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Informational Hearing
of the
Assembly Committee on Utilities and Commerce
State Capitol, Room 437
Sacramento, California
Tuesday, June 6, 1989

"DON'T HANG UP!"
The PUC and Telephone Service in the 90's — Regulation, Deregulation, or Reregulation?

Assemblywoman Gwen Moore, Chairwoman
Robert Jacobson, Consultant
Yvonne Wilson, Committee Secretary

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Special Hearing
June 6, 1989, 9:00 AM
State Capitol, Room 437, Sacramento

"DON'T HANG UP!": THE PUC AND TELEPHONE SERVICE IN THE 90'S -- REGULATION, DEREGULATION, OR REREGULATION?

Testimony

Public Utilities Commission
Pacific Telesis Group
GTE California
California Telephone Association
AT&T
US Sprint
MCI Communications
CAL-TEL (Long-Distance Carriers)
Bay Area Teleport
Dun & Bradsteet/Donnelley Publishing
American Newspaper Publishers Association
California Cable Television Association
Information Providers Association
API Alarm Company
Yellow Phone of San Francisco
Centex Telemanagement
Amvox
Extension Connection
TURN
California Bankers Clearinghouse Association
Center for Public Interest Law
City of Los Angeles
NAACP

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The Public's Interest in Telecommunications Regulation

In 1910, after years of strife between the utilities and their customers, the people of California enacted by initiative Article XII of the California Constitution., laying the groundwork for an autonomous Public Utilities Commission (PUC) free of utility influence. Now this institution is at the heart of a struggle to determine its role in managing the shape of of California's telecommunications future into the next decade, and beyond.

The issue is telephone service and how it should be regulated in the 1990's and beyond.

From all appearances, Californians are quite pleased with the quality of telephone service in this state. Polls taken by the telephone companies indicate a rising level of satisfaction with their service. Moreover, there are more Californians now using personal computers to conduct business and leisure activities than in any other state. New telecommunications services are ready to be implemented

by the telephone companies as soon as they receive PUC authorization; some are already being offered on an interim basis, pending resolution of jurisdictional disputes between the PUC and the FCC. And telephone company profits have hit record heights, exceeding 14 percent return on equity in recent years. (For example, Pacific Bell, in 1988, earned approximately $1.2 billion on revenues of $11 billion.)

One might ask, in these circumstances, what substantial societal gains can be attained by relaxing regulation of the telephone companies?

On the other hand, to hold with the opponents of regulatory change that the telephone companies should not be permitted in any way to advance the coming "information society" may be short-sighted and deny the appropriate use of billions of dollars of ratepayer investments represented by telephone company assets and labor.

Unfortunately, these larger issues of accountability and responsible planning for Californians' collective future may be lost in the welter of self-serving claims and counterclaims being put forward by the telephone companies and their opponents in several pending regulatory proceedings.

This hearing is intended to examine the role of regulation in the evolution of California's telecommunications infrastructure and how pending regulatory proceedings, and future legislation, may shape this role.

A Complex Telecommunications Industry Challenges California's Regulators

Five years ago, the Bell System monopoly was dismembered at the hands of the U.S. Justice Department and AT&T's own executives. Today, different firms provide long-distance and local telephone service, under supervision by a federal court and the Federal Communications Commission; still other firms offer other information services. The success of this policy.is still hotly debated.*

* Today, after three decades,the Federal Communications Commission's policy of inducing competition in the telecommunications industry is facing serious criticism. International competition

What is not debatable is that the American telecommunications industry is considerably more complex than it was before 1984.

This is certainly the case in California, where telephone company revenues exceed $15 billion annually. California, probably the most lucrative and fastest-growing telecommunications market in North America (and possibly the world), is a region exceedingly dependent on the appropriate provision and regulation of telecommunications services. All public telecommunications providers in California, to a greater or lesser degree, are regulated by the Public Utilities Commission (PUC):

• AT&T, MCI, US Sprint, Allnet, and a host of smaller "resellers" provide *long-distance voice and data service* in California. (The Los Angeles-San Francisco "hop" is the "hottest" -- most frequently used -- transmission link in the world.

• California's two largest telephone companies, Pacific Bell (a subsidiary of Pacific Telesis, a holding company), and GTE California (a subsidiary of GTE Corp.), provide *local voice and data telephone service* to approximately 11 million and 2.5 million telephone customers, respectively.

• Twenty-two smaller telephone companies provide *local voice and data service* to an additional half-million Californians.

These long-distance carriers and the local telephone companies provide the *public telecommunications network*, the infrastructure on which California's future information economy can grow. These telecommunications firms thus have a responsibility and an incentive to support the development of an information economy; but they may also be tempted to exploit this development to their own advantage.

---

from Continental Europe, Japan, and Canada, where integrated national telecommunications networks provide a solid platform for technological innovation, is one reason for this reassessment. But the rudderless nature of American telecommunications policy, which is encouraging "niche" competition on the margins but industry concentration in the "core," invites skepticism. *See*, Horwitz, The Irony of Regulatory Reform, "Introduction" (attached).

The PUC, faced with a very complex situation, is today asking, "How shall we manage change?" One solution proposed to the Commission is that it permit the telephone companies or other private interests greater leeway to make long-range policy. This conceptual proposal is sometimes labeled "regulatory flexibility" or "marketplace-driven regulation." Two proceedings taking place right now will test the PUC's will to hew to its historical regulatory responsibilities: The "Alternative Regulatory Framework" Investigation (I. 87-11-033), which began in September 1987; and the "Enhanced Services" proceeding (A. 88-08-031).

The Traditional Goals of Regulation

Before considering its "alternatives," utility regulation and its traditional purposes must first be appreciated.

The traditional goals of utility regulation include: (a) assuring just and reasonable rates, (b) preserving the ability of the utility enterprise to attract capital on reasonable terms, (c) preventing abuse of monopoly power and undue discrimination among customers, and (d) assuring adequate service. In California, "adequate service" has always been meant "high quality."

Traditional rate-of-return regulation ideally links rates to costs (including the cost of capital). Rate-of-return regulation meets the reciprocal interests of utilities and their customers: (a) For the utilities, capital attraction on reasonable terms; and (b) for their customers, just and reasonable prices (rates) for service. The PUC, in the past, has used the *general rate case* as the principal proceeding for determining appropriate rates for the utilities. During a general rate case, which may last several years, public hearings afford both formal and informal opportunities for testimony by anyone with an interest in the utility's operation. The PUC also has the crucial duty of *rate design*: deciding who pays what for which service.

The PUC also has important oversight responsibility for telephone company investments in new technology. These investments must be sufficient

but not excessive. In the late 1970's, when subscribers complained about General Telephone's poor service, the PUC permitted GTE's rates to rise, to cover the company's investments in new state-of-the-art switching equipment. This year, after extensive investigations of Pacific Bell's technology investments revealed that some of these investments were not necessary, the PUC directed Pacific Bell to reduce its rates by more than $120 over the next three years. In the future, as telephone company planners call for additional investments, the PUC's vigilance in this area may be become even more important.

Finally, the PUC can intervene on the ratepayers' behalf when the telephone companies or those who use their facilities employ unfair business or marketing practices. In 1985, the PUC fined Pacific Bell $17 million for abusive marketing practices that resulