discount to Pacific's and GTEC's "retail" prices. Instead, Citizens proposes a formula which it believes will assure that the LECs recover their legitimate costs. Citizens' formula would make the wholesale price equal to the retail price less avoided costs plus any specific added costs incurred for a true co-carrier relationship.

Citizens supports requiring LECs to provide bundled services to CLCs at wholesale prices with the exception that: (1) no resale should be required for services which the Commission has mandated prices to be set below TSLRIC or DEC, whichever is lower, for social policy reasons; and (2) the resale of switched access lines for switched access purposes should be prohibited without payment of applicable switched access charges.

TURN

TURN supports the avoided cost wholesale discount proposed by AT&T of 28% for Pacific and 24% for GTEC. TURN also supports AT&T's recommendation for an additional 2% discount for each area for which LEC provisioning is unsatisfactory. If the Commission determines that the LEC's avoided costs are less than what AT&T has found, TURN recommends that the Commission adopt a discount based on its own calculation of avoided costs, plus a discount for each of the five areas of unsatisfactory provisioning identified by AT&T. TURN suggests that a discount of up to 25% would be appropriate.

TURN is concerned that affordable flat rate service will not be available for resale. According to TURN, this is a popular service, and the LECs should be required to wholesale flat rate service with a cost-based discount.

<u>DRA</u>

Until costs are determined in the OANAD or Universal Service proceedings, DRA recommends that basic business services should be offered for resale at the current, IRD-based tariffed rates for 1MB service, less avoidable retailing costs. DRA recommends using the avoidable retailing costs included in cost studies upon which IRD adopted rates are based. Since neither Pacific nor GTEC has provided such cost studies, DRA recommends using as an alternative the avoidable retailing costs calculated by AT&T. Accordingly, DRA's recommended rate for basic business access service for Pacific is its 1MB rate of $10.32/month less 28% and for GTEC is GTEC's 1MB rate of $19.22/month less 24%. However, DRA would add back 5% for Pacific since Pacific's 1MB rate of $10.32/month was set at 5% below DEC in IRD. DRA also recommends that additional usage charges proposed by Pacific and GTEC should be reduced by 28% and 24%, respectively, to account for avoidable retailing costs.

DRA recommends that Pacific and GTEC not be required to offer resale of basic residential services until appropriate cost-based residential rates are determined in the OANAD or Universal Service proceedings. DRA believes that rates for basic residential services were set below cost in the IRD proceeding for public policy reasons, and that it would be inappropriate to authorize the resale of residential service at below-cost rates. DRA is concerned that the LECs not be allowed to seek recovery of revenue losses alleged to represent below-cost rates.

DRA opposes GTEC's proposed rate of $25.92 (plus additional usage charges) which DRA states is substantially higher than GTEC's IRD rates of $17.25 for 1FR, $10.00 for 1MR, and $19.22 for 1MB. DRA states that GTEC's IRD rates provide the required revenue contribution and preserve GTEC's financial security. For GTEC to charge a wholesale rate greater than its

retail rates would, in DRA's view, result in unjustified additional revenues while unduly inhibiting resellers' ability to compete against GTEC. DRA therefore recommends that GTEC's wholesale rate for business be set at the current 1MB monthly rate of $19.22 less 24% for avoidable retail costs. For residential, DRA recommends that GTEC's wholesale rates equal the current tariffed rates with no adjustment for avoidable retail costs. However, GTEC's proposed usage charges should be reduced by 24%.

DRA supports there being no end user restriction for the resale of local service if the Commission adopts uniform wholesale rates for both business and residential services, such as those proposed by Pacific and GTEC. However, if the Commission adopts wholesale rates that are different for business and residence local exchange service, DRA recommends that the Commission impose use and user restrictions on all local exchange service providers, similar to those currently applicable to incumbent LECs. Otherwise, the resellers could purchase residential or lifeline services at discounts and unfairly resell those services to business customers at a profit.

DRA supports AT&T's proposal for additional discounts on resold LEC services that are inferior to the same service the LEC provides to its own customers. DRA agrees with AT&T that such an approach would incent the LECs to expeditiously provide all interconnection and intercompany arrangements necessary for resellers to provide services comparable to the LECs'.

<u>Public Advocates</u>

Public Advocates is concerned that California's minority, low-income, and limited-English-speaking communities may not benefit fully and equally from local competition. According to Public Advocates, Pacific, GTEC, and the CLCs intend to focus their energies on serving business and affluent residential customers. Public Advocates believes that carriers

will compete for the high revenue customers by offering them lower rates and new technologies such as ISDN, ATM, Internet access, and frame relay. On the other hand, Public Advocates perceives a lack of commitment by carriers to provide new or lower cost services to low-income, minority, and limited-English-speaking communities. Public Advocates asks the Commission to prevent local carriers from implementing the above mentioned pricing and marketing strategies which discriminate against California's disadvantaged communities.

California Department of Consumer Affairs (DCA)

DCA recommends that monopoly building blocks necessary to provide service to end users be unbundled and sold at wholesale rates. DCA believes that wholesale rates for monopoly building blocks should exclude costs that are avoided by selling the service at wholesale instead of retail. DCA also recommends that LECs should not be required to provide resellers with competitive services that CLCs can obtain from other sources.

C. Discussion

1. General Program for Adopting Resale Rates

The resale rates we adopt in this decision are interim in nature and will permit certificated CLC resellers to begin competitively reselling the LECs' bundled local exchange service effective March 31, 1996. Because cost studies for unbundled network elements have not yet been approved in OANAD, the wholesale rates we adopt herein necessarily cover only bundled local exchange service and do not reflect TSLRIC-based costs. In the OANAD proceeding, parties will be developing TSLRIC studies which will be used to develop wholesale rates for unbundled network elements. Once these rates are adopted in OANAD, we shall begin to use them to replace the interim wholesale rates adopted in this order.

Likewise, our adopted wholesale rates are on a statewide average basis for each LEC. As discussed below, we

recognize the merits of geographic deaveraging of rates and adopt a plan for the subsequent adoption of geographically deaveraged LEC retail rates. While parties disagree on the specific levels of geographic costs, there is general agreement that costs can vary dramatically between low and high cost areas. Given the significant variation in costs, statewide average wholesale prices will provide uneconomic pricing signals to competitors who are deciding whether to resell or build their own facilities. Accordingly, we intend to concurrently develop geographically deaveraged wholesale cost studies and rates under a schedule to be announced to permit the CLC resellers to compete effectively.

Our goal in establishing interim wholesale rates is to promote economic efficiency and a level playing field among all competitors. These goals will be met by setting wholesale rates in relation to the cost of service and by assuring that the bundled elements and features offered for resale match as closely as possible the retail service packages which the LECs currently market. Since the determination of cost-based rates for wholesale service is yet to be made, we must adopt an interim solution that will allow resale to begin March 31, 1996, while striking a fair balance between the interests of competing LECs and CLCs, and promoting competitively priced retail service to consumers.

Until further order of the Commission, wholesale rates should be set high enough that LECs are fairly compensated. Otherwise, this would give resellers an unfair competitive advantage relative to the LECs as well as facilities-based CLCs. Wholesale rates should be set low enough so that CLC resellers are not subjected to price squeezes which impede or prevent the CLCs from offering a competitive price. The determination of wholesale rates during this interim period prior to completion of OANAD cost studies and price determinations is, of necessity, an imprecise art.

2. Resale Restrictions

In this decision, we will address the issues of wholesale rates and restrictions on the resale of LEC retail services. In D.96-02-072 regarding Phase II issues which were subject to written comments only, we addressed other terms and conditions of resale including operational interface requirements. We conclude that the proposed tariffs of Pacific and GTEC are overly restrictive in terms of the limited range of services which would be available for resale. The LECs should amend their tariffs to incorporate the list of services set forth on Table 1 below for resale. Unless the range of services which the LECs proposed to offer for resale is expanded, CLC resellers will be prevented from competing in a meaningful way with the LECs.

We conclude that most existing resale restrictions should be removed on the services listed in Table 1 below effective March 31, 1996. We find the LECs' arguments in opposition to removal of resale restrictions to be based largely on appeals for protecting the status quo with respect to LEC market share and profitability. These arguments constitute an untenable basis to refrain from implementing meaningful resale competition at this time. Resale restrictions proposed by the LECs must be removed if we are to achieve our goal to promote a viably competitive resale market. We do not believe that the removal of resale restrictions as adopted in this decision is unfair to Pacific and GTEC even though it necessarily subjects them to new risks as well as new opportunities of a competitive marketplace. Moreover, we are also conducting hearings regarding the impacts of our adopted rules on the "franchise" of the incumbent LECs and on their ability to earn a return on investment.

We shall direct the LECs to offer their residential 1FR and 1MR service for resale. While the LECs do not object to CLCs reselling to residential customers, they would restrict resale to only the 1MB service which could be resold either to residential or business customers. We conclude that the adoption of the LECs proposed restriction would effectively foreclose resale competition in the residential market. While the LECs would be able to offer residential customers a 1FR flat rate which offers customers unlimited local calling, CLC resellers would be forced to pay retail usage charges for local calling under the LECs' proposal. CLC resellers would be placed at a significant disadvantage in profitably competing for 1FR customers.

We agree with AT&T/MCI, certain current features of the LECs' wholesale offerings would be inferior to the LECs' retail offering. For example, Pacific's provisional wholesale custom calling tariff omits key vertical services such as call waiting. Pacific witness Pitchford, however, indicated that Pacific was planning to make call waiting available to resellers. We direct Pacific to make call waiting, as well as all other vertical services missing from its current wholesale tariff, available to CLCs effective March 31, 1996. This will serve as a supplement to the seven custom calling services currently in Pacific's provisional Wholesale Custom Calling Services Tariff. The additional vertical features will be priced to at least reflect the 17% and 12% discounts off the retail rates as adopted in this Decision. We also direct the LECs to make intraLATA toll service available for resale.

Pacific indicated that its billing system cannot accommodate the resale of its optional calling plans for toll service because the billing system used to bill resellers cannot apply the applicable individual end-user discounts. GTEC stated that its billing system has similar limitations. Consequently,

as an interim measure, we shall direct Pacific and GTEC to offer its toll service for resale on a bulk basis subject to a discount off the DDD tariff rate. The discounted rate for residence customers will be the average price residence customers pay Pacific (less avoided costs). The discounted rate for business customers will be the weighted average rate for business customers (less the 17% and 12% avoided costs). Pacific and GTEC shall provide the necessary usage and revenue data to CACD to enable CACD to calculate the appropriate discounts off the DDD tariff rates.

We shall further direct Pacific and GTEC to implement the necessary modifications to their billing systems to make their optional calling plans available to CLC resellers within six months from the effective date of this order. Accordingly, by September 1, 1996, Pacific and GTEC shall file an amendment to their wholesale tariffs making available their optional calling plans to resellers. The calling plans shall be offered at wholesale rates which apply the avoided cost discount which we adopt below to the existing LEC retail calling plan rates.

We agree that CLC resellers should not be permitted to resell Pacific's and GTEC's optional business calling plans to residential customers at this time. The business calling plans are designed to compete with IECs' high-volume calling plans sold to businesses and are not available to residential customers. We shall examine in Phase III of this proceeding the basis for continuing resale restrictions on the LEC's toll calling plans for business customers.

While we are generally supportive of lifting resale restrictions where it will promote a competitive marketplace, we recognize that some remaining restrictions are appropriate with respect to use and user as well as the range of services subject to resale, as discussed below.

With respect to Centrex and Centranet, we conclude that certain issues need further examination before we authorize CLC resale of these services other than at tariff rates. We agree with Pacific that Centrex should be resold only as a business system to single businesses and not as a network infrastructure, toll aggregation tool that undermines the federal law on presubscription timing. (Section 271(e)(2) of the Telecommunications Act of 1996 provides that intraLATA presubscription await Pacific's entry into the interLATA market.) The balance set by the law would be upset if CLCs could give their customers presubscription through Centrex sale. It would be inappropriate to use resale of Centrex as a tool to aggregate toll from unrelated end users. We shall consider in Phase III of this proceeding what changes to the Centrex and Centranet retail services may be necessary to make them appropriate for competitive resale by CLCs. We shall consider imposing appropriate use and user restrictions limiting Centrex and Centranet to resale as business systems in place of premises based equipment (i.e., PBX).

Private lines are already available for resale under the LECs' existing tariffs. Accordingly, as an interim measure, we will make no change in the existing private line tariff. CLCs may purchase private lines for resale at existing tariff rates.

Customer owned pay telephone (COPT) lines are already sold to COPT providers, not to end users as a retail service, and are already essentially a wholesale service. Accordingly, since COPT is very similar to a wholesale service, it logically follows that there are no avoided retail costs associated with the marketing of COPT. To adopt an avoided cost discount for COPT service would simply enable all COPT providers to avoid paying current tariff COPT rates by obtaining CLC certification.

Accordingly, we shall not apply any avoided cost discount for purposes of determining CLC wholesale rates applicable to COPT. We will, however, permit CLC resellers to purchase COPT service at existing tariff COPT rates.

We shall also defer to Phase III consideration of whether to authorize CLC resale of semipublic service. Outstanding issues must be resolved regarding how resale of this service would be structured and how the responsibility for phone maintenance, coin collection, and related matters would be treated between the LEC and CLC. Questions must also be addressed regarding the potential opportunities for arbitrage of seimpublic service. Another issue involves the implications of the FCC's exclusion of semipublic service pay telephone sets from the definition of customer premises equipment as discussed in Pacific's comments to the proposed ALJ decision.

While we find no reason to restrict CLCs' ability to resell ISDN, we shall not at this time apply an avoided cost discount to ISDN because ISDN costs will be considered in the application of Pacific to increase ISDN rates (A.95-12-043) and we have not yet acted on the Application. In contrast to residential tariffs, there are not as many offsetting revenue sources to compensate the LECS for ISDN. Accordingly we shall authorize as an interim measure CLC resale of ISDN service with the wholesale rate set equal to retail rates. We shall reevaluate this interim approach including the determination of a wholesale rate once we have resolved A.95-12-043.

We shall also not require the LECs to offer grandfathered services for resale except in the case of customers who currently receive grandfathered service from the LEC. We shall lift the restriction on CLC resale of grandfathered services to those customers who currently receive such grandfathered service from the LEC. Lifting this restriction will enhance the ability of CLCs to compete for customers with grandfathered services. Pacific points out that in addition to grandfathered private lines, it also has grandfathered vertical services.

To prevent arbitrage, we will continue the LECs' current use and user restrictions on the sale of residential access lines. We find no valid reason why resale restrictions should be maintained on the other services listed in Table 1 below. Lifting resale restrictions on these services will enhance competition. Accordingly, we direct the LECs to amend their proposed wholesale tariffs to conform as closely as possible to the LEC retail offerings currently available for all services listed in Table 1 below:

TABLE 1
Category II Services Subject to Resale

* Residential 1FR and 1MR service
* 1MB
* Local usage, ZUM, and EAS
* All vertical features (except for grandfathered services)
* Customer-owned Pay Telephone (COPT) line and features
* Centrex/CentraNet[10]
* ISDN, both PRI and BRI
* IntraLATA toll
* Private lines (except grandfathered services)

Pacific and GTEC have not justified adding additional charges for separate items such as usage and 411 calls, which are part of their retail basic exchange service. Accordingly, we direct the LECs to amend their tariffs to include these items under the basic wholesale rates. This directive means that LECs are not to charge CLCs for local usage for wholesale 1FR service, and are to give a $3 local usage allowance for 1MR service. It also means that CLCs are not charged for any type of 0-calls or for any other services or functions which LECs provide to their own end-users at no charge.

10 Current use and user restrictions shall remain in place pending further examination in Phase III of the proceeding.

We also note that neither Pacific nor GTEC has provided in their tariffs for resellers to offer Universal Lifeline Telephone Service (ULTS). Accordingly, we shall authorize CLC resellers to receive reimbursement from the ULTS fund for the ULTS service they provide to qualified end users.

3. Adopted Wholesale Rates

We next address the quantification of wholesale rates. In the absence of OANAD cost studies, we conclude that the existing retail rates provide a useful starting point to determine interim wholesale rates for local exchange service. We find however GTEC's proposed wholesale rate which exceeds it retail rate to be unreasonably high. GTEC has failed to provide any evidence as to what LRIC is embedded within its rate or whether the implied contribution above LRIC is reasonable. GTEC's proposal to include an additional contribution from anticipated losses in intraLATA toll revenues is contrary to our goal of setting wholesale rates only at the cost of providing the service. An increase in GTEC's interim wholesale rate is not the proper remedy to address any lost opportunity to generate intraLATA toll revenues. In the franchise impacts hearings phase of this proceeding, we are already separately addressing issues related to possible diminution in the LECs' opportunity to earn a fair return as a result of local exchange competition.

We conclude, however, that while retail rates are a useful starting point, simply setting wholesale rates equal to the LECs' retail rate will unfairly overcompensate the LECs and undermine the viability of CLC resale competition. We are persuaded that there are differences in the cost of providing retail versus wholesale local exchange service. Accordingly, adopted wholesale rates should account for differences between wholesale and retail costs. Failure to adjust for avoided retail costs (such as end-user billing, marketing, and customer service expenses) in adopting wholesale rates could result in overstating the true wholesale cost of service and undercutting the ability of resellers to recover a sufficient retail mark up to allow for a

viable resale market. On the other hand, if the adjustment for avoided retail costs is too large, the LECs will not be compensated for their true costs. Moreover, facilities-based CLCs could be placed at a competitive disadvantage in pricing their retail service if CLC-resellers are able to purchase wholesale local exchange service below its cost.

The only parties to present quantifiable evidence regarding the magnitude of avoided retailing costs were AT&T/MCI through witness Lee Selwyn. However, parties' critique of Selwyn's methodology focuses on some key areas which we feel warrant examination, and we are not willing to adopt AT&T's proposal without modification. In the following section, we discuss the four major areas where we found AT&T's methodology to be flawed, and conclude with a description of how we have adjusted Selwyn's proposal to take those flaws into account in our own estimate of avoided retailing costs.

First, AT&T's model allocates 100% of uncollectible expenses to retail based on the assumption that any uncollectible expense is totally avoided at the wholesale level. On cross-examination, AT&T's witness Selwyn indicated that uncollectibles at the wholesale level would be nothing like those experienced at the retail level and therefore his assumption of zero was reasonable. (Tr. p. 2914.) In further cross-examination, Selwyn indicated that he was not familiar with Sonic Communications, Inc. While Selwyn may not be familiar with the name Sonic, our recent experience with Sonic and our recognition of the millions of dollars that company owed Pacific and GTEC when it went bankrupt are all too clear in our minds. We therefore cannot accept the assumption of zero uncollectibles at the wholesale level and have modified the model accordingly.

A second change comes in determining an allocation factor for marketing and customer services. During cross-examination, a number of parties questioned Selwyn on various subaccounts which

did not appear to support his analysis which was done at the aggregate account level. A key area of discussion centered around the Marketing and Customer Services expense category, which Selwyn allocated 100% to retail activities.

Parties pointed to selected examples of individual accounts under Marketing and Customer Services which do not appear to be related exclusively to retail functions. One of those accounts allocated 100% to retailing was Account 32.6622 Number Services. This category includes both paper directories and 411 directory assistance, both of which will be part of the access line package resellers buy at wholesale from the LECs. Thus, those expenses are not exclusively retail in nature. A second category we found troublesome was 32.6623 Customer Services, which includes costs incurred in establishing and servicing customer accounts as well as billing and collection services performed on behalf of interexchange carriers. The latter is clearly only a wholesale service, while the former must include some wholesale components as well. We find merit to the argument that there will be some expense involved in dealing with CLC customers. While Selwyn decried the need to look at subaccounts and pointed out there would be offsetting adjustments in the other categories, that argument is not convincing when 100% of the costs associated with Marketing and Customer Services are allocated to retail service. Therefore, we have adjusted the allocation factor for the Marketing and Customer Services category to reflect that some of the expenses are wholesale in nature.

Our third adjustment comes in the category of maintenance expense which Selwyn treated the same as depreciation expenses. Our analysis led us to determine that maintenance should be treated the same as the marketing, uncollectible and support categories so it was combined with those categories and a single allocation factor developed for the entire group. In its comments to the proposed ALJ decision, Pacific stated that maintenance and support

expenses are not avoided in the offering of wholesale service. However, we are not persuaded by Pacific's argument. AT&T's Reply Comments have convinced us that some maintenance and support expenses are avoided. AT&T reiterates Dr. Selwyn's testimony that indeed some maintenance and support expenses are avoided by wholesale pricing.

The final adjustment relates to overhead expenses. Selwyn excluded overheads from his development of the allocation factors, which we do not find to be appropriate. Our analysis includes overheads in the development of all our allocation factors.

Parties' criticisms and our own analysis confirm that Selwyn's methodology is an imprecise approximation. Yet, while imprecise, Selwyn's approach affords us a starting point to determine a reasonable approximation of avoided retail costs. Based on our analysis of the Uncollectible and Marketing and Customer Service categories, we determined that they did not warrant being allocated totally to LECs' retailing functions. Instead, we grouped those two categories with the category "Support Expenses" (which in Selwyn's model was allocated partly to retail and partly to wholesale expense). We also included maintenance and overheads and developed a single allocation factor for the combined group. The change in allocation factors results in changes in the overall percentage discounts which represent avoided retailing expenses. For Pacific, the percentage drops from AT&T's proposed percentage of 28% to 17%. For GTEC, the percentage drops from 24% to 12%.[11]

We shall adopt wholesale rates for Pacific and GTEC which generally incorporate avoided retail costs based on this refinement

11 The revised calculation of the avoided cost percentages for Pacific Bell and GTEC is set forth in Appendices B and C.

of the methodology proposed by AT&T. These rates will be used in the interim until we have data from the OANAD proceeding to establish appropriate wholesale rates. We shall not apply the 17% and 12% discounts to residential rates or rates for certain other services, as discussed below.

Our approach addresses concerns raised by Sprint, TCG, TW, CCTA and MFS that setting LEC resale rates at large wholesale discounts below actual costs would give CLC resellers an unfair advantage and discourage investment by facilities-based CLCs. Our reformulation of the AT&T/MCI model reduces the margin between wholesale and retail to better reflect avoided retailing costs which should help to spur development of competing networks. At the same time, we find that the wholesale/retail margins we are adopting are adequate to provide a viable marketing opportunity for CLC resellers, while still allowing LECs the opportunity to cover their wholesale costs.

Following are the adopted 1MB wholesale rates for the two companies, derived by applying a 17% discount for Pacific and a 12% discount for GTEC to the 1MB retail rate:

Retail/Wholesale Rate Comparison for Pacific and GTEC

	1MB Retail	Adopted 1MB Wholesale
Pacific	$10.32	$8.57
GTEC	19.22	16.91

The LECs are directed to apply the above adopted percentage discounts of avoided costs to develop wholesale rates for 1MB, local usage, ZUM, EAS, vertical services for features not covered under existing wholesale tariffs and intraLATA toll. As discussed above, COPT, Centrex/CentraNet, private line and ISDN shall be priced at existing retail rates. Vertical features covered under existing wholesale tariffs will continue to be priced at existing wholesale tariff rates. Directory assistance and other operator services are not subject to the avoided cost discounts at this time.

We shall direct the LECs to establish a separate wholesale tariff rate for residential retail rates for both flat

(1FR) and measured service (1MR). Until the conclusion of cost studies in OANAD, we will not have definitive data concerning whether ex sting residential rates are priced below TSLRIC. Yet, we did finc n D.94-09-065 that the residential rates we adopted in that decisi were already below the LECs reported direct embedded costs. Acc ingly, while we decline to apply the full 17% and 12% discounts to the LECs' 1FR and 1MR retail rates, we still conclude that at least some discount off residential retail rates is needed to spur resale competition in the residential market. Accordingly, we will apply a 10% discount for for Pacific and a 7% discount for GTEC in setting wholesale 1FR and 1MR rates. We believe the 10% and 7% discounts are a conservative measure of retail costs which the LECs avoid in providing residential service. Since the LECs will avoid these costs at the wholesale level, the net effect on the LECs of applying these discounts to residential retail rates should be zero. Our adopted residential discounts are a temporary expedient and will likely change, if the OANAD cost studies reveal that residential rates are priced below LRIC. Additionally, the Universal Service proceeding's disposition of rate and subsidy issues may affect the discount. Our adoption of the 10% and 7% residential discounts will in the meantime help promote resale competitions in the residential sector. To prevent arbitrage, we will continue the LECs' current use and user restrictions on the sale of residential access lines to business customers.

We reject the LECs' arguments that pricing wholesale residential service equal to the 1FR and 1MR retail rates would constitute unlawful confiscation or unfair compensation. Pacific's claims regarding its compensation levels for residential service (Nugent/Exh. 81/Table 2) ignore revenue which it receives from various sources and which subsidizes residential customers. Until OANAD cost studies are finalized, we will not have a complete record of the TSLRIC of residential service. Moreover, in considering whether Pacific and GTEC will be adequately compensated under the adopted wholesale residential rates, it is appropriate to consider all of the revenues which the LECs receive associated with reselling residential service, not just the revenues from the basic

access line, itself. This complete revenue package includes intraLATA toll, switched access from IECs, and vertical features. In addition to the monthly rate for local exchange service, residential subscribers also pay a federally mandated end-user common line (EUCL) charge. Pacific's current EUCL is $4.61 for multi-line business customers and $3.50 for single line buiness customers. GTEC's business customers pay $6.00. We believe that the LECs will continue to receive these revenues in a resale environment.

The EUCL charge reflects the Federal Communications Commission's (FCC) determination of the interstate portion of nontraffic sensitive (NTS) costs that should be collected from the basic exchange subscriber. Because the LECs' costs to provide basic exchange service include the costs of interstate access, a failure to account for the EUCL charge in setting rates would overcompensate the LEC for the cost of providing service. Given that LECs will continue to receive the EUCL either directly from end users when the LECs bill on behalf of resellers, or indirectly from end users through resellers if resellers do their own billing, the EUCL must be taken into account when computing the revenues the LECs will receive from resold local exchange service. Pacific indicates that it will begin billing CLCs directly for the EUCL once it receives FCC approval. Thus, the LECs will likely have these and other revenue sources to offset any claimed shortfall in residential revenues.

Moreover, the LECs have been given an opportunity to address the potential impacts of our overall regulatory program for local exchange competition in the franchise impacts phase of this proceeding. The wholesale rates we established in this decision are only one part of our overall regulatory program. Whether a wholesale rate is so low that it is confiscatory depends on whether the utility has the opportunity to earn a fair return. "Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its

investors for the risks assumed certainly cannot be condemned as invalid. ..." (Federal Power Commission v. Hope Natural Gas (1943) 320 U.S. 591, 602.) The question of whether the overall regulatory program provides the LEC an opportunity to earn a fair return will be addressed in the franchise impacts phase of this proceeding.

We consider the adopted wholesale rates to be consistent with the pricing principles established in IRD. In D.95-07-054, we asked for comment on the following statement: "If the Commission considers Pacific's and GTEC's basic service a monopoly building block and concludes that presently there are no competitive elements in basic service, then the price of basic service must equal the tariffed rate element of the monopoly building block, the actual price for service." We agree with AT&T/MCI that the relevant monopoly building block is the underlying wholesale distribution, switching, and transport service. Accordingly, the wholesale price can be lower than the retail price of basic service to the extent the latter includes avoidable retailing costs.

In addition to the monthly recurring charges applicable to wholesale service, the LECs will incur one-time costs when a LEC customer transfers to a CLC reseller. These nonrecurring costs relate to the administrative work involved in transferring a customer's account from the LEC's billing and accounting system to that of the CLC reseller. In their proposed wholesale tariffs, neither Pacific or GTEC indicated what they proposed for nonrecurring charges related to the transfer of a LEC customer to a CLC reseller.

As an interim measure, we shall limit the amount that LECs may impose as a nonrecurring charge to the existing retail tariff charges applicable to the transfer of a customer account who remains at the same service location, less avoided retailing costs. These rates are found in Pacific's tariff schedule Cal PUC No. A3, Network and Exchange Services, and in GTEC's tariff schedule Cal PUC No. A-41, Service Connection, Move, and Change Charges. We find that these charges are the best interim proxies for the nonrecurring charges applicable to switching customers from LECs to CLC resellers.

For Pacific, the applicable charges to be used from this tariff is the "Supersedure Charge" of $5 per residential account and $7 per account for all other services. For GTEC, the applicable charges to be used from its tariff are $17.50 for residential accounts and $34.50 for all accounts other than residential. These charges are derived from the section of the GTEC tariff labeled "Service Order Activity: Subsequent Order." These charges are lower than GTEC's initial order charges of $23 per residential account and $49.57 for business accounts. In the interests of avoiding prohibitively high nonrecurring charges which may tend to inhibit competition, we shall direct GTEC to use the lower "subsequent order" charges as an interim proxy for setting nonrecurring charges.

Consistent with our methodology for applying avoided cost discounts to wholesale services, we shall also apply the 17% discount for Pacific and a 12% discount for GTEC to the retail nonrecurring charges referenced above. We shall examine in Phase III of this proceeding what appropriate nonrecurring charges should be imposed prospectively related to the transfer of a LEC customer account to a CLC reseller.

IV. Retail Pricing Flexibility

A. Overview

In D.89-10-031, we placed LEC services into three categories based primarily on the degree of market power that the LECs possess for each service. As the degree of market power diminishes from Category I (monopoly services) to Category II (partially competitive or discretionary services) to Category III (fully competitive services), the extent of pricing flexibility available to the LECs increases.

In D.95-07-054, we adopted initial rules for the retail pricing of local exchange service by CLCs. The adopted rules allowed CLCs more pricing flexibility than was allowed Pacific and GTEC. In response to LECs' claims that they should be allowed the same pricing flexibility as the CLCs, D.95-07-054 ordered

evidentiary hearings to determine how much LEC pricing flexibility is appropriate given the advent of local exchange competition.[12] The ALJ Ruling of August 18, 1995, clarified the scope of pricing flexibility issues to be addressed in Phase II evidentiary hearings. Specifically, the ALJ Ruling stated that parties' testimony should address the principles and framework which should apply to LEC pricing flexibility; propose pricing mechanisms that permit interim pricing flexibility without cost studies; and present proposals regarding how subsequent pricing flexibility could be implemented and coordinated with the cost studies being developed in the OANAD docket.[13]

1. Parties' Positions

Pacific and GTEC

The LECs argue that in order to have effective competition, the LECs must be able to compete on the same terms and conditions granted to the CLCs. The LECs claim that if they are unable to mount a competitive response to the CLCs, consumers will not obtain the best prices or the widest array of services that they could otherwise. For example, Pacific states if the LECs are the low cost producers, consumers may still be unable to buy services at the lowest cost because of the pricing restrictions placed on the LECs. The LECs further argue that handicapping them is not in the public interest because it blocks the normal functioning of the market through artificial government intervention, resulting in lower economic efficiency and fewer consumer benefits.

The LECs state that in the past, the Commission has not relied upon market power as the test for granting the LECs pricing

12 D.95-07-054, mimeo, pp. 34, 41, 42.

13 ALJ Ruling of August 18, 1995, p. 9.

flexibility. Instead, the LECs state that the Commission previously granted the LECs pricing flexibility when markets were opened to competition. For instance, the LECs state that in D.88-09-059, when competition was authorized for high speed private line service, the Commission simultaneously granted the LECs pricing flexibility by moving this service from Category I to II. Similarly, in D.94-09-065, when the Commission authorized competition for intraLATA toll, low speed private line, Centrex, and operator services, the Commission also allowed the LECs pricing flexibility by reclassifying these services to Category II. Even if the Commission believes that a market power test should be used to determine pricing flexibility, Pacific and GTEC claim that they do not possess market power[14] sufficient to deter entry by CLCs into the local market. Even if the LECs do possess market power, GTEC states there is no evidence that it will hinder the development of competition.

According to the LECs, several factors demonstrate their lack of market power. First, the LECs already face competition in existing competitive markets such as intraLATA toll. The LECs believe they will face equally stiff competition in the local exchange market. Second, the LECs believe that the sheer number of petitioners seeking to offer local exchange service (66 as of September 1, 1995) demonstrates that local exchange competition will be immediate and robust. Third, the LECs note that among the

14 Various definitions of market power were put forth by the parties. AT&T's witness Dr. Mayo defined market power as "the ability of a firm to control prices to exclude competition." (Ex. 30, p. 7.) MCI's Dr. Cornell defined market power as "the ability by a firm to raise prices above competitive level prices...and sustain that price increase for some nontransitory period of time." (9 RT 1409.) GTEC's Mr. Wilks defined market power as "the ability to restrict the entrance of new providers based solely upon GTEC's presence." (Ex. 34, p. 31.)

new entrants are large, well-financed competitors with great expertise in the telecommunications industry, such as AT&T, MCI, and Sprint. The LECs believe that the presence of these large and skilled competitors assures vigorous competition. Finally, the LECs state their competitors will enjoy a significant competitive advantage in their ability to bundle all telecommunications services to create valuable packages for customers -- something the LECs cannot do because of their lack of interLATA authority.

The LECs also argue that they lack market power because there are no significant barriers to entry. According to the LECs, the only barrier to entry was removed when the Commission allowed facilities-based competition to begin on January 1, 1996, and resale competition to commence on March 1, 1996. In addition, GTEC states that even if some entry barriers remain, they will either be removed or diminished significantly by the rules issued in this proceeding. GTEC states that the new rules for interconnection, unbundling, resale, interim number portability, E-911, and ancillary LEC services adopted in this proceeding will restructure the local exchange market, facilitate market entry, and further reduce the LECs' market power.

The LECs deny that competition will develop only slowly. Both LECs cite the 66 CLC petitions as evidence that competitors are poised to grab market share from the LECs. GTEC adds that it tried, but was unable, to discover from the Coalition evidence about the level of competition GTEC will face. GTEC thus believes there is no evidence that CLCs will not immediately and vigorously pursue the local exchange market.

GTEC argues that the LECs will have little opportunity or incentive to abuse their diminishing market power. GTEC believes the facilities-based CLCs will provide many substitute capabilities, and any abuse by the LECs will cause customers to abandon the LECs for the CLCs.

Citizens

Citizens believes that the LECs possess market power by virtue of their control over essential facilities. In recognition of the LECs' market power, Citizens recommends that a LEC should only be allowed pricing flexibility within defined geographic areas and on a service by service basis, and only if the following conditions are met. First, the LEC removes a key barrier to entry by providing nondiscriminatory interconnection to essential inputs. Second, an authorized competitor enters a defined geographic area of the incumbent LEC's territory to provide a comparable competitive service. Finally, the competitor is not solely reselling a bundled LEC offering.

Citizens disagrees with the Coalition's recommendation that the LECs be denied pricing flexibility until the incumbent LECs have met criteria beyond those recommended by Citizens. Citizens believes that withholding pricing flexibility from the incumbent LECs would give the LECs little incentive to freely open their facilities and market to competitors. Citizens believes that as long as an incumbent LEC demonstrates that it has opened its facilities to competitors on a nondiscriminatory basis, the Commission should allow the LEC the flexibility necessary to compete for services in those geographic areas where the LEC faces competition.

Coalition

The Coalition believes that the LECs possess overwhelming market power for local exchange services, and that the LECs' market power will not be seriously eroded by the entry of CLCs.

The Coalition presents a long list of items which it believes demonstrates that the LECs possess tremendous market power protected by various barriers to competition. Among the items on the Coalition's list are the following:

1. The LECs have nearly 100% of the market for local exchange services;

2. The absence of true number portability results in CLC customers being charged to retain their existing number(s) and being unable to obtain CLASS features if they keep their existing number;

3. The lack of CLC access to LEC data bases including SS7 signaling;

4. The lack of CLC access to numbering resources, enabling the LECs to be the only competitor able to easily offer personalized telephone number service;

5. The lack of interconnection arrangements;

6. The existence of resale restrictions;

7. LECs are the only competitors with access to existing rights of way and conduits;

8. LECs are the only competitors with the ability to offer 1+ intraLATA toll service;

9. LECs are the only competitors with ubiquitous networks capable of serving every customer in their service territories;

10. LECs are the only competitors with an established relationship with each customer and historical information regarding customer usage;

11. The markedly greater expense associated with winning customers relative to the cost associated with customer retention;

12. LECs may submit "express contracts" to the Commission which are automatically approved in 14 days while IEC competitors in the interLATA market must wait 40 days for approval of their contracts; and

13. The substantial time it will take for CLCs to build ubiquitous facilities throughout California, leaving many LEC customers without competitive alternatives for years to come.

To promote the development of competition, the Coalition recommends that the Commission: (1) eliminate barriers to entry; (2) identify services subject to effective competition and significant market power, and (3) adopt efficient pricing for inputs that are subject to monopoly power which are sold to downstream competitors. The Coalition identifies four specific barriers to entry that must be removed before competition will be able to develop: (1) the absence of true number portability; (2) the absence of access to LEC data bases including SS7 signaling; (3) the absence of access to numbering resources; and (4) the lack of interconnection arrangements. To protect competition, the Coalition recommends four polices: (1) removal of resale restrictions, (2) unbundling, (3) imputation, and (4) design of nondiscriminatory interconnection rules.

The Coalition states that CLCs should be subject to fewer regulations than LECs because the CLCs lack market power in the local exchange market. Because the CLCs lack market power, the Coalition believes that the market will effectively discipline CLCs' behavior. For example, the Coalition states a CLC cannot obtain customers unless its rates are lower and/or its service is better than the LEC's. Thus, Commission regulation is unnecessary to ensure that CLCs' rates are not excessive. Because CLCs lack market power, the Coalition believes that additional regulation would impose costs without any offsetting public policy benefits, and create an unnecessary barrier to entry.

The Coalition cites several Commission precedents of tailoring regulation to a level commensurate with (but inversely proportional to) the degree of market power a utility possesses.

The Coalition recommends that until there is solid evidence that competition for Category I services has taken hold, the LECs must not be granted any additional regulatory flexibility for these services. Otherwise, the Coalition

believes that the LECs will use their market power and new-found regulatory flexibility to impede the development of local competition.

<u>DRA</u>

Given the CLCs' nondominant status, DRA believes that no public interest would be served by imposing the same pricing regulations on the CLCs that are presently on (and appropriate for) the LECs. DRA believes that CLCs will have no market power at the start of local competition due to their almost complete lack of market share. DRA believes that CLCs will have difficulty capturing market share and eroding the LECs' market power as long as barriers to competition remain, including: absence of true number portability; lack of CLC access to LEC data bases, including SS7 signalling; lack of CLC access to numbering resources; and lack of interconnection arrangements. Conversely, DRA believes that the LECs will initially have substantial market power since they will have virtually the entire market for local services.

DRA anticipates that competition will evolve only gradually. DRA believes that regulation of the LECs should steadily be relaxed as the market becomes more competitive. However, before ending the economic regulation of the LECs, DRA recommends that the Commission make a formal finding that effective competition actually exists. According to DRA, the preconditions to an effectively competitive marketplace include intraLATA equal access and interLATA relief. In determining whether an effectively competitive marketplace actually exists, DRA recommends the Commission evaluate: (1) breadth of the relevant market; (2) LEC market share; (3) ease of market entry and exit; (4) ability of competitors to expand capacity and capture sales; (5) willingness of customers to switch providers; (6) price elasticity of demand; and (7) the percentage of

customers for whom choice is available and the percentage that have availed themselves of that choice.

Other Parties

The Department of Defense & Federal Executive Agencies (FEA) agree with the Coalition and DRA that the LECs will retain significant market power over local exchange services for some time to come. FEA believes that the CLCs will have little market power and sees no need to regulate the prices charged by the CLCs other than requiring them to file tariffs.

LDDS and The California Department of Consumers Affairs (DCA) believe that the LECs will face competition in some local areas, but that many customers will be reliant on the facilities of the LECs for many years to come, if not forever.

MFS states that the LECs will continue to control bottleneck monopoly facilities, and that the Commission must assure that CLCs have access to these facilities on the same basis as the LECs themselves if local exchange competition is to develop. Accordingly, MFS sees Commission involvement as essential to the development of local exchange competition. MFS believes that the key to the development of real competition is the building of competing local exchange networks, and that the Commission should avoid any action which would impede investment in competing local exchange networks.

2. Discussion

Our adopted rules for pricing flexibility are both responsive to and influential upon competition. Our goal is to establish an environment conducive to the development of an economically efficient marketplace. The rules should promote a level playing field within which economically efficient decisions will be rewarded through the workings of a competitive marketplace.

A threshold issue to resolve is the standard of proof which must be met in order to find that the local exchange market

is sufficiently competitive to justify additional pricing flexibility for the LECs. We find that both the LECs and the Coalition offer unacceptably extreme standards by which to evaluate the issue of pricing flexibility. While the Coalition would have us grant the LECs no flexibility, the LECs believe we should immediately move its local exchange services to Category II subject to immediate pricing flexiblity. GTEC advocates eliminating a wide range of regulatory restrictions on the LECs which are not applicable to CLCs.

While we find that varying degrees of competition can be expected in certain market segments within Pacific's and GTEC's service territory in the near term, we do not find evidence that Pacific and GTEC will automatically lose their dominant market position overnight merely because CLCs have been granted certificates to enter the local exchange market. Yet, we do find evidence to indicate that CLCs are poised to aggressively compete with the LECs for a share of their local exchange market to the extent remaining barriers permit. Accordingly, we shall grant limited additional pricing flexibility to the LECs effective March 31, 1996 in relation to the degree of competition we expect to materialize in the immediate future. It would be premature, however, to make sweeping changes in LEC pricing rules at this point before competition has become sufficiently developed. LEC pricing flexibility must be granted in progressive stages in proportion to the responsiveness of the market to competition. Our adopted rules have laid the groundwork for CLCs to begin to compete, and we intend to monitor the progress of competition and continue to adjust our interim rules accordingly.

Since January 1, 1996, the legal entry restrictions have been removed with respect to facilities-based offering of local exchange service by CLCs within the territories of Pacific and GTEC. Effective March 31, 1996, the legal restrictions on

entry for CLCs seeking to resell the LECs' basic exchange service will also be lifted. Thus, CLCs can compete either by resale or by offering service using their own facilities through interconnection to the LECs' network. While CLCs will face different problems and opportunities depending on which of these options is used, there will be at least initial competitive inertia and handicaps to overcome under either approach. The listing of constraints cited by the Coalition and enumerated above illustrate the fact that CLCs will not immediately be able to competitively penetrate LEC markets on a widespread basis.

While our adopted interim rules enable facilities-based CLCs to arrange interconnection with the LEC network, it remains for the CLC to negotiate a successful interconnection arrangement and to build or acquire the facilities to enable it to serve customers. The CLC will also remain at a competitive disadvantage with respect to access to LEC numbering resources. Particularly because of the scarcity of numbering resources within California, CLC access to numbering resources in certain densely populated markets may be constrained. While we will soon adopt rules requiring the LECs to offer interim number portability to the CLCs, the interim number portability methods employed will still result in inferior service relative to the LECs in certain respects. Until permanent service provider number portability is implemented, facilities-based CLCs will be at a competitive disadvantage in this respect.

Nonetheless, facilities-based CLCs will also realize certain offsetting competitive advantages relative to the LECs. Facilities-based CLCs will be able to define their service territories in a manner which offers the best profit opportunities and will be able to compete in low cost areas against LECs and CLC resellers who are constrained by statewide average rates.

CLC resellers, however, will have certain inherent competitive advantages particularly in the near term over facilities-based CLCs. CLC resellers will not be constrained by the need to build extensive facilities since they will merely be reselling service provided by another carrier's facilities. Yet, they will still be largely dependent upon the LECs who will still control the facilities over which the resale service is provided. We have sought to establish wholesale rates which will approximate costs of wholesale service. Because of the uncertainty over the true costs of wholesale service (to be determined in OANAD), the ability of CLC resellers to obtain a significant share of the local exchange market remains to be seen.

While we recognize that certain CLCs represent large entities which are national or international in scope, we must focus our analysis on the competitiveness of the local exchange markets within the service territories of Pacific and GTEC. We believe that the access to capital, the ability to bundle toll, long distance and local services, as well as the skilled telecommunications expertise of such large entities will be significant factors in those CLCs' ability to penetrate the LECs' markets. Nonetheless, it will still take some time for this process of market penetration to occur. Moreover, large IECs will be constrained from the joint marketing of long distance and local service, as provided in the recently enacted Federal Telecommunications Act.

As discussed in further detail below, we conclude that the presence of CLCs poised to enter the market already creates sufficient basis to provide some additional regulatory flexibility to the LECs immediately in certain respects. We also conclude that further pricing flexibility will be appropriate once critical threshold events occur, as we discuss below.

One of the key factors to be considered in granting future pricing flexibility is the extent to which competition develops and customers throughout California have a real choice in selecting a local provider. While it is clear that the local exchange market is not sufficiently competitive to lift all pricing restrictions presently imposed on the LECs, it remains to be determined exactly what threshold should be used to determine when competition is sufficiently robust to eliminate the need for remaining restrictions.

We appreciate that the measurement of market power is a difficult matter, and parties have not provided sufficiently detailed proposals to develop a definitive process for determining market power or translating it into specific pricing policies. Accordingly, while we find the list of criteria offered by the Coalition and DRA a useful starting point to evaluate the progress of competition, further development is needed to produce and implement a means of evaluating changes in the LECs' market power. Accordingly at this time, we will not adopt any specific value for market share losses or other measures as definitive evidence of a competitive market. We find the proposed 15% market share loss standard to be too arbitrary for use in determining whether to grant additional pricing flexibility. We will consider in Phase III of this proceeding the development of more specific benchmark criteria for finding that a competitive market exists.

We conclude, however, that certain pricing flexibility measures can be implemented effective March 31, 1996 while additional flexibility can be implemented following adoption of appropriate costing/pricing studies. We consider below proposals for specific forms of pricing flexibility and discuss the outcomes we are adopting.

B. Recategorization of Category I Services to Category II

1. Parties' Positions

Pacific and GTEC

Pacific and GTEC recommend that all Category I services for which competition is permitted be immediately moved to Category II or be accorded the same pricing flexibility as services presently in Category II. Pacific and GTEC believe this would be consistent with several Commission decisions, including D.94-09-065 where the Commission moved newly competitive services, such as toll and Centrex, from Category I to Category II. Pacific and GTEC state that Category II pricing flexibility is justified by the competitive threat they face as evidenced by the 66 CLC petitions filed thus far.[15] Furthermore, Pacific and GTEC believe that Category II pricing flexibility will enable them to lower prices and bring the benefits of competition to California. Pacific adds that if the LECs are not granted pricing flexibility, price umbrellas will result which will harm consumers. Pacific states that

15 In its opening brief, GTEC references material regarding the level of competition faced by the LECs that was stricken from the record by the ALJ during evidentiary hearings. Use of the stricken material is completely inappropriate and may constitute a violation of Rule 1 of the Commission's Rules of Practice and Procedure. We will disregard the stricken material since it has no evidentiary value.

A motion to strike portions of GTEC's opening and reply briefs was filed on January 23, 1996, by the Coalition on the basis that GTEC's briefs improperly cite documents and other information which were not admitted into evidence, and therefore, not part of the record in this case. None of the portions of GTEC's briefs which have been cited in the motion to strike have been relied upon as a basis for this decision. Before a ruling on the motion to strike, however, GTEC and other parties will have an opportunity to file a reply to the motion.

Category II pricing flexibility will not harm competition since cost-based Category II price floors prevent LECs from pricing below cost, and Category II price caps prevent LECs from charging monopoly prices.

Pacific states that services moved from Category I to Category II would initially have no price floors, but that the price floors could be developed in the OANAD proceeding and put into place during the second quarter of 1996. GTEC, on the other hand, asks that the Commission's review and approval process of price floors not delay the granting of pricing flexibility on an expeditious basis.

<u>Citizens</u>

Citizens recommends that LECs be allowed pricing flexibility on a service-by-service basis only if (1) the LEC provides nondiscriminatory interconnection to essential inputs; (2) an authorized competitor enters an incumbent LEC's territory to provide a comparable competitive service; and (3) the competitor is not solely reselling a bundled LEC offering.

Citizens recommends that the Commission define necessary inputs broadly so as to cover all necessary functions, features, and services required by CLCs. An element should be deemed necessary if it is required by the CLC to provide comparable service, cannot be reasonably duplicated, and there is no economic alternative to the competitor in terms of quality, quantity, and price.

According to Citizens, essential inputs should be tariffed and priced at TSLRIC. Because of the large number of inputs needed by new entrants, Citizens believes that it will initially be necessary to employ the imputation principles adopted in the IRD decision (D.94-09-065) to price many of the necessary inputs. As an alternative, Citizens recommends a "short cut" method to pricing necessary inputs to expedite opening the local exchange market to competition. Citizen's

"short cut" approach is to employ price ceilings rather than price floors. Citizens believes this would avoid the LECs having to produce countless complex cost studies and a concurrent need for the Commission to scrutinize all of the studies. Where cost studies are available, the Commission should continue to use a price floor and imputation analysis, but where cost studies have not yet been developed, the Commission could use the "short cut" price ceiling approach.

<u>Coalition</u>

The Coalition opposes Pacific's and GTEC's requests to move local exchange services from Category I to Category II. The Coalition believes that the LECs will combine their market power in the local exchange market with pricing flexibility to impede competition. As evidence of the LECs' market power, the Coalition states the LECs have 100% of the switched local exchange service market and are the only carriers capable of serving every customer in their service territories. The Coalition believes a variety of structural barriers will perpetuate the LECs' market power. These structural barriers include the absence of true number portability, the lack of CLC access to LEC databases such as SS7 signaling, and the lack of CLC facilities to compete with the LECs throughout their service territories.

The Coalition believes the proper procedure for LECs to seek pricing flexibility is under the rules established by NRF (D.89-10-031). According to the Coalition, the Commission anticipated the development of competition for all LEC services and structured NRF so as to allow for the reclassification of services upon petition and evidentiary showing by the LECs. The Coalition recommends that the Commission review the LEC's request for pricing flexibility under the NRF framework on a service by service basis.

The Coalition notes that the Commission granted AT&T pricing flexibility only after a demonstration that its market power had significantly diminished. The specific criteria used by the Commission in D.86-07-017 to assess AT&T's market power and the level of pricing flexibility that was warranted were as follows: The market share of AT&T and its competitors; the extent of facilities ownership by competitors; the ease of market entry and exit; the size of individual carriers; customer satisfaction; and changes in prices and the mix of available services. The Coalition states that the Commission later refined in D.93-02-010 the criteria for assessing AT&T's market power to eight criteria.

In analyzing a LEC's request for pricing flexibility for a service, the Coalition believes the Commission should evaluate the LEC's market power over the service using the same eight criteria established in D.93-02-010. These criteria are: (1) determination of the relevant market, (2) market share, (3) LEC and CLC earnings, (4) ownership of facilities by other carriers, (5) ease of market entry and exit, (6) individual carriers' size and growth potential, (7) equal access and other technical factors, and (8) service options and customer satisfaction. By following this approach, the Coalition states the LECs will be granted pricing flexibility commensurate with the lessening of their market power as measurable competition actually emerges.

If the Commission decides in this proceeding that LECs should be allowed to reclassify Category I services to Category II, the Coalition recommends that the Commission first remove barriers to competition. Specifically, before allowing basic exchange services to become Category II services, the Coalition believes there must be: (1) TSLRIC studies performed and price floors in place; (2) price, terms, and conditions that allow facilities-based and resale competition; (3) true number

portability; (4) access to LEC databases, including SS7; (5) CLC access to numbering resources; and (6) interconnection arrangements.

DRA

Even though DRA believes the LECs will have substantial market power at the outset of competition, DRA believes that the LECs should be allowed pricing flexibility for most local exchange services. DRA believes that the opening of the local exchange market to competition results in most local exchange services being "partially" competitive and thus qualifying for Category II pricing flexibility. However, DRA recommends pricing flexibility only be allowed after cost-based price floors and ceilings are established. Moreover, DRA recommends keeping certain services in Category I due to their continued monopoly status until competition for these services becomes more evident (i.e., basic service elements, 911 service, and public policy payphones).

2. Discussion

We conclude that most local exchange services should be moved to Category II since they conform to our Category II definition of "partially competitive services for which the local exchange carrier retains signficant (though perhaps declining) market power" (D.89-10-031, p. 152). We conclude that it will enhance competition to permit this recategorization. While we acknowledge that the LECs will continue to retain significant market power at least during the initial implementation of competition, our institution of competitive local exchange service as outlined in this and previous orders creates a "partially competitive" market consistent with the Category II definition.

We will retain Category I status for certain limited services. We shall adopt DRA's proposal to retain Category I status for the following services: public policy payphones,

911 services, and basic service elements (BSEs) as well as for basic network functions developed in OANAD. Because of the unique public policy and safety characteristics of public policy payphones and 911 services, it is appropriate to retain Category I status for them. Since BSEs represent bottleneck elements of the LEC networks, they do not exhibit the characteristics of partially competitive services and should remain in Category I. We shall also retain Category I status for collocation and the Network Interconnection Charge since these remain monopoly services. We shall reclassify most remaining local exchange services to Category II effective March 31, 1996. As defined in the IRD decision, Category II services are subject to flexible pricing rules within established floor and ceiling limits. The revised listing of Category I and Category II services is set forth on Table 2 below:

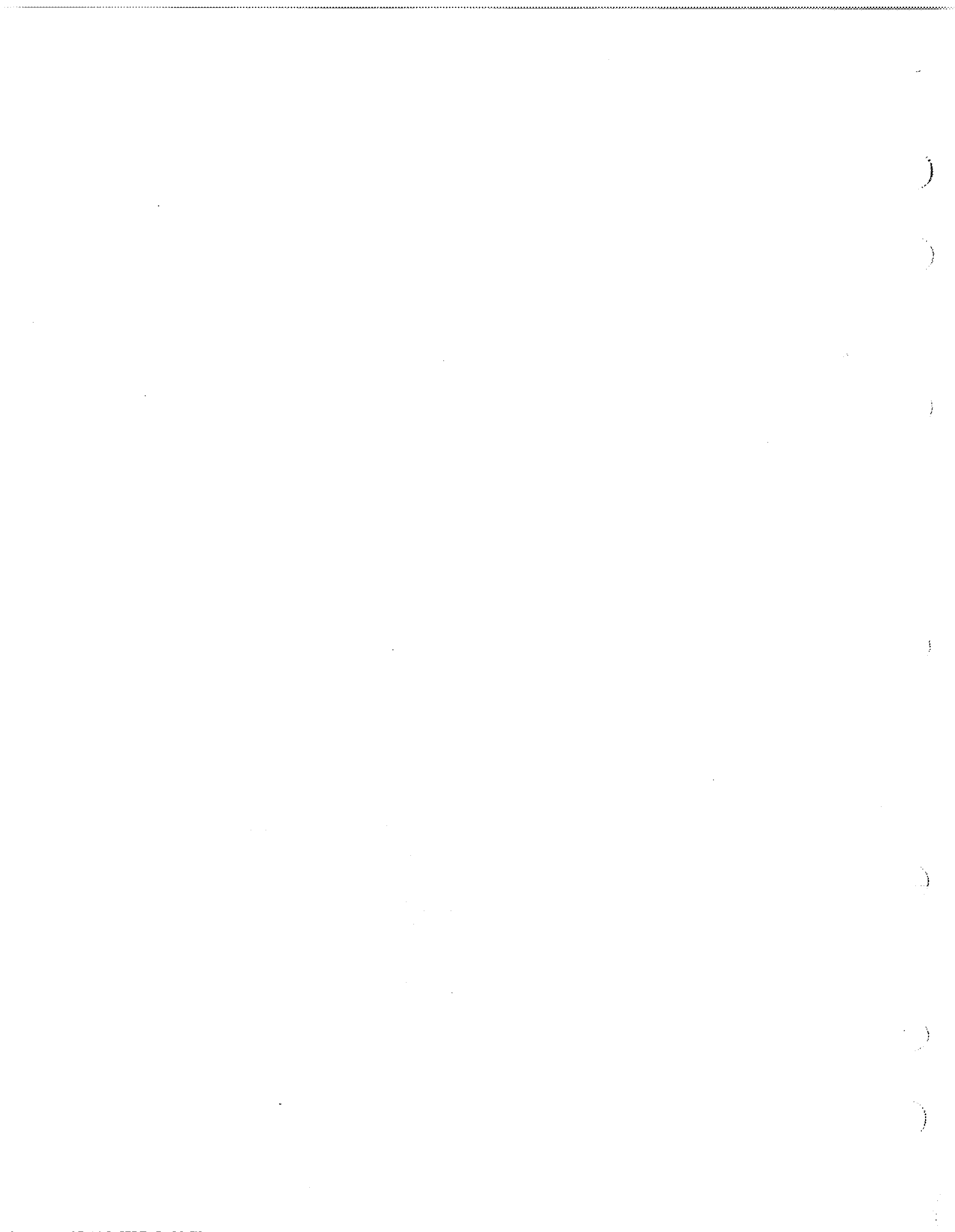

TABLE 2

CATEGORY I SERVICES

Network Interconnection Charge (NIC)
Collocation arrangements
Public policy pay telephone service
Switching portion of switched access
E-911 service
Basic Service Elements - other Open Network Architecture services
Pacific's Multiple Line Call Detail Service (see D.93-11-014)
All wholesale services ordered in this decision
CLC - Remote Call Forwarding

CATEGORY II SERVICES[16]

Basic exchange services
Semipublic telephone service
Customer-owned pay telephone (COPT) access line
IntraLATA directory assistance
Local measured usage
Zone Unit Measurement (ZUM)
Extended Area Service
Foreign Exchange Service
Foreign Prefix Service
Directory listing services
IEC directory assistance
Operator services (0+)
Operator services (0-)
IntraLATA message toll (Direct Distance Dialed (DDD), optional calling plans (OCPs), 800, WATS, operator-handled calls (OPH), calling card, coin)
Custom calling/vertical services
Centrex/CentraNet service
PBX trunk line service
Special access
Private line
Billing and collection services (except Pacific's Multiple Line Call Detail Service)
Local transport, except the Network Interconnection Charge
ISDN, both Pri and Bri

16 Retail oferings of the services are in Category II, and wholesale offerings are in Category I.

Because price floors for the remaining reclassified Category II services have not yet been established, however, the LECs shall not be immediately authorized to implement Category II price flexibility on March 31, 1996. This restriction is consistent with our policy stated in the IRD proceeding that "[b]efore an LEC may exercise pricing flexibility for Category II services...it must establish a price floor for the service." (D.94-09-065, p. 284.)

Similarly, in our recent decision to move local transport (LTR) services from Category I to Category II, we identified two criteria for deciding whether to recategorize a service as Category II: (1) whether sufficient competition exists within the market, and (2) whether the LECs have submitted cost study data sufficient to establish price floors required for Category II pricing flexiblity (D.95-04-073, pp. 41-42). In that decision, we found that the LTR service met the first prong of the test, but not the second. Thus, we reclassified LTR service to Category II, but required the LECs to submit cost data which would be used to establish price floors.

We shall follow a similar approach for the reclassified Category II local exchange services. The LECs will be permitted to implement pricing flexiblity for tariffed Category II services once relevant price floors are established for the reclassified services. The process of establishing price floors is currently underway in the OANAD proceeding. Until appropriate price floors are approved, the LECs shall be required to continue pricing these services at existing tariffed rates. Before we approve price floors for these reclassified Category II services, we shall consider in the NRF proceeding how to develop and use price floors for exercising pricing flexibility.

We recognize, however, that competition will develop in certain markets earlier than others, and accordingly, conclude that pricing flexibility with respect to customer-specific contracts

should be implemented gradually in recognition of such competition. Thus, for those services which are moved from Category I to Category II pursuant to this decision, we shall establish the following provision. We shall consider approval of LECs' advice letter requests for pricing flexibility for customer specific contracts on an exchange-by-exchange basis contingent on (1) the establishment of a customer-specific price floor for the service in accordance with D.94-09-065 and (2) the demonstration of competition within a given exchange as defined below.

It is not enough that the LECs are required to include customer-specific price floors in their advice letter filings. We are concerned that without service-wide price floors against which customer specific price floors can be compared, there would be too much opportunity for gaming the price floor results. Accordingly, for customer-specific contracts covering those services which are moved from Category I to Category II pursuant to this decision, we shall add the second precondition requiring a showing of competition from at least one facilities-based CLC. We do not believe it is necessary to prohibit any LEC pricing flexibility until service-wide price floors are established in OANAD in those local exchanges where such competition develops.

The mere lifting of legal barriers to competitive entry, however, is not evidence of competition sufficient to warrant LEC pricing flexibility for customer-specific contracts. Thus, we shall only permit the LECs to seek authority for Category II pricing flexibility on a case-by-case basis for customer-specific contracts where the LEC makes a showing that at least one facilities-based CLC is actively competing against it within the majority of exchanges served by the customer subject to the flexibly-priced contract. As evidence that the facilities-based CLC is actively competing, the LEC must show that the CLC has executed an interconnection agreement with the LEC, has opened one or more NXX codes within the exchange, and has originated or terminated traffic to CLC customers within the LEC's exchange.

We shall further require that the competing CLC must be other than Pacific or GTEC. This restriction will prevent the

incumbent LECs from being able to meet the test for customer-specific contracts merely by executing an interconnection agreement with each other in their roles as CLCs.

We conclude that the presence of at least one facilities-based CLC will provide a valuable check against the power of the LEC to engage in anticompetitive pricing through customer-specific contracting. The requirement for the presence of one facilities-based CLC will provide a more meaningful indication of competition than reliance only on CLC resellers. The CLC reseller's prices are significantly keyed to the LEC's wholesale rates. The LEC will still be collecting revenue from the sales made by CLC resellers and can enter into a customer-specific contract below the wholesale rate charged to the reseller. By contrast, the facilities-based CLC is independent of the LEC and can compete against the LEC based on the CLC's own cost structure irrespective of what wholesale rates the LEC may charge resellers.

In the case of Category II services which were so classified prior to today's order, existing rules for the approval of customer-specific contracts shall remain in place. However, in the case of contracts for bundled services that include services we have placed in Category II as a result of today's order, we shall apply the rules we have designed for these services. We shall not require a showing of competition by a facilities-based CLC for approval of customer-specific contracts for existing Category II services.

Any LEC advice letter request for a customer specific price floor must also conform the the process outlined in D.94-09-065:

> "[C]ustomer-specific LRICs must be calculated on an appropriate uniform per-unit basis (e.g., per-foot, per-line). The LEC must establish per-unit LRICs in a compliance filing setting forth the calculation and cost basis for the unit price. The LEC may then apply the unit price to the appropriate characteristic of the customer..... to establish customer-specific LRICs for use in calculating price floors for

the individual contracts. (D.94-09-065, p. 229.)

The pricing flexibility permitted for Category II services will retain sufficient safeguards to prevent the LECs from setting anticompetitive prices. The LECs will not be allowed to raise Category II prices above established price caps absent the filing of an application. Since the LEC price floors will impute the contribution from monopoly building blocks, the LECs will not be able to price squeeze their competitors. This recategorization will enhance the opportunity for competition between LECs and CLCs, but will not enable the LECs to engage in anticompetitive practices.

C. Bundling of Services

1. Parties' Positions

Pacific, GTEC, Citizens, and DRA recommend that the LECs be granted authority to package Category I, II, and III services into a single offering. According to Pacific and GTEC, there is strong customer demand for service packages, and the LECs would be at competitive disadvantage if they were not given the right to offer packages. These four parties agree that the LECs should also provide the components of their packaged services on an individual basis, thus allowing customers to purchase only those services they want or need, and allaying any concerns about illegal tying arrangements or other anticompetitive bundling arrangements.

Pacific recommends that the price floor for any package be the sum of the price floors of the individual parts of the package (including any imputation requirement in setting the price floors), with the same principle applying to a package's price ceiling. If packaged Category I services do not have a price ceiling and floor, Pacific and DRA propose using the retail rates of the Category I services in establishing the price of the package's floor and ceiling. TURN asks that any imputation structure adopted by the Commission not result in an increase to

basic exchange service rates. Pacific believes that when packaging residential services, the existing imputation rules for subsidized services should apply, but that the subsidy payment must be included in the revenues received to determine whether the price is above the price floor.

DRA recommends the lifting of the Commission's current prohibition on offering local exchange services in customer specific contracts that was established in D.94-09-065. DRA recommends allowing such contracts if they are consistent with GO 96-A contract rules adopted in IRD. DRA also believes the Commission should require that the customer-specific DEC for any local exchange services included in the contract be imputed in the contract floor. Finally, DRA recommends that the LECs not be authorized to use express contract procedures for services for which no service-wide floors and ceilings have been approved. Nor does DRA believe that the LECs should be granted pricing flexibility below DEC in customer-specific contracts until service-wide or rate element cost studies are approved.

The Coalition opposes allowing Pacific and GTEC to bundle Category I services with Category II or III services. The Coalition states that "tying" of noncompetitive basic local exchange service with competitive Category II and III services is per se anticompetitive when the LECs have sufficient economic power over basic local exchange services to restrain free competition for Category II and III services.

The Coalition states that bundling of Category II and III services can be allowed, but only if established Commission safeguards for bundling are rigorously enforced. These safeguards include those established in D.94-09-065 which precluded bundling in the form of contracts that include Category I services at other than tariffed rates; and D.94-09-065 and Resolution T-15613 which prohibit the bundling of certain monopoly services, including

residential subscriber service, basic exchange lines, ZUM, local usage, and the access line portion of semipublic telephone service.

The Coalition and TURN recommend the strict enforcement of the Commission imputation safeguards when bundling Category II services with Category III services to assure that monopoly elements are not subsidizing competitive products. Furthermore, the Coalition states its view that PU Code §§ 453, 532, and 2882.5 together dictate that LECs must demonstrate, prior to the offering of a package, the imputed underlying costs of any Category II service bundled with a Category III or nonregulated service.

2. Discussion

We conclude that the LECs should be granted the flexibility to bundle Category II local exchange service with Category III services (including all services moved from Category I to II in this decision) as long as no "tying arrangements" are involved and our imputation rules are strictly observed. This bundling comports with the rules in D.89-10-031 for bundling of Category II and III services.

A tying arrangement arises under antitrust laws when a seller conditions the sale of one product (the tying product) or service on the purchase of a separate product or service (the tied service). Such arrangements are in violation under Section 1 of the Sherman Act, Section 3 of the Clayton Act and Section 5 of the Federal Trade Commission Act. In addition, there are two provisions of the Cartwright Act that can apply to tying arrangements; Sections 16720 and 16727. These two sections together have been characterized as analogous to Section 1 of the Sherman Act. (Corwin v. Los Angeles Newspaper Bureau, Inc., 4 Cal. 3d 842, 852 (1971).)

Tying arrangements generally involve the supplier's use of economic power or leverage in the market for the tying product to curb competition in the tied product and deny customers a free choice with respect to the products they purchase. Because such

tying arrangements have been viewed as having little purpose other than the restriction of competition, they have been considered unlawful per se. In two recent cases, Jefferson Parish Hospital District No. 2 v. Hyde, 466 US 2 (1984(and Eastman Kodak Co. v. Image Technical Services, 504 US 451 (1992) the Court reaffirmed that tying arrangements are per se unlawful.

Accordingly, for any bundled service offering, the LECs must also offer customers the opportunity to purchase the service on a stand-alone basis at the authorized tariff rates. We find no reason to conclude that the mere authorization allowing the LECs to bundle Category II and III services on this basis constitutes an anticompetitive tying arrangement. Federal case law supports the conclusion that bundling of services does not constitute an unlawful tying when the offered terms do not preclude purchase of the separate services. (**Robert's Waikiki U-Drive**, 732 F.2d 1403, 1407 (9th Cir. 1989).)

Moreover, we find no basis in antitrust law to conclude that an unlawful tying would necessarily result merely from the LECs offering a bundled Category II and III service at a discount relative to the tariff rates for the separate services. In **Amerinet v. Xerox Corporation**, 972 F.2d 1483, 1500 (8th Cir. 1992), the court found no unlawful tying merely because the separate products were more expensive than the bundled product. The court did find, however, that "an illegal tying arrangement may still be shown if the defendant's policy makes the purchasing of the tying and tied products together 'the only viable economic option...'"

Thus, we will not prohibit the LECs from offering bundled Category II and III services at any discounts relative to the tariff rates for the separate services. On the other hand, if the price differential between a bundled package and the separate services was so great that customers were economically coerced into buying unwanted or overpriced Category III services, then could a valid claim that an lawful tying had occurred. The opportunity for

the LECs to offer a bundled service which is a customer's only viable economic option, however, is constrained to the extent that the bundled price of the Category II product cannot go below the price floor and the separate Category II prices cannot go above the ceiling. In any event, Pacific and GTEC are placed on notice that any bundled arrangements they enter into pursuant to our adopted rules are subject to applicable antitrust laws regarding unlawful tying arrangements, and they shall be liable for any applicable penalties or sanctions resulting from violation of those laws.

Accordingly, effective March 31, 1996, LECs may bundle Category II and III services as long as customers are able to purchase the individual services separately at tariffed rates, and as long as proper imputation of price floors for each separately unbundled Category II service is verified. As prescribed under PU Code § 2282.5: "Cross-subsidy of the enhanced services by the noncompetitive services offered by the local exchange telephone corporation is prohibited." For any bundled tariffed Category II services, we shall require a full demonstration of the imputed underlying tariffed rates. We shall not allow bundling of Category I services.

D. <u>Geographic Deaveraging</u>

1. <u>Parties' Positions</u>

Pacific, GTEC, LDDS, Citizens and DCA support allowing the LECs to set cost-based, geographically deaveraged rates, with geographically-based costs determined in the OANAD proceeding. Pacific would make one exception for residential services which Pacific believes should not have geographic-based prices. These parties generally agree that geographic deaveraging provides correct economic signals to both CLCs and to customers. Without geographic deaveraging, the CLCs may be encouraged to enter low cost areas protected by the umbrella of averaged LEC prices, and dissuaded from serving high cost areas where the LECs charge below their costs due to averaged LEC prices. Unless the geographic

price distortions are corrected, these parties believe a truly cost-based competitive marketplace cannot emerge.

To the extent that the cost to serve high cost areas makes the price prohibitive, Citizens recommends that the Commission's universal service system be used to ensure that prices are kept at an affordable level. If the Commission forces GTEC to maintain average prices, GTEC recommends the Commission mandate that a universal service contribution be collected from CLCs to address the revenue needs associated with high cost areas.

The Coalition and TURN oppose geographic rate deaveraging. According to the Coalition, allowing entry by CLCs will not affect the LECs' overwhelming market power which will continue to persist because, among other things, many ratepayers will not have competitive alternatives available to them for many years to come. The Coalition states that if the Commission permits rate deaveraging immediately following entry, the LECs intend to wield their market power by imposing significant rate increases on large numbers of ratepayers with no competitive options for local exchange service, resulting in widespread discrimination of the sort that averaged rates were designed to limit. Moreover, the Coalition believes that deaveraging would result in significant anticompetitive conduct by the LECs who would drop rates in areas where they face incipient competition and underwrite those decreases by raising rates to captive customers.

The Coalition recommends that deaveraging not be permitted until there are sufficient competitive alternatives available to ratepayers to limit potential discrimination and anticompetitive behavior. However, if geographic deaveraging is allowed before then, the Coalition recommends that it be subject to four conditions. First, there should be no deaveraging of residential basic service given that the Universal Service Fund will ensure that LECs are made whole for the cost of providing basic service in high cost areas. Second, there should be no

deaveraging until OANAD cost studies have been completed and verified by the Commission. Third, deaveraging should be offered to ratepayers based on their cost characteristics and not on the lack of competitive alternatives available to them. This means that all ratepayers with the same cost characteristics should receive the same rates. Finally, deaveraging should not be permitted below the exchange level to avoid the administrative burden of many different rates for the same service.

2. <u>Discussion</u>

We recognize that geographic deaveraging may promote more efficient pricing. Under the existing LEC rate structure which is based on statewide averages, retail rates do not reflect the costs of serving different geographic regions. Once LEC rates are geographically deaveraged and prices are allowed to more closely match costs of service, CLCs will have a greater incentive to enter new geographic markets which were not previously cost effective to serve. Thus, geographic deaveraging should increase rather than constrain competition. CLCs will be encouraged to enter a geographic market if they can offer a more competitive price than the LEC. While we agree that allowing geographically cost-based prices may be necessary in a competitive environment, statewide average rates must remain in place for LECs for the present and until relevant cost studies by relevant geographic region have been completed and approved.

Before deaveraged rates can be implemented, studies must be completed to determine the appropriate costs of serving different geographic regions. Although cost studies are presently being prepared in the OANAD proceeding to develop rates for unbundled network elements, those cost studies will not necessarily provide all the necessary information needed to determine geographically deaveraged costs. Moreover, in the Universal Service proceedings, we are considering using a "proxy" cost study to estimate the cost of basic service to residential customers

throughout the state based on geography. Under the proxy factor method, we would examine a sample of actual costs from different geographic areas. Accordingly, we shall coordinate with the ongoing work in companion proceedings and subsequently determine a procedural schedule for the preparation, review, and approval of cost and price studies which can be used for adoption of geographically deaveraged rates. The studies should provide data which would separately identify wholesale and retail costs and prices. Appropriate coordination between the OANAD, Universal Service, and NRF proceedings will assure that relevant cost data are shared among these proceedings accordingly.

The Universal Service High Cost Voucher fund as proposed in the Universal Service proceeding, may reduce the need for rate deaveraging in the residential market. The availability of subsidies from the fund should allow LECs and CLCs to serve high cost areas at affordable rates and reduce or eliminate the need for residential rate deaveraging.

Once appropriate geographically deaveraged prices have been allowed, we shall then be prepared to revise the rules in this proceeding authorizing implementation of geographically deaveraged wholesale and retail rates. After hearing from parties, we may also consider implementing geographically deaveraged pricing gradually on an exchange-by-exchange basis as cost data becomes available. We find no necessity to require a separate showing of some minimum level of market share loss by the LECs or other related measures before we approve the use of geographically deaveraged Category II services. We shall, however, require that each LEC offer the same geographically deaveraged rates to all ratepayers within a designated geographic region. This requirement is consistent with PU Code § 453(a) which states: "No public utility shall as to rates, charges, service, facilities, or in any other respect, make or grant any preference or advantage to any corporation or person subject any corporation or person to any

prejudice or disadvantage." These restrictions will provide appropriate safeguards against the risk of discriminatory pricing in those geographic regions where there may be few or no CLCs serving customers. The LECs will not be able to reduce rates below the geographically deaveraged price floors nor raise rates above the geographically deaveraged price caps.

For the immediate future, however, and until the appropriate pricing studies are concluded, we shall not permit the LECs to geographically deaverage any of their rates. Likewise, the interim wholesale rates for basic service which we approve in this order do not reflect any geographic deaveraging. Therefore, the lack of geographically deaveraged prices will not competitively handicap the LECs in relation to CLC resellers. On the other hand, facilities-based CLCs will not be constrained by the LECs' statewide average rates, but will be able to target specific geographic regions and price their service accordingly. In this respect, facilities-based CLCs will have a competitive advantage until geographically deaveraged rates are implemented for the LECs and CLC resellers.

E. <u>Miscellaneous LEC Pricing Flexibility Issues</u>

Our interim rules established in D.95-07-054 permitted greater flexibility to the CLCs in comparison to the LECs. We reject, however, the proposal of GTEC to abolish all differences and to establish identical rules for both the LECs and CLCs with respect to pricing and tariffing requirements. GTEC's list of proposed changes includes elimination of all service category distinctions, removal of all cost study requirements, removal of all LEC earnings limitations, and complete parity with the CLCs regarding the filing of tariffs and turnaround times and procedures for making rate changes. The list of proposed changes in pricing rules as outlined in GTEC's listing (Exhibit 43, Attachment A) of the differences between the regulatory rules for LECs versus CLCs is overly broad and unjustified at this time.

We find it appropriate, however, to grant the LECs additional flexibility to make effective customer-specific contracts without a formal Commission resolution, as is presently required under GO 96-A and consistent with the requirements of this Decision. Instead, CACD will be authorized to informally approve such contracts, or to provisionally reject them and prepare a resolution for those cases where major modifications are required which would go beyond CACD's ministerial function. CACD shall also be authorized to dismiss protests to customer-specific contracts when appropriate. By removing the formal resolution requirement, LECs should be able to place customer-specific contracts into effect several weeks sooner, thereby enhancing the LECs' competitive flexibility. Customer-specific contracts will still be subject to the regular 40-day notice period. We shall also modify the rule for LEC advance notice of Category II rate decreases to require only five-day, instead of 10-day, advance notice. This change will conform to the CLC notice requirement adopted in D.95-07-054.

Except for the specific changes we adopt herein, we find no basis to grant any remaining changes in pricing rules for the LECs at this time. It is appropriate to retain more flexible rules for the CLCs in comparison to the LECs at least for the immediate future. While the additional regulatory flexibility will provide the CLCs certain limited competitive advantages over the LECs, we conclude that these advantages will be counterbalanced by the overall market dominance which the LECs will continue to have for at least some period following March 31, 1996. The market dominance of the LECs justifies retention of the existing regulatory rules governing the LECs for the present time. We reserve the right to continue to monitor the progress of competition within the industry and to revise the rules over time as conditions warrant.

While the LECs and CLCs will initially be subject to "asymmetrical" requirements in various respects, we do not view

this as unbalanced or unfair regulation. Because we are dealing with a changing market which we hope to move toward the ultimate goal of full competition, it will be challenging to craft rules which exactly balance the LECs' and CLCs' opportunities and constraints at any single point in time though this is our intent. Nonetheless, when the disparities in market power between the LECs and CLCs are considered along with the adopted rules in the overall regulatory equation, we conclude that the rules we put in place effective March 31, 1996 promote the goal of overall regulatory symmetry for the immediate future.

F. CLC Pricing Policies

1. Introduction

In D.95-07-054, the Commission required hearings to consider evidence regarding CLC pricing policies and whether there would be harm to consumers if CLC costs studies were not required.[17]

2. Parties' Positions

Pacific and GTEC

Pacific believes that formal cost studies are unnecessary in a competitive environment. Pacific, however, is concerned that unreasonable charges assessed by a CLC against Pacific would harm its customers who would have to pay inflated rates. Pacific thus recommends that CLCs with more than five percent of the nation's presubscribed access lines (e.g., AT&T, MCI, and Sprint) should be required to submit minimal cost support to CACD demonstrating that their prices for interconnection and interim number portability are reasonable. Pacific recommends that CLCs submitting cost support should be able to have their prices become effective immediately pending a CACD review.

17 D.95-07-054, mimeo, p. 34.

Pacific and GTEC both recommend that LECs should be allowed the same rules for timing of price changes, new product introductions, contracts, and other product and pricing requirements as will be allowed CLCs.[18] For example, if CLCs are allowed to make minor rate increases within five days, the LECs believe they should be allowed the same right; and if CLCs are not required to submit reports tracking the revenues and costs of contracts, the LECs state they should not have to, either. The LECs argue that asymmetric regulation is not in the public interest because it handicaps the normal functioning of the market through artificial government intervention, resulting in lower economic efficiency and fewer consumer benefits.

<u>Citizens</u>

As a general principle, Citizens believes that Commission rules governing new entrants should be as minimal as possible. Following this principle, Citizens recommends that CLCs not be required to file cost studies in order to offer a service. Citizens views cost studies as a barrier to entry and not justified by the CLCs' lack of market power. Instead, Citizens recommends that CLCs be required to justify their prices if a complaint is filed charging the CLC with below cost pricing.

<u>Coalition</u>

The Coalition opposes any cost study requirement being imposed on the CLCs, while it supports such a requirement for the LECs. The Coalition believes that stricter regulation of the LECs is justified by the many competitive advantages enjoyed by the LECs such as: LEC customers retain their existing telephone numbers without charge; it costs less for LECs to retain their customers

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18 GTEC would abandon the current cost study requirements for LECs once price floors are approved in the OANAD proceeding and pricing flexibility established for services moved from Category I to Category II.

than for CLCs obtain customers; LECs' ability to offer 1+ intraLATA toll service; and LECs can offer ubiquitous facilities-based service, an important feature for large business customers with multiple locations.

The Coalition also states that CLCs should be subject to fewer regulations than LECs because the CLCs lack market power in the local exchange service market, and the market will therefore effectively discipline their behavior. For example, the Coalition states a CLC cannot obtain customers unless its rates are lower and/or its service is better than the LEC's. Thus, Commission regulation is unnecessary to ensure that CLCs' rates are not excessive, argues the Coalition. Because CLCs lack market power, the Coalition believes that additional regulation would impose costs without any offsetting public policy benefits. Symmetrical regulation between LECs and CLCs would thus create a barrier to entry.

Finally, the Coalition states that the different rules for LECs and CLCs, though appropriate, are not significantly different. Rate increases, except those defined as minor for the CLCs, are effective on 30 days' notice for both LECs and CLCs; while introduction of new services requires 40 days' notice for both LECs and CLCs.

<u>DRA</u>

DRA recommends allowing maximum pricing flexibility for the CLCs, and requiring CLCs to file tariffs that clearly state the rates, charges, terms, and conditions for all local exchange services the CLCs provide. DRA recommends against granting the LECs regulatory parity with the CLCs due to what DRA sees as the LECs' continued dominance of the local exchange market. DRA thus believes that the LECs should abide by the current rules regarding LEC rate changes, cost studies, imputation, establishing new services, and revising tariffed terms and conditions other than rates.

3. <u>Discussion</u>

We decline to impose on the CLCs cost study requirements or restrictions on the ability to bundle interLATA and competitive local exchange service. Consistent with our findings in Section IV.A above that the LECs retain dominant market power, we do not believe the CLCs have the power to engage in anticompetitive pricing. Accordingly, it would be an unnecessary constraint on the competitive marketplace to impose such restrictions.

V. Rating Area Consistency

A. Introduction

In D.95-07-054, the Commission ordered CLCs to conform to the LECs' existing NXX rating areas and methodology[19] for an interim period pending evidentiary hearings on the long-term resolution of CLC rating area designation.[20] The ALJ Ruling of August 18, 1995, directed parties to address in their Phase II testimony whether the CLCs should be required to conform to established rating areas.

B. Parties' Positions

Pacific and GTEC

Pacific and GTEC recommend that CLCs be required to use existing NXX rating areas to rate and bill calls until long-term number portability is implemented. The LECs argue that the use of

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19 A rate center is a physical point within an exchange, such as a post office building, from which distance to another exchange is measured in airline miles to identity whether a particular call will be billed as a long distance, toll, or local call. Each rate center's vertical and horizontal (V&H) geographical coordinates are used to calculate airline mileage. This method of rating calls is used throughout the United States.

20 D.95-07-054, p. 30.

inconsistent rating areas could result in misrated and misbilled calls.[21] The LECs are concerned that the misrated calls would have the largest effect on the LECs' high volume customers, the very LEC customers that the CLCs would target. In addition, the misbilling caused by the use of disparate rate areas could impair the Commission's ability to determine what compensation mechanism is appropriate after the conclusion of the one-year interim period for bill and keep.

The LECs further argue that using existing rating areas will minimize customer confusion. According to the LECs, customers have an understanding borne of experience of what constitutes a local or toll call. If each CLC were allowed its own rating area, the designation of a call as local or toll would change each time a call was placed to a customer of a different carrier. The result would be customers having difficulty in knowing whether they are making a local or toll call.

The LECs argue that inconsistent rating areas would affect all carriers nationally and should be undertaken only after the development of new national standards. Finally, Pacific is concerned that allowing CLCs to use different rating areas could impair the reliability of the E-911 network. Pacific does not oppose modifying E-911 to cope with different rating areas, but only after careful study.

Pacific acknowledges that a requirement for rating area consistency may accelerate NPA exhaustion. However, Pacific believes accelerated number exhaust is preferable to thousands of

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21 Misrated calls could occur where CLC's NXX codes inconsistently span several of the LEC's rating areas, causing the LEC to be unable to determine in which of its rating areas the call actually terminated, thereby precluding the LEC from correctly billing the call in accordance with its local/toll bands.

misrated calls per day. Pacific adds that its recommendation for consistent rating areas is meant to facilitate local competition, and thus the costs caused by the accelerated NPA exhaust should be shared by the industry. In all, Pacific estimates that it will incur $70 million[22] of additional costs for accelerated NPA exhaust due to local competition. Pacific asks for authority to track these costs using a balancing account mechanism, and to recover these costs through a surcharge on all telecommunications end-users.

GTEC states that a "super rate center" alternative as proposed by the Coalition is a possible compromise approach. A super rate center results from combining several contiguous incumbent LEC exchange areas (each with its own rate center) into a single CLC rate center. GTEC finds that super rate centers would reduce, but not eliminate, the number exhaust problem or misrating problems.

Citizens

Citizens supports all carriers being required to use the same NXX rating areas as already established for the incumbent LECs. Without rating area consistency, Citizens believes there will be customer confusion. In addition, Citizens states that inconsistent rating areas will cause carriers nationally to experience serious technical problems in identifying, transporting, and pricing calls. Citizens does not believe that a requirement for consistent rating areas should restrict carriers from developing different calling areas to accommodate customer need and demand.

Coalition

The Coalition opposes the requirement of consistent rate centers since it would exacerbate the already serious problem of

22 Exhibit 22, p. 46.

statewide number exhaust, and would force each CLC to open a unique NXX in every existing LEC rate center in which the CLC offers service. Given that Pacific and GTEC together have more than 559 rate centers, each CLC providing service throughout the two LECs' service territories would need to obtain at least 559 NXX number blocks totaling more than 5,590,000 telephone numbers, causing immediate and widespread number exhaust. The Coalition is concerned that the resulting number exhaust would shut the CLCs out of some or all markets due to a lack of NXX codes, which would benefit the LECs but impede competition.

The Coalition is concerned that as number exhaust accelerates due to the use of consistent rate centers, solutions to the problem could further impede competition. As an example, the Coalition cites a CACD report dated November 9, 1995, regarding number exhaust for the 310 area code. In their report, CACD recommends a freeze on assigning numbers when only 48 NXXs remain, and that there be a lottery for the allocation of the remaining codes. The Coalition believes the freeze and lottery could preclude new entrants from obtaining NXXs and offering service in the 310 area.

The Coalition states that call misrating is a minor and temporary problem that will be solved by true local number portability (LNP). According to the Coalition, prior to the implementation of true LNP, few customers will be impacted by call misrating since competition will be slow to develop and there will be few CLC customers. Moreover, the call misrating applies only to facilities-based CLCs, not resale CLCs, further limiting the number of affected customers. Finally, there will be no call rating problem for the customers of facilities-based CLCs who use interim LNP since their telephone numbers (and thus their rating center location) will remain the same.

The Coalition is concerned about a co-carrier agreement between Pacific and MFS Intelenet of California (MFS). Under the

agreement, MFS would obtain at no charge a unique NXX in every Pacific Bell rate center area that MFS offers service. The Coalition is concerned the agreement would exacerbate the number exhaust problem by requiring MFS to obtain full blocks of 10,000 numbers even where MFS had no need for so many numbers; and would discriminate in favor of MFS by providing MFS with NXXs at no charge while all other CLCs are charged to open new codes.

To reduce the problems associated with using inconsistent rate centers, the Coalition recommends the Commission adopt the proposal by TCG to modify the Terminating Point Master (TPM). Currently, to rate a call, all carriers use a national file called the TPM, which identifies the rate center to which a particular NPA-NXX number is assigned. TCG's proposal would modify the TPM so it could recognize that a particular NXX has been assigned to a CLC. Once the TPM has recognized that a particular NXX was assigned to a CLC, the rating system would look to a separate file in order to properly rate the call. TCG believes its proposal can be implemented fairly easily with little cost. The Coalition notes that several facilities-based IECs, including AT&T, MCI, and Sprint, would be as impacted by TCG's proposal as the LECs, yet these IECs are willing to pursue it further. The Coalition therefore recommends that if the Commission feels compelled to address call misrating prior to true LNP, the Commission approve TCG's proposal and move forward with an examination and implementation of the technical details associated with its adoption via workshops.

The Coalition recommends that the Commission consider implementing "super rate centers" in the short term to minimize possible call misrating. Under this approach, CLCs would obtain an NXX covering a number of current LEC exchange areas. The number of LEC exchanges subsumed by a CLC super rate center could be calibrated to make the number as small as possible while avoiding number exhaust. This calibration could vary by geographic area in

order to account for the varying risks of number exhaust. The super rate center approach would only need to be in effect until either TCG's solution is deployed, or until permanent LNP is deployed.

During the period that the TCG proposal to modify the TPM is being evaluated and tested, the Coalition recommends that the Commission address possible customer confusion through customer notification. The Coalition believes that providing information and a list of "local NXXs" in the form of directory guides, bill inserts, and other mailings would be an efficient and inexpensive means of preventing customer confusion, and would avoid the number-exhaust-producing requirement that CLCs obtain NXXs in every rating center where they have customers. The Coalition believes that customers would quickly learn from experience, just as they do now, which calls are local and which are not.

The Coalition believes the LECs have caused customer confusion due to inaccurate information the LECs have disseminated to their customers regarding how calls are currently rated. To alleviate the customer confusion, the Coalition asks that the Commission require Pacific and GTEC to make a special mailing that would (1) apprise customers of the correct manner in which calls are rated, (2) advise customers that in order to know whether a call is local, ZUM, or toll, the customers must refer to the "NXX charts" in their phone books or to the "detachable card" that the Coalition recommends that Pacific should be ordered to provide to its customers. Finally, the Coalition recommends that Pacific and GTEC be required to provide information for customers on how to reach carriers when calls have been misrated.

The Coalition states that the use of inconsistent rate centers can be done without harm to the E-911 system by arranging for special trunking where necessary to assure proper routing of E-911 calls.

The Coalition is opposed to Pacific's request for authority to recover costs for accelerated NPA exhaust. The Coalition believes that accelerated NPA exhaust is due mostly to the LECs insistence that CLCs use consistent rating areas, and that they should therefore be the parties to bear the costs for accelerated NPA exhaust. The Coalition also believes that the costs for area code splits are part of the LECs' ongoing costs of business under NRF, and that Pacific has never before received Z-factor treatment for costs to split area codes.

<u>DRA</u>

DRA recommends that the Commission require CLCs to match the LECs' existing rate centers. DRA believes that such a policy will reduce customer and carrier confusion about the local or toll nature of a particular call. DRA doubts that use of consistent rate centers will substantially increase number exhaust over the next few years since DRA believes that competition will be slow to develop. DRA states that implementing true number portability will ultimately eliminate the necessity of matching LEC and CLC rate centers. Until then, DRA finds the proposals to modify the TPM or use super rate centers to be infeasible since the proposals are too vague or suffer from other defects.

DRA recommends that CLCs be allowed to offer local calling areas that equal or exceed the size of the LECs' 12-mile local calling area, but that CLCs should not be permitted to offer local calling areas smaller than the LECs' local calling areas. DRA believes that the ability of CLCs to offer larger local calling areas may enable them to gain local market share and thereby generate some of the consumer benefits that local exchange competition is expected to provide.

C. Discussion

We recognize that number exhaustion is a serious concern, and that requiring CLCs to obtain a separate NXX code in each rate center could signficantly increase the number of NXX codes to be

opened. Pacific has 449 rate centers while GTEC has over 100. Assuming CLCs are to be charged for NXX code openings, the result would be increased costs for CLCs to enter new rating areas or to be foreclosed or delayed from entry into certain areas if no more NXX codes were available within a rating area. Another negative result of accelerated number exhaustion is the added costs and customer disruption resulting from more frequent NPA relief measures such as area code splits. Yet, while we remain concerned regarding these consequences, we must weigh these problems against the negative customer impacts of abandoning our policy of rating area consistency, (i.e., misrating of calls and customer confusion).

Although customers may not all precisely understand how calls are rated, they generally have some sense of which calls are rated as local. Immediately eliminating any CLC requirements to match existing rating areas without appropriate consumer education would likely lead to customer confusion and misrating of calls. We also agree that these negative impacts would be experienced chiefly by the incumbent LECs' customers and could create a competitive disadvantage for the LECs.

We conclude that under the rating area proposals of either the LECs or the Coalition, there is some risk of negative impacts, and no solution can be absolutely problem free. We must weigh these impacts and adopt a solution that results in the least overall negative effects. On balance, we conclude that the best solution is one which preserves scarce number resources and promotes the development of facilities-based competition. Requiring CLCs to open a separate NXX code in every rate center in which they serve customers would create an unacceptable acceleration of number exhaustion and inhibit the growth of facilities-based competition. Accordingly, effective March 31, 1996, we shall not require CLCs to open a separate NXX code in each rate center in which they offer service.

We also recognize, however, concurrently with the lifting of this restriction, we need to address parties' concerns over the potential for customer confusion and call misrating resulting from inconsistencies between LEC and CLC NXX rating areas. While the problems associated with the use of different rating areas between CLCs and LECs are of concern to us, we believe they can be reasonably dealt with by developing appropriate mitigation measures through technical workshops. The timely implementation of appropriate mitigation procedures following these workshops will provide for a transition period to mitigate any call misrating and customer confusion resulting from the use of different NXX rating areas between LECs and CLCs. Accordingly, we shall direct CACD to convene a technical workshop during March 1996 to address necessary mitigation measures on a priority basis to mitigate call misrating and to educate consumers regarding the manner in which the rating of local calls of CLC subscribers will be determined. CACD shall prepare a draft workshop report for parties comments following the workshop and present the final report to the ALJ no later than May 17, 1996.

We believe that the measures developed through the technical workshops can be implemented before any significant impacts from the use of differing CLC/LEC rating areas would be felt. The need to open NXX codes will only be an issue for facilities-based CLCs since resellers simply rely on LECs' existing NXX code designations. Facilities-based CLCs, however, must first execute interconnection agreements, build or acquire necessary facilities, open NXX codes, and actually sign up subscribers before beginning to offer local exchange service. Given the pace of progress toward facilities-based competition since the market was opened on January 1, 1996, we do not believe that a significant number of customers would be served using a CLC's NXX codes before appropriate mitigation measures could be put into place.

In any event, we shall direct Commission Advisory and Compliance Division (CACD) to monitor the NXX code assignment process. We shall also require that until appropriate mitigation measures are adopted, any facilities-based CLC which enters into a commitment to begin providing local exchange service to a customer served by an NXX rating area which is inconsistent with that of the LEC shall first notify CACD.

The topics to be covered in the workshop are discussed below.

While the TCG proposal to modify the TPM is not presently developed sufficiently to permit its implementation, it has the potential to be implemented with additional work. We direct the CACD to convene a workshop to identify the additional implementation details which would need to be resolved to make the TCG proposal workable and to develop a timetable for implementing those details. To the extent workshop participants are unable to reach agreement on particular details, they may file separate comments dissenting from the report. We will consider the results of the workshop report and assess whether to implement the TCG proposal or other alternatives including a timetable for implementing the super rate center proposal and for implementing a customer awareness program to inform them concerning the new procedures for determining how a local call will be rated.

Likewise, the MCI proposal to use a "super rate center" approach is not sufficiently developed to implement as an interim solution until the TCG proposal can be implemented. MCI does not explain how the size of each "super rate center" would be determined. If sized too large, it would not really serve to avoid customer confusion, and if sized too small, it would fail to alleviate the scarcity of NXX codes.

In considering any change in existing rating area consistency, we must also assure that E-911 service is not impaired. The existing NXX-to-rating-point system supports E-911

service. Pacific's E-911 Tandem Selective Routing function is NXX and wire center based. The Selective Routing feature routes calls to the appropriate Public Safety Answering Point (PSAP) based on the Automatic Number Identification (ANI) and the associated Emergency Service Number (ESN) in Pacific's E-911 Management System.

Each Tandem Selective Route receives data from a number of corresponding rate centers and distributes the E-911 calls to the appropriate PSAP. The PSAP dispatches the appropriate agency (i.e., fire, ambulance) to the caller based on the caller's location information as recorded in the Master Street Address Guide (MSAG), If the ESN system fails, the Selective Routing telephone number database serves as a redundant safeguard. This safeguard is based on the rate center and associated NXX of the caller's ANI.

The Coalition claims the E-911 problem could be solved by requiring separate dedicated trunks. We believe, however, the technical details of how such trunking arrangements can be implemented should be worked out expeditiously in technical workshops. Parties should address via workshop the best means to ensure E-911 service reliability as the existing NXX code assignment procedures are changed. Before any CLC begins offering service through an NXX rating area which differs from the LEC, we shall require that they first provide assurance to CACD that separate dedicated trunks are in place to handle E-911 calls or that equivalent means are provided to ensure the integrity of E-911 service.

Another technical concern to be addressed in the workshops is to assure that the measurement of local traffic would not be impaired by the elimination of rating area consistency. In D.95-12-056, we directed all carriers to provide measurements of local versus toll traffic. We must therefore assure that any subsequent rating area differences allow for the ability to measure local traffic.

We also need a developed timetable regarding the preparation, dissemination, and assimilation of any customer awareness program to educate customers concerning the new procedures for determining the rating of local calls involving CLC customers and to consider any other appropriate mitigation measures to deal with any customer confusion or negative reaction which may still occur.

As part of Phase III, we shall therefore also give consideration to proposed means of implementing appropriate mitigation measures and a timetable for doing so.

Rating area consistency is only one of many factors determining the rate with which number exhaustion will occur. In D.95-08-052, we directed that as part of this rulemaking, the assigned ALJ solicit comments regarding a statewide policy for dealing with "California's exploding number usage" and appropriate remedies for area code relief.

The assigned ALJ also deferred consideration of the issue of NXX code opening costs to a later phase of this proceeding.[23] The charge, if any, which CLCs are assessed for NXX code openings will also have a bearing on the impacts of rating area consistency.

We shall direct that both the issues of NXX code opening costs and mitigating measures to deal with LEC/CLC rating area differences be further considered in Phase III of this proceeding.

In Resolution T-15824, adopted on January 17, 1996, we conditioned approval of Pacific Bell Advice Letter No. 17879 upon Pacific maintaining a memorandum account for NXX code opening costs for MFS until the Commission establishes costs and any recovery mechanisms for NXX code openings. As an interim measure to become effective March 31, 1996, we shall further direct Pacific to establish a separate memorandum account to track the number of NXX

23 Per ALJ bench ruling on October 30, 1995.

codes opened for each CLC. Since we have deferred the issue of rate setting for NXX code opening costs to Phase III, the memorandum account will not initially record any revenues collected for code openings. Once we have determined in Phase III what rates, if any, should be established for NXX code openings, we shall direct Pacific to apply the adopted rates to the NXX code openings as reflected in the memorandum account and to determine the amount of compensation due and to bill the CLCs accordingly. (We separately address the LECs' proposals to recover implementation costs in Section VI below.)

A related, but separate issue is that of how large the local calling area of the CLC should be. DRA proposes that CLCs should be able to have local calling areas larger than -- but no smaller than -- the existing LEC local calling area of approximately 12 miles. No party disagreed with this proposal, and we find it reasonable. Accordingly, we will place no restriction on the maximum size of the CLCs' designated local calling areas, but shall require that the local calling area be no smaller than that of Pacific and GTEC.

VI. LEC Recovery of Costs of Implementing Local Competition

A. Introduction

The ALJ Ruling of August 18, 1995, and the Assigned Commissioner Ruling dated October 26, 1995, directed parties to address in Phase II of this proceeding the recovery of costs incurred by LECs for implementing local competition.[24] In addition, the Commission in D.95-08-052 ordered that costs associated with NXX code opening were to be addressed in this

24 ALJ Ruling of August 18, 1995, p. 9, and ACR, p. 11.

proceeding.[25] In a bench ruling on October 30, 1995, the ALJ deferred addressing NXX code opening costs to a later phase of this proceeding[26] except for the topic of a balancing account to record NXX opening costs.[27]

B. Parties' Positions

Pacific

Pacific projects that it will incur $32,474,000 for implementing local exchange competition, and recommends that it be authorized to recover the $32 million via a one-year surcharge of 0.59% on all of its end users. A summary of the cost elements comprising the $32 million figure is summarized below:

LOCAL COMPETITION IMPLEMENTATION COSTS

Implementation Activity	Cost
Resale	$7,471,000
Operator Support Services	$5,763,000
E-911	$1,367,000
DNCF	$3,569,000
LISA	$4,124,000
Data Exchange	$1,056,000
Interconnection Project	$9,124,000
TOTAL	$32,474,000

Pacific states that its estimate of $32 million is based on detailed analyses of the incremental work that will be needed to offer interconnection, INP, and resale services to the CLCs; and

25 D.95-08-052, OP 8.

26 10 RT 1787.

27 Some parties' briefs address the merits of whether LECs should be allowed to charge CLCs for NXX opening costs which is beyond the scope of this decision. The issue of whether and to what extent LECs will be authorized to charge for NXX opening costs will be addressed in a subsequent decision.

excludes any costs for activities to help Pacific better compete against the CLCs. As an alternative, Pacific would agree to track its actual implementation costs and recover them via a Z factor type of mechanism.

Not included within Pacific's $32M are costs associated with NXX code opening and accelerated NPA exhausts. To recover these costs Pacific proposes a balancing account mechanism, with costs recovered via a surcharge on Pacific's end users. Pacific would file an annual advice letter to true up surcharge revenues with actual costs booked to the balancing account, apply interest to any over or under collection of the balancing account, and adjust the surcharge as necessary. Under Pacific's proposal, Commission staff would be able to review and verify Pacific's costs and their recovery.

GTEC

GTEC recommends that it be allowed to recover its estimated implementation costs of $7.2 million via a two-year surcharge on all the end users of LECs and CLCs. GTEC believes that it has provided detailed information demonstrating the reasonableness of its estimate of $7.2 million, broken down as follows:

LOCAL COMPETITION IMPLEMENTATION COSTS

General Implementation Labor	$ 554,908
Total Systems Modifications (includes specific labor hours, vendor and hardware costs)	$2,092,085
Resale	$2,000,000
Network Interconnection	$ 219,189
Customer Notification	$2,322,651
TOTAL	$7,188,833

(Exhibit 82, Attachment 1.)

Included among GTEC's implementation costs is $2.2 million for bill inserts and mailings to notify customers about facilities-based and resale competition, and to explain the impacts of local competition. GTEC states that similar bill inserts were required by the IRD decision, and GTEC intends to submit the bill inserts and mailings to the Commission for approval. GTEC's states that its costs for implementing local competition could be affected by the final rules adopted by the Commission. GTEC thus recommends that the Commission review its actual implementation costs, and requests authority to seek recovery of additional costs it incurs as a result of the final local competition rules.

GTEC believes a surcharge on all end users is a fair method to recover its implementation costs since the Commission has ruled that local competition is in the public interest and thus all telecommunications users in the State should equally bear the costs of local competition. In addition, GTEC believes an all end user surcharge avoids GTEC subsidizing the CLCs' market entry, thus advancing the Commission's goals of economic efficiency and regulatory parity.

Coalition

The Coalition supports LECs being given an opportunity to recover their recorded implementation costs following a review and approval process conducted by the Commission. To the extent the Commission permits recovery of implementation costs, the Coalition recommends that they be recovered through a surcharge on all LECs and CLCs in proportion to the number of access lines they serve.

The Coalition opposes the Commission pre-approving the LECs' estimated implementation costs for two reasons. First, the Coalition believes that the LECs' cost estimates are speculative since they are forecasts. Second, the Coalition believes the LECs have overstated their implementation costs by including

costs the LECs would have incurred in any event. In particular, the Coalition states that GTEC is not entitled to recover costs for customer notification since this is a marketing cost, not an implementation cost. The Coalition states that all LECs and CLCs will provide information about their services to customers. In addition, the Coalition states that all LECs and CLCs are required to provide information about the prices, terms, and conditions of their basic exchange service pursuant to Universal Service rules. The Coalition states that CLCs will not be allowed to pass along these costs, and neither should the LECs.

TURN

TURN opposes LECs recovering implementation costs for several reasons. First, TURN finds the LECs' proposals provide them with an incentive to drive up implementation costs in order to impede competition. Second, TURN believes that the LECs benefit from the opening of the local exchange market to competition since the LECs may in turn be allowed into the interLATA market; hence the LECs should bear the implementation costs, not the ratepayers. Third, TURN states that the CLCs must bear all of their own implementation costs, and the LECs will be given an unfair competitive advantage if they are able to recover their implementation costs from ratepayers. Finally, TURN opposes GTEC's recovery of costs for customer notification since TURN considers this a marketing cost, not an implementation cost. TURN states that Universal Service rules require that all LECs and CLCs provide information to their customers about the prices, terms, and conditions of their basic exchange service. TURN states that CLCs will not be allowed to pass along these costs, and neither should the LECs.

If the Commission decides to allow LECs to recover implementation costs, TURN supports the costs being recovered via a surcharge on all local exchange providers in proportion to the number of lines they serve.

DRA

DRA opposes allowing the LECs to recover any costs for implementing local exchange competition. DRA believes that the LECs' costs will be offset by the benefits the LECs will receive by being allowed to compete in each other's service territories and ultimately being allowed into the interLATA market as a result of local exchange competition.

DRA also finds the LECs' requests to be one sided since they call for the ratepayers to absorb all of the costs but share none of the profits the LECs may realize as a result of local competition. DRA notes that CLCs will also have their own implementation costs for which they have no guarantee of recovery. DRA thus sees the LECs being given an unfair advantage if they were guaranteed recovery of their implementation costs while the CLCs were not.

If the Commission allows the LECs to recover implementation costs, DRA recommends that the Commission first review the LECs' actual implementation costs and then authorize their recovery via a surcharge on the ratepayers of the LEC that incurred the costs. In addition, DRA recommends that the costs attributable to a specific service, such as number portability, resale, or interconnection, should be recovered in the rates charged to the purchasers of those services, and not from a general surcharge applied to all end users or a specific company's ratepayers. Finally, DRA supports setting a separate phase for a generic review of number exhaust and code opening issues.

C. Discussion

The LECs' request to recover implementation costs raise issues as to (1) what costs the LECs will incur in connection with implementing the Commission's local competition rules, and (2) whether, how, or to what extent the LECs should be compensated for such costs.

Merely because a LEC is expected to incur additional costs as part of providing service, there is no automatic entitlement that it be made whole for such costs on a dollar-for-dollar basis. In a competitive market, firms are not guaranteed recovery of specific costs on a dollar-for-dollar basis. Instead, competitive firms must recover their costs through the normal course of business by competing for greater sales or by being more efficient.

It would send an inappropriate signal to the LECs if we were merely to preapprove any of their estimated expenses. The LECs should be financially responsible for the consequences of their management decisions on how to implement competition and should have the incentive to be as efficient as possible in implementing competition. Guaranteed preapproval negates the incentives of the LECs to manage its implementation costs efficiently.

We recognize, however, that the LECs will need to perform various activities as outlined in their testimony to implement the infrastructure for local exchange competition and that some level of costs will be incurred by the LECs associated with these activities. Moreover, we expect society as a whole to benefit from the implementation of local exchange competition. Accordingly, we conclude that reasonably incurred costs to implement competitive local exchange service are appropriate, and it is not unreasonable that end-users pay for such costs.

The LECs' proposal for an end-user surcharge has the appeal of spreading any implementation costs among all customers who are beneficiaries of a competitive market including customers of the CLCs. We have imposed end-user surcharges in the past for certain limited purposes where there is a demonstrated public interest in doing so. Moreover, the LECs will institute the technical infrastructure for local exchange competition not only for their own use but also to permit CLCs to compete in the local

exchange market and allow all customers to benefit from competition.

We do not find, however, that the cost estimates presented by Pacific and GTEC are sufficiently reliable as a measure of the amount which the LECs will incur for each of the activities listed. The LECs admit that the actual costs which will be incurred are subject to great uncertainty. Accordingly, we cannot treat the estimates with any degree of reliability as a basis for quantifying any prospective recovery at this time.

We shall consider establishing an end-user surcharge for certain reasonably incurred implementation costs at a later date in either this proceeding or the NRF proceeding when more reliable cost data is available. The LECs will have to demonstrate that the costs they seek to recover provide benefits to the public interest and are consistent with our general policy for establishing end-user surcharges. We will not preapprove recovery of any specified amount of implementation costs for Pacific or GTEC at this time. We will, however, authorize Pacific and GTEC each to establish a memorandum account to record actual implementation costs incurred on and after January 1, 1996, the date when local exchange competition was officially instituted.

The authorization to track recorded costs should not be construed as an assurance that recorded costs will automatically be subject to recovery through a surcharge. We will direct the LECs to file a report by January 1, 1997 providing the recorded balance in the memorandum account broken down by the major categories corresponding to the estimated implementation costs presented in the testimony in Phase II. The ALJ will establish a further schedule for considering the issue of compensation, if any, for implementation costs in a later phase of this proceeding or in the NRF. We shall then consider what amounts, if any, should be subject to recovery through a end-user surcharge. The LECs are placed on notice that they will be responsible for justifying the reasonableness and consumer benefits of any

amounts which they seek to recover through an end-user surcharge. We will not guarantee or preapprove recovery of any implementation costs at this time.

Findings of Fact

1. The initial rules for local competition adopted in D.95-07-054 set March 1, 1996 as the implementation date for the competitive bundled resale of local exchange service within the service territories of Pacific and GTEC.

2. Pacific and GTEC filed proposed tariffs for bundled resale on October 2, 1995.

3. The determination of TSLRIC-based rates for resale service is yet to be made in the OANAD proceeding.

4. Pacific's proposed 1RL wholesale tariff provides a basic access line, without any packaged local usage, which can be resold by a CLC to either business or residential customers throughout Pacific's territory.

5. Pacific's proposed 1RL rate of $10.32 coincides with its retail measured 1MB rate.

6. GTEC's proposed wholesale rate of $25.92 plus usage charges is substantially higher than GTEC's retail rates of $17.25 for 1FR, $10.00 for 1MR, and $19.22 for 1MB.

7. GTEC's proposed wholesale rate is intended to preserve GTEC's level of contribution from providing local exchange service, irrespective of whether such service is provided at the wholesale or retail level.

8. The LDDS "wholesale local network platform" (WLNP) concept which calls for an end-to-end network configuration to make the resold service appear seamless to the end user may be a worthwhile long-term goal.

9. Certain current features of the LECs' provisional wholesale offerings would be technically inferior to the LECs' retail offerings.

10. AT&T presented an overall quantification of the avoided retailing costs included in LEC retail rates.

11. AT&T used a "tops down" analysis of recorded FCC accounting data to quantify the avoided retailing costs reflected in Pacific's and GTEC's proposed wholesale rates.

12. Based upon its quantification of avoided retailing costs, AT&T computed a downward adjustment of 28% from Pacific's and 24% from GTEC's retail rates.

13. The AT&T methodology overstates Pacific's and GTEC's avoided retail costs.

14. The calculation in Appendices B and C to this decision which yields a wholesale discount of 17% for Pacific and 12% for GTEC provides a reasonable approximation of avoided retail costs for setting interim wholesale rates for 1MB, local usage, ZUM, EAS, intraLATA toll, and vertical features not already included in the LECs' existing wholesale tariffs.

15. The application of a 17% discount results in a wholesale 1MB rate of $8.57 for Pacific, and the application of a 12% discount results in a $16.91 1MB rate for GTEC.

16. COPT, private line, Centrex, CentraNet, directory assistance, operator services, and ISDN services should be authorized for resale at the existing tariffed rates for these services.

17. Vertical features covered under existing wholesale tariffs should continue to be offered for resale at rates applicable to those existing wholesale tariffs for vertical features.

18. Given that the LECs charge different rates to business and residential customers on a retail level, it would provide a more balanced competitive market for the wholesale rates for business and residence customers to reflect a wholesale rate differential.

19. The residential retail 1MR and 1FR rates are already set below the direct embedded cost (DEC) submitted in IRD.

20. Until OANAD cost studies are finalized, there will be some uncertainty as to the TSLRIC costs of residential service and whether current residential rates are below that cost.

21. The complete revenue package associated with resale, including intraLATA toll, switched access, EUCL, and vertical features allows the LECs to recover additional margin to compensate for any shortfall in residential access line revenues.

22. The functions associated with the avoided retailing costs reflected in the LEC retail rate represent competitive elements which can be performed by the CLCs as well as the LECs.

23. The franchise impacts hearings phase of this proceeding will separately address issues related to impairment in the LECs' opportunity to earn a fair return as a result of local exchange competition.

24. D.89-10-031 established three categories of service for Pacific Bell and GTEC; Category I, for basic monopoly services; Category II for discretionary or partially competitive services for which the LEC retains significant (though perhaps declining) market power; and Category III for services where the LEC retains insignificant market power or state jurisdiction has been preempted.

25. The lack of true number portability provides a competitive disadvantage to facilities-based CLCs relative to Pacific and GTEC.

26. Pacific and GTEC possess dominant market power in their local exchange market even though legal barriers to market entry have been lifted.

27. Pricing flexibility for reclassified Category II tariffed services will enable Pacific and GTEC to lower prices and bring the benefits of competition to California once applicable price floors are determined and approved.

28. Category II pricing flexibility prevents the LECs from charging anticompetitive prices because (1) Category II price

floors, which include imputed contributions for monopoly building blocks, prevent LECs from pricing below cost and engaging in price squeezes against their competitors; and (2) Category II price caps limit the maximum amount LECs may charge.

29. In D.94-09-065, the Commission required that before a LEC may exercise pricing flexibility for Category II services, it must first establish a price floor for the service.

30. In D.95-04-073, the Commission identified two criteria for deciding whether to recategorize a service from Category I to Category II: (1) whether sufficient competition exists within the market, and (2) whether the LECs have submitted cost study data sufficient to establish price floors required for Category II pricing flexibility.

31. Allowing pricing flexibility for reclassified Category II tariffed local exchange services only after cost studies have been performed and adopted by the Commission mitigates against the anticompetitive exercise of market power by Pacific and GTEC.

32. The process of establishing TSLRIC costs which can be used to develop Category II price floors is currently underway in the OANAD proceeding.

33. D.94-09-065 required that customer specific LRICs be calculated on an appropriate uniform per-unit basis (e.g., per foot, per line) and that the per-unit LRICs need to be established in a compliance filing that sets forth the calculation and cost basis for the unit price.

34. Public policy payphones and E-911 services have unique public policy and safety characteristics.

35. Basic Service Elements represent bottleneck elements of the LECs' networks and do not exhibit the characteristics of partially competitive services.

36. There is customer demand for bundled service packages.

37. The California Business and Professions Code Section 16727 defines tying arrangements as a requirement that as a

condition of purchasing one product, a buyer must purchase a different (or tied) product.

38. Requiring Pacific and GTEC to provide the components of their bundled services on an individual, stand-alone basis is intended to allow customers to purchase only those services they want or need.

39. A bundled service offering would constitute an unlawful tying if customers were compelled to purchase services they do not want in order to obtain local exchange service.

40. The Commission's imputation safeguards help assure that monopoly elements do not subsidize competitive products.

41. The Commission in D.94-09-065 precluded Pacific and GTEC from entering into contracts that offered Category I services at other than tariffed rates.

42. The service territories of Pacific and GTEC constitute a geographically diverse market; the companies may have different costs to serve their different geographic regions.

43. The existing LEC rate structure of service-territory-wide average rates may not accurately reflect the costs of serving many of California's different geographic regions.

44. Geographic deaveraging of rates based upon Commission-approved cost studies and price determination would promote efficient pricing and provide correct economic signals to both customers and competitors.

45. Without the geographic deaveraging of LEC rates, the facilities-based CLCs may be encouraged to enter low cost areas protected from competition by the umbrella of averaged LEC prices, and dissuaded from serving high cost areas where the LECs must charge below their costs due to geographically averaged LEC prices.

46. Once LEC rates are geographically deaveraged and prices are allowed to more closely match costs of service, CLCs will have a greater incentive to compete in new geographic markets which were not previously cost effective to serve.

47. Cost studies being prepared in the OANAD and the Universal Service proceedings will not necessarily provide all the necessary information needed to determine geographically deaveraged costs.

48. The Universal Service High Cost Voucher Fund will ensure that LECs and CLCs are compensated for the cost of providing basic residential service in high cost areas.

49. Since facilities-based CLCs will be able to target specific geographic regions and price their service accordingly, they will have a competitive advantage until geographically deaveraged rates are implemented for the LECs and CLC resellers.

50. PU Code § 453(c) prohibits public utilities from discriminating between ratepayers who are similarly situated.

51. Pacific and GTEC will need to perform various activities to implement the infrastructure for local exchange competition and will incur costs in the process.

52. Pacific projects $32,474,000 for its costs of implementing local exchange competition, excluding Pacific's costs associated with NXX code opening and accelerated NPA exhausts.

53. GTEC projects $7.2 million for its costs of implementing local exchange competition.

54. The LECs will institute the technical infrastructure to implement local exchange competition not only for their own benefit but also to permit CLCs to compete in the local exchange market.

55. Customers as a whole will benefit from the implementation of competition for local exchange service.

56. In a competitive market, firms are not guaranteed recovery of specific costs on a dollar-for-dollar basis.

57. It would be a disproportionate burden on the LECs and their customers if there was no means for implementation costs to be shared among other competitive local carriers.

58. Guaranteeing Pacific and GTEC recovery of their estimated implementation costs provides them with little incentive to manage these costs in an efficient manner.

59. Pacific's and GTEC's current implementation cost estimates are based on uncertain outcomes in the local exchange proceeding, and therefore are subject to change.

60. Under the adopted NRF price cap formula, the LECs absorb unanticipated cost increases while reaping the productivity rewards for being more efficient.

61. A rate center is a physical point within an exchange from which distance to another exchange is measured to identify whether a particular call will be rated as a long distance, toll, or local call.

62. In D.95-07-054, CLCs were ordered to match the LECs' existing rate centers for an interim period pending the resolution of CLC rating area designation in Phase II hearings.

63. While CLCs use of NXX codes which spanned several LEC rating areas could result in customer confusion and misrated calls, this problem could be mitigated through a consumer awareness program.

64. The negative impacts of misrated calls and customer confusion due to the use of inconsistent rating areas would be experienced chiefly by the incumbent LEC customers and could create a competitive disadvantage for the LECs.

65. The misrating caused by the use of disparate rating areas could require implementation of alternative measures to the ability to measure local versus toll traffic.

66. If each CLC were allowed its own rating areas, the designation of a call as local or toll would change each time a call was placed to a customer of a different CLC. Absent the timely implementation of mitigation measures, the result would be customer confusion as to whether they are making a local or toll call.

67. Requiring CLCs to use rate centers consistent with established LEC rate centers avoids such customer confusion.

68. Allowing CLCs to use different rating areas could adversely impact the E-911 network, unless special trunking is provided to assure proper routing of E-911 calls.

69. Consistent rate centers require a CLC to open a separate NXX in every LEC rate center in which the CLC offers service, thereby causing increased use of NXX codes and accelerated NPA exhausts.

70. Accelerated number exhaust would constrain the CLCs entry into some markets due to a shortage of NXX codes, and result in additional costs and customer disruption from more frequent NPA relief measures such as area code splits.

71. The issue of rating area consistency is only one of many factors determining how quickly number exhaustion will occur.

72. A super rate center results by combining several contiguous incumbent LEC exchange areas, each with its own rate center, into a single CLC rate center.

73. Super rate centers would enable CLCs to obtain an NXX covering a number of current LEC exchange areas, calibrated to make the number of combined rate centers as small as possible while trying to minimize number exhaust.

74. Use of super rate centers by CLCs will reduce, but not eliminate, the potential for number exhaust and the misrating of calls.

75. To rate a call, all carriers use a national file called the Terminating Point Master (TPM) which identifies the rate center to which a particular NPA-NXX number is assigned.

76. There is insufficient information on the record to immediately implement TCG's proposal for modifying the TPM in a way that would eliminate the possibility of misrating and misbilling associated with CLCs' using inconsistent rate centers.

77. There is insufficient information on the record to immediately implement super rate centers as an interim solution to the call misrating/misbilling associated with the use of inconsistent rate centers.

78. Customer confusion caused by use of inconsistent rating areas could be alleviated through information disseminated by an effective customer notification program.

79. The interim rules set forth in D.95-07-054 permit greater regulatory flexibility for the CLCs in comparison to the LECs.

80. The additional regulatory flexibility permitted the CLCs provides them with certain limited competitive advantages over the LECs which are counterbalanced by the overall market dominance which the LECs will continue to have for some time.

81. Stronger regulatory requirements for the LECs compared to the CLCs is warranted by the current market dominance of the LECs compared to the CLCs and promotes the goal of overall regulatory symmetry.

Conclusions of Law

1. Interim wholesale rates that will allow competition for resale of bundled local exchange service should be initiated within the service territories of Pacific and GTEC effective March 31, 1996.

2. Permanent wholesale rates should not be set until applicable cost studies and price determinations have been finalized and approved in the OANAD proceeding.

3. Interim wholesale rates should be set in a manner which promotes economic efficiency and a level playing field among all competitors for local exchange service within the Pacific and GTEC service territories.

4. Interim wholesale rates should be set in relation to the cost of wholesale service for bundled elements and features which match as closely as possible the retail service features which the LECs currently market.

5. Resale restrictions should be lifted on those retail services set forth on Table 1 of this decision with exception that use and user restrictions on the resale of residential service to business customers should be maintained.

6. Th terms and conditions under which to authorize CLC resale for Centrex, Centranet, and semipublic services should be examined in Phase III of this proceeding.

7. The applicability of wholesale discounts for ISDN service will be reexamined after the Commission has resolved A.95-12-043, Pacific's application to increase ISDN rates.

8. Restrictions on resale of existing grandfathered services should be lifted as long as resale is made to a customer currently receiving grandfathered service from the LEC.

9. Current use and user restrictions on Centrex and CentraNet should remain in place pending further examination in Phase III.

10. CLC resellers should receive reimbursement from the Universal Lifeline Telephone Service (ULTS) fund for the ULTS service they provide to qualified end users.

11. Pacific and GTEC have not justified adding additional charges in their wholesale tariffs for usage charges associated with flat residential services and 411 calls that are within the current allowance for retail services.

12. Simply setting wholesale rates equal to retail rates without adjustment for avoided retailing costs will unfairly overcompensate the LECs and undermine the viability of CLC resale competition.

13. Incumbent LECs as well as facilities-based CLCs could be placed at a competitive disadvantage in pricing their retail service if CLC resellers are able to purchase wholesale local exchange service without fairly compensating the LECs' cost.

14. GTEC has failed to show what LRIC is embedded within its proposed wholesale rate or whether the implied contribution above LRIC is reasonable.

15. GTEC's proposal to include an additional contribution from anticipated losses in intraLATA toll revenues is contrary to the goal of setting interim wholesale rates no higher than retail rates.

16. Setting GTEC's interim wholesale rate higher than its retail rate is not the proper way to make up for any lost opportunity to generate intraLATA toll revenues.

17. Adopted wholesale rates should account for avoided retail costs (such as end-user billing, marketing, and customer service expenses).

18. For the purposes of setting interim wholesale rates, an approximate adjustment for avoided retailing costs through imprecise, is superior to making no adjustment at all.

19. AT&T's proposed quantification of avoided retailing costs should be adjusted to reflect a retail cost differential of 17% for Pacific and 12% for GTEC, and the adjusted discounts should be applied to all the wholesale services in Table 1 of this order except residential access lines, vertical features covered under existing wholesale tariffs, private lines, COPT, Centrex/CentraNet, and ISDN.

20. AT&T's proposed additional discount of 10% for specified technical deficiencies in wholesale offerings is arbitrary and should not be adopted.

21. It is consistent with the imputation rules for price floors established in IRD to price wholesale service below the retail 1MB retail business rate as long as the wholesale price subtracts only those avoided retailing costs which represent competitive functions.

22. It is appropriate to establish wholesale discounts for the 1MR or 1FR rates of 10% for Pacific and 7% for GTEC to arrive at reasonable residential wholesale rates.

23. In considering whether Pacific and GTEC will be fairly compensated for wholesale residential service, it is appropriate to consider all of the revenues which the LECs receive associated with reselling residential service, not just the revenues from the access line itself.

24. Pricing wholesale residential service at discounts of 10% and 7% below the residential retail rates of Pacific and GTEC, respectively, would not constitute an unlawful confiscation of property as long as the LEC is able to be fairly compensated from the total package of revenues it receives.

25. Pacific and GTEC should be allowed to recover from CLC resellers for nonrecurring charges associated with transferring customers' accounts from the LEC to a CLC reseller. On an interim basis, such nonrecurring charges should be limited to the LECs' existing retail rates for transfers of customer accounts who remain at the same physical location, less a 17% discount for Pacific and a 12% discount for GTEC.

26. The issue of appropriate nonrecurring charges for Pacific and GTEC should be examined as part of Phase III of this proceeding.

27. The interim LEC wholesale rates adopted in this order should be superseded by wholesale rates established in the OANAD proceeding once those rates are finalized and approved.

28. At least during the initial transition to a competitive marketplace, these interim rules must retain certain restrictions on the LECs' pricing flexibility in recognition of their market dominance to guard against anticompetitive pricing practices.

29. The progress of competition should be monitored on an ongoing basis to allow for the possible removal of any unnecessary

regulatory restrictions on either the LECs or the CLCs when justified to allow the forces of competition to work.

30. Institution of competition for local exchange services as outlined in this and previous orders creates a "partially competitive" market for many of Pacific's and GTEC's local exchanges services consistent with the definition of Category II contained in D.89-10-031.

31. Except as specified in Table 2 in this decision, all other Category I services of Pacific and GTEC should be moved to Category II effective March 31, 1996, since they conform to the definition of Category II services set forth in D.89-10-031.

32. Category I services reclassified to Category II by this order should be priced at their currently tariffed rates with no pricing flexibility until appropriate cost studies are completed, and Category II price floors are adopted by the Commission.

33. The LECs should be permitted to implement pricing flexibility for tariffed Category II services once relevant price floors are established in the OANAD proceeding for the reclassified services.

34. The restrictions on LEC pricing flexibility for reclassified tariffed Category II services should not apply to customer-specific contracts, if and only if a customer-specific price floor has been approved and a facilities-based CLC has executed an interconnection agreement, opened one or more NXX codes, and originated or terminated traffic within the exchange served by the customer.

35. Allowing LECs to enter into contracts at below tariff rates for reclassified Category II services within a local exchange before any facilities-based CLC had begun to offer service within the majority of exchanges served by the customer subject to the flexibly-priced contract would give LECs an undue competitive advantage.

36. Pacific and GTEC may bundle those services moved from Category I to Category II by this decision with other Category II

and III services so long as no unlawful tying arrangements are involved.

37. Every Category II service that is bundled into a packaged offering should also be provided on an individual basis so that customers may purchase only those services they want or need at the authorized tariff price.

38. The prices for Category II services sold apart from a bundled offering should reflect the proper imputation of price floors.

39. Tying arrangements are illegal when the seller has sufficient economic power to restrain free competition in the tied product through the tying arrangement.

40. There is no tying arrangement under California's antitrust laws merely because the LECs offer customers any of their services individually or in combination with other services.

41. PU Code §§ 453, 532, and 2882.5 together require LECs to demonstrate, prior to the offering of a package, the imputed underlying costs of any Category II service bundled with a Category III or nonregulated service.

42. Pacific and GTEC should not be authorized to bundle the remaining Category I services with Category II and/or III services.

43. The Commission should lift its prohibition on offering certain local exchange services in customer specific contracts that was established in D.88-09-059. Such contracts should be allowed if they are consistent with the requirements of this Decision and GO 96-A contract rules adopted in IRD.

44. Pacific and GTEC may not enter into contracts which include Category I services at other than tariffed rates.

45. Pacific and GTEC should be authorized to file advice letters for customer-specific contracts that include bundled Category II services for which no service-wide floors and ceilings have been approved. These advice letters should comply with GO 96-A.

46. Pacific and GTEC should be granted pricing flexibility in customer-specific contracts for reclassified Category II services for which customer specific price floors have been submitted and approved and where a facilities-based CLC has executed an interconnection agreement, opened one or more NXX codes, and originated or terminated traffic within the exchange served by the customer.

47. The price floor for any package should be the sum of the price floors of the individual parts of the package (including any imputation requirement in setting the price floors).

48. When packaging residential services, the existing imputation rules should apply.

49. The subsidy payment should be included in the revenues received in determining whether the price of a package is above the price floor.

50. The LECs service-territory-wide average retail and wholesale rates should remain in place until cost studies by relevant geographic region have been completed and approved by the Commission.

51. The venue for the development of LEC cost studies and pricing specifically aimed at geographic deaveraging should be set by subsequent Commission action.

52. The assigned ALJ in the venue for geographic deaveraging cost studies should determine a procedural schedule for the preparation, review, and approval of cost studies and pricing which can be used for adoption of geographically deaveraged wholesale and retail rates.

53. Any rate deaveraging should be offered to ratepayers on a nondiscriminatory basis so that all ratepayers in the same geographically defined service area should pay the same rates.

54. Once appropriate geographically deaveraged costs have been approved, the LECs may be authorized to implement geographically deaveraged prices by specific Commission action.

55. LECs should not have to show some minimum level of market share loss or other related measures of competition before being authorized to implement geographic deaveraging.

56. LECs' deaveraged prices should be treated as Category II services and subject to geographically deaveraged price floors and caps.

57. The requirement for advance notice of LEC rate decreases for Category II services should be changed from 10 days to 5 days.

58. The requirement for a Commission resolution for approval of LEC customer-specific contracts should be eliminated effective March 31, 1996, except where more than a ministerial function is involved.

59. Reasonably incurred costs to implement local exchange competition are appropriate costs of service.

60. It is reasonable that end-users' rates reflect some recognition of costs to implement local exchange competition.

61. Pacific and GTEC should each be authorized to establish a memorandum account to record actual implementation costs incurred on and after January 1, 1996.

62. Pacific and GTEC should each file a report by January 1, 1997, providing the recorded balance in the memorandum account broken down by the major categories corresponding to the estimated implementation costs presented in the testimony in Phase II.

63. A schedule should be established in a later phase of this or some other appropriate proceeding for considering the issue of compensation for implementation costs, including a review of recorded implementation costs and consideration of what amounts, if any, should be subject to recovery through an end-user surcharge.

64. The LECs will be responsible for justifying the reasonableness of any amounts which they seek to recover through an end user surcharge.

65. No cost recovery for implementation costs should be approved at this time.

66. The ultimate disposition of the issue of whether CLCs should continue to conform with existing LEC rating areas should be determined by the record developed in Phase III of this proceeding in conjunction with formulating an integrated statewide policy on number usage and resolving relevant technical issues through workshops.

67. CLCs should not be required to open a separate NXX code in every rating center in which they offer service.

68. CLCs should not be permitted to offer local calling areas smaller than the LECs' 12-mile local calling areas.

69. The issue of NXX code opening costs should be considered in Phase III of this proceeding

70. Pacific should establish a separate memorandum account to track the number of NXX codes opened for each CLC.

71. Except for the specific changes we adopt herein, there is no basis to grant any remaining changes in pricing rules for the LECs or CLCs at this time.

72. The progress of competition within the local exchange market should be monitored and rules governing the LECs and/or CLCs may be revised over time as conditions warrant.

O R D E R

IT IS ORDERED that:

1. Pacific Bell (Pacific) and GTE California (GTEC) shall each file a tariff in accordance with General Order (GO) 96-A by March 21, 1996, to become effective on March 31, 1996, which provides for the competitive resale of local exchange service to certificated competitive local carrier (CLC) resellers in conformance with the prices, terms, and conditions set forth in each of their respective proposed resale tariff filings dated October 2, 1995, except for the modifications set forth below.

2. CACD shall have until April 15, 1996, to review the tariffs and notify Pacific and GTEC of any deficiencies in their filings.

3. Pacific and GTEC shall file revised tariffs by September 1, 1996, offering their optional toll calling plans for CLC resale.

4. For residential customers, Pacific and GTEC shall establish separate wholesale tariff rates equal to their current residential 1MR and 1FR retail rates with an adjustment for avoided retailing costs of 10% for Pacific and 7% for GTEC.

5. The tariffed wholesale rate for 1MB service for Pacific shall be $8.57.

6. The tariffed wholesale rate for 1MB service for GTEC shall be $16.91.

7. Pacific and GTEC shall amend their proposed wholesale tariffs to include all services within the wholesale offering as set forth on Table 1 of this decision and shall apply the 17% discount (for Pacific) and 12% discount (for GTEC) to those services except for residential access lines, vertical features covered under existing wholesale tariff, private lines, COPT, Centrex/CentraNet, ISDN, directory assistance, and operator services.

8. Pacific and GTEC shall offer ISDN, Centrex/CentraNet, private line, directory assistance and operator services and COPT for resale at existing tariffed rates, and shall offer all vertical features not covered under existing wholesale tariff rates at 17% and 12% discounts, respectively, from retail rates.

9. Pacific shall provide by March 18, 1996 intraLATA toll data to CACD necessary to compute the wholesale rates for intraLATA toll. Pacific and CACD shall meet and confer on the calculation of the discounts to enable Pacific to make a compliance filing by March 29, 1996, regarding the appropriate intraLATA toll wholesale rates. Such filing will become effective on March 31, 1996.

10. Pacific shall modify its billing system to enable it to offer intraLATA toll custom calling plans and shall file an amended tariff offering such plans by September 1, 1996.

11. The local exchange carriers (LECs) shall make intraLATA toll service available for resale.

12. The local exchange services offered within Pacific's and GTEC's tariffed resale rate shall be expanded to include the services set forth on Table 1 of this decision.

13. Pacific shall limit any nonrecurring charges billed to CLC resellers to an amount no higher than the existing retail tariff charges found in its tariff schedule CAL PUC NO. A3 of $5 per residential line and $7 per line for all other services, less the avoided cost discount of 17%.

14. GTEC shall limit any nonrecurring charges billed to CLC resellers to an amount no higher than the existing retail tariff charges found in its tariff schedule CAL PUC No. A-41 of $34.50 per business line and $17.25 per residential line, less a discount of 12% for avoided retail costs.

15. Effective March 31, 1996, services shall be classified in Category I and II as set forth in Table 2 of this decision.

16. The LECs shall be allowed to offer flexible prices under customer-specific contracts for reclassified Category II services effective March 31, 1996, subject to the filing of advice letters which include customer-specific price floors and showing of facilities-based competition.

17. Pacific's and GTEC's Category I services shall be reclassified as Category II effective March 31, 1996, except for those specified in Table 1 of this decision.

18. A workshop, coordinated by Commission Advisory and Compliance Division (CACD), shall be convened beginning at 8:00 a.m. on March 25, 1996, to address the following topics:

a. The feasibility of implementing TCG's proposal to modify the Terminating Point Master in order to allow for inconsistent

rating areas without the attendant misrating and misbilling problems.

b. The feasibility of implementing the super rate center proposal.

c. Means of assuring integrity of E-911 service and the ability to measure local traffic if existing rating area rules are changed.

d. The steps and timetable for implementing a customer awareness program regarding new procedures for determining how calls will be rated as CLCs establish NXX rating areas which differ from those of the LECs.

19. CACD shall prepare a workshop report as scheduled by subsequent ALJ ruling. To the extent workshop participants are unable to reach agreement on particular details of the report, they should be authorized to file separate comments dissenting from the report.

20. Phase III of this proceeding shall consider the results of the workshop report and determine appropriate mitigation measures to be adopted, including a timetable for customer awareness programs to educate customers about the new procedures for rating calls involving CLC customers; and to consider any other appropriate mitigation measures to deal with any call misrating or other negative consequences which may result from different NXX rating areas between LECs and CLCs.

21. No CLC shall begin to serve customers from NXX rating areas which are inconsistent with those of the LEC without first notifying CACD and providing assurance that adequate provision has been made to ensure the integrity of E-911 service.

22. Pacific and GTEC shall establish a memorandum account to record actual implementation costs incurred on and after January 1, 1996, and shall file a report setting forth actual implementation costs recorded in the memorandum account effective January 1, 1997.

This order is effective today.

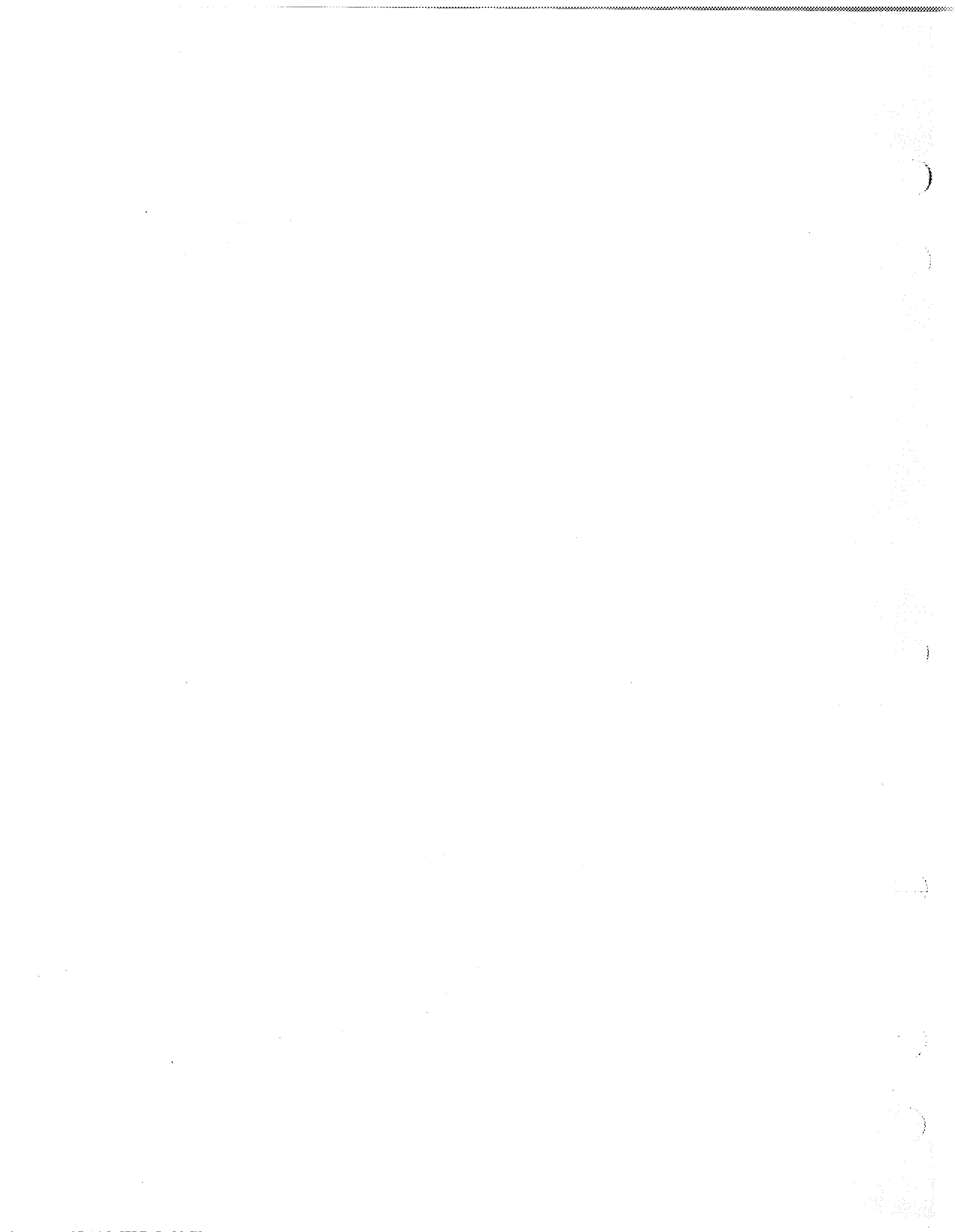
Dated March 13, 1996, at San Francisco, California.

DANIEL Wm. FESSLER
President
P. GREGORY CONLON
JESSIE J. KNIGHT, JR.
Commissioners

I will file a joint written dissent.

/s/ HENRY M. DUQUE
Commissioner

/s/ JOSIAH L. NEEPER
Commissioner



APPENDIX A
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List of Appearances

Respondents: David Discher and Theresa Cabral, Attorneys at Law, and Pillsbury, Madison & Sutro, by James B. Young, Attorney at Law, for Pacific Bell; Judith Endejan and Susan Rossi, and Munger, Tolles & Olson, by Henry Weissman, for GTE California, Incorporated; Orrick, Herrington & Sutcliffe, by Robert Gloistein, Attorney at Law, for Contel of California, Inc.; and Barbara Snider, Attorney at Law, for Citizens Utilities Company.

Interested Parties: Eric Artman, Attorney at Law and Swindler & Berlin, by Andrew Lipman and Richard Rinder, Attorneys at Law, for MFS Communications Company and Subsidiaries, Carmela Castellano, Attorney at Law, for NCLR, SLLC, FAA, FCRA, KSCC; John Clark, Attorney at Law, for California Association of Long Distance Telephone Companies, Inc., Caltel; Jeffrey Beck and Jullisa Bronfman, Attorneys at Law, for CP National, Evans Telephone Company, GTE West Coast Incorporated, Kerman Telephone Company, Pinnacles Telephone Company, The Siskiyou Telephone Company, Tuolumne Telephone Company, and The Volcano Telephone Company; Shelley Bergum, for Deaf & Disabled Telecommunications Program; Cooper, White & Cooper, by E. Garth Black, Mark Schreiber and Sean Beatty, Attorneys at Law, for Roseville Telephone Company, Ducor Telephone Company, Calaveras Telephone Company, California-Oregon Telephone Company, Winterhaven Telephone Company, Foresthill Telephone Company, Sierra Telephone Company, Happy Valley Telephone Company, Hornitos Telephone Company and Ponderosa Telephone Company; Blumenfeld & Cohen, by Stephen Bowen, Attorney at Law, for MCI Telecommunications Corporation; Peter Casciato, Attorney at Law, for Time Warner AxS of California, L.P. and Association of Directory Publishers; Jon Chambers, for Sprint Telecommunications Venture; Ellen Deutsch, Attorney at Law, for Electric Lightwave, Inc.; Davis, Wright & Tremaine, by Joseph Faber, Attorney at Law, for California Committee for Large Telecommunications Consumers; Alan Gardner, Glen Semohr, Carrington Phillip and Jennifer Johns, Attorneys at Law, for California Cable Television Association; William C. Harrelson, Attorney at Law, for MCI Telecommunications Corporation; Manning Lee and Teresa Marrero, for TCG; Thomas Long and Bruce J. Weston, Attorneys at Law, for Toward Utilities Rate Normalization; Graham & James, by Martin A. Mattes, Attorney at

APPENDIX A
Page 2

Law, for California Payphone Association; Patrick McMahon, Attorney at Law, for Sprint Communications Company, L.P.; Michael A. Morris, Attorney at Law, for Teleport Communications Group; Terry Murray, for Murray & Associates; Karen M. Potkul, Attorney at Law, and McCutchen, Doyle, Brown & Enersen, by Terry J. Houlihan, Attorney at Law, for AT&T Communications of California; Law Offices of Earl Nicholas Selby, by Earl Nicholas Selby, Attorney at Law, for ICG Access Services, Inc.; Cecil O. Simpson, Jr., Attorney at Law, for U.S. Department of Defense and All Other Federal Executive Agencies; Jerry Varcak, for Bank of America; and Virginia J. Taylor, Staff Counsel, for California Department of Consumer Affairs.

Commission Advisory and Compliance Division: Dorothy Duda, Karen Jones, and Jonathan Lakritz.

Division of Ratepayer Advocates: Helen Mickiewicz and Ira Kalinsky, Attorneys at Law.

Public Advisor's Office: Robert Feraru.

(END OF APPENDIX A)

Appendix B: Avoided Retail Costs as a Percentage of Total LEC Expenses for Pacific Bell

Source: Exh. 45, Appendix A /Note 1
Page 1
CACD 1/18/96

			SOCC REFERENCE LINE	ETI CALCULATIONS	Allocation Factor	(see Page 2 for Derivation)
Operations	a.	Total Operating Revenue (530 and 5300)	line 187+186			$8,080,276
	b.	Total Operating Expenses (excluding return + taxes) (720, 5300, 7370, 7540)		p1. line c + lines e through i		$6,639,448
Operating Expenses	c.	Dep. and Amort. (6561 to 6565)	line 252			$1,650,250
	d.	Return and Taxes		p.1 line a - line b		$1,440,828
	e.	Maintenance (6211 to 6540)	lines 210+211+214+219+229+245+246			$1,965,973
	f.	Marketing and Customer Svc (6611 to 6623)	lines 257+261			$1,344,338
	g.	Uncollectibles (5300)	line 186			$109,781
	h.	Overhead Exp. (6711 to 6790 + 7370 +7540)	lines 265+274+297+308			$1,213,208
	i.	Support Expenses (6112 to 6124)	lines 201+206			$355,898
	j.	Total Operating Expenses (including return + taxes)		p.1 lines c through i		$8,080,276
Retail Portion of Operating Expenses	k.	Retail Depreciation Exp.		p.1 line c * p.2 line f	0.050	$82,834
	l.	Retail Return and Taxes		p.1 line d * p.2 line f	0.050	$72,322
	m.	Retail Maintenance Exp.		p.1 line e * p.2 line f	0.269	$529,731
	n.	Retail Mktg and Customer Svs. Exp.		p.1 line f * 100%	0.269	$362,231
	o.	Retail Uncollectible Exp.		p.1 line g * 100%	0.269	$29,580
	p.	Retail Support Exp.		p.1 line i * p.2 line e	0.269	$95,897
	q.	Total Retail Exp. w/ Overhead:		p.1 lines k through p		$1,172,595
	r.	Total Exp. Less Overhead:		p.1 line j - line h		$6,867,068
	s	RETAIL EXP. AS % OF TOTAL:		p.1 line q / line r		17.08%

Note 1: Comments of AT&T Communications of California and MCI Telcommunications Corporation on the Proper Wholesale Rate

Appendix B: Avoided Retail Costs as a Percentage of Total LEC Expenses for Pacific Bell

ource: Exh. 45, Appendix A /Note 1
age 2
erivation of Allocation Factors from Page 1

			SOCC REFERENCE LINE	ETI CALCULATIONS	
ep 1: Interim Support sset Factor		(a)		p.2 line b / line c	18.63%
	Total Support Assets (account 2110)	(b)	line 51		$4,567,233
	Total Plant In Service (account 260)	(c)	line 86		$24,517,275
ep 2: Retail Support location Expense ctor (b/a) (% of pport Assets to be signed to Retail nctions)	Interim Support Asset % Allocation Factor (pg 1, Lines M-P)				26.94%
	Total Maint. and Mktg/customer svc exp.	(d)		p. 1 line e + line f	$4,989,198
	Mktg and Customer Svc share	(e)		p.1 line f / p.2 line d	26.94%
ep 3: Capital Allocation ctor (Dep, Return d Taxes, Maint. Exp.)	% Allocation Factor of Dep., Maint., Return, Taxes to be assigned to "Retail" functions (pg 1, Lines K-M)	(f)		p.2 line a * line e	5.02%

te 1: Comments of AT&T Communications of California and MCI Telcommunications Corporation on the Proper Wholesale Rate

ppendix C: Avoided Retail Costs as a Percentage of Total LEC Expenses for GTEC

ource: Exh. 45, Appendix A /Note 1
age 1
ACD 1/18/96

			SOCC REFERENCE LINE	ETI CALCULATIONS	Allocation Factor	(see Page 2 for Derivation)
perations	a.	Total Operating Revenue (530 and 5300)	line 187+186			$2,843,224
	b.	Total Operating Expenses (excluding return + taxes) (720, 5300, 7370, 7540)		p1. line c + lines e through i		$2,008,189
perating xpenses	c.	Dep. and Amort. (6561 to 6565)	line 252			$564,888
	d.	Return and Taxes		p.1 line a - line b		$835,035
	e.	Maintenance (6211 to 6540)	lines 210+211+214+219+229+245+246			$494,462
	f.	Marketing and Customer Svc (6611 to 6623)	lines 257+261			$334,101
	g.	Uncollectibles (5300)	line 186			$85,302
	h.	Overhead Exp. (6711 to 6790 + 7370 +7540)	lines 265+274+297+308			$328,413
	i.	Support Expenses (6112 to 6124)	lines 201+206			$201,023
	j.	Total Operating Expenses (including return + taxes)		p.1 lines c through i		$2,843,224
etail Portion Operating penses	k.	Retail Depreciation Exp.		p.1 line c * p.2 line f	0.0331	$18,717
	l.	Retail Return and Taxes		p.1 line d * p.2 line f	0.0331	$27,669
	m.	Retail Maintenance Exp.		p.1 line e * p.2 line f	0.2315	$114,460
	n.	Retail Mktg and Customer Svs. Exp.		p.1 line f * 100%	0.2315	$77,339
	o.	Retail Uncollectible Exp.		p.1 line g * 100%	0.2315	$19,746
	p.	Retail Support Exp.		p.1 line i * p.2 line e	0.2315	$46,534
	q.	Total Retail Exp. w/ Overhead:		p.1 lines k through p		$304,465
	r.	Total Exp. Less Overhead:		p.1 line j - line h		$2,514,811
	s.	Portion of Retail Exp. (incl. overhead)		p.1 line q / line r		12.11%

ote 1: Comments of AT&T Communications of California and MCI Telcommunications Corporation on the Proper Wholesale Rate

Appendix C: Avoided Retail Costs as a Percentage of Total LEC Expenses for GTEC

Source: Exh. 45, Appendix A /Note 1
Page 2
Derivation of Allocation Factors

Step	Item	Line	SOCC REFERENCE LINE	ETI CALCULATIONS	Value
Step 1: Interim Support Asset Factor		(a)		p.2 line b / line c	14.31%
	Total Support Assets (account 2110)	(b)	line 51		$1,121,769
	Total Plant In Service (account 260)	(c)	line 86		$7,836,827
Step 2: Retail Support Allocation Expense Factor (b/a) (% of Support Assets to be assigned to Retail Functions)	Interim Support Asset % Allocation Factor (p.1, Lines M-P)				23.15%
	Total Maint. and Mktg/customer svc exp.	(d)		p. 1 line e + line f	$1,443,301
	Mktg and Customer Svc share	(e)		p.1 line f / p.2 line d	23.15%
Step 3: Capital Allocation Factor (Dep, Return and Taxes, Maint. Exp.)	% Allocation Factor of Dep., Maint., Return, Taxes to be assigned to "Retail" functions (p.2, Lines K-M)	(f)		p.2 line a * line e	3.31%

Note 1: Comments of AT&T Communications of California and MCI Telcommunications Corporation on the Proper Wholesale Rate

(END OF APPENDIX C)

Henry M. Duque and Josiah L. Neeper, Commissioners, dissenting:

We dissent from the decision of our colleagues that adopts resale rates of local telecommunications services while constraining the ability of incumbent local exchange carriers from meeting the prices of their competitors. We conclude that these policies are unwise, unneeded, and not based on the evidence in the record.

The Commission has adopted a decision that requires incumbent local exchange carriers to provide residential telecommunications services to their competitors at a discount. Previously, we concluded that these services are priced below their costs. Thus, the Commission's decision mandates that incumbent carriers provide a service to competitors at discounts from prices already below their costs.

We conclude that this pricing policy confuses the heavy fist of regulation with the invisible hand of markets. If the incumbent carriers were to propose below-cost prices to us, we would likely reject their pricing policy as anti-competitive. To adopt such a policy as pro-competitive makes no policy sense to us. This pricing policy further aggravates the economic distortions that arise when prices depart from costs. Moreover, the policy retards competition because it makes it more difficult for facilities-based carriers to enter markets where a below-cost resale service is readily available.

The discounts adopted in this decision for residential basic services --10 percent for Pacific and 7 percent for GTEC -- have no basis in the evidentiary record of this proceeding. Although evidence supported a range of policy discounts, the figures of 10 and 7 percent can claim no basis in the evidence presented, nor are they justified as reasonable in the decision adopted today. Thus, the decision has an arbitrariness that makes it unreasonable.

This decision severely limits the ability of Pacific and GTEC to offer comprehensive contracts even when a customer has a proposal from a competitor offering a combination of facilities-based and resold services. For Pacific or GTEC to exercise pricing flexibility, they must make a complicated regulatory showing regarding the facilities of the competitor making an offer in the majority of local exchanges serving the customer. The burden of demonstrating this in a competitive market will consume so much time that the regulatory web encumbering an incumbent's counteroffer will make it non-competitive. Thus, the decision produces an irrational result: it essentially deprives Pacific or GTEC from making a competitive counteroffer to a customer operating in multiple locations throughout the state while it requires Pacific and GTEC to assist a competitor in making a statewide offering by furnishing the competitor with the services it needs at a discount.

The heavy hand of regulation also leaves its mark on the decision's regulation of the already competitive toll market. This decision sets a resale margin on toll services despite the fact that they are available from many vendors. Thus, the decision introduces more regulation where none is needed.

This regulation is not only unneeded, it will likely prove wasteful of time and resources. The Commission's last major venture into setting resale margins was in the cellular industry. In that sector of the telecommunications industry, California regulation resulted in a resale margin that was less than half those that arose in open markets throughout the country. For years, the Commission's major regulatory actions in the cellular industry consisted of penalizing carriers for unauthorized discount promotions. Despite this regulatory action, the Commission publicly complained about California's high cellular rates. We fear that this decision sets us down this faulty policy track once again.

We regretfully conclude that this decision subjects California business to more regulation under the guise of producing a "free market." We believe that more regulation is inimicable to free markets and competition that truly serve California. We therefore must dissent.

/s/ HENRY M. DUQUE

Henry M. Duque
Commissioner

/s/ JOSIAH L. NEEPER

Josiah L. Neeper
Commissioner

March 13, 1996

San Francisco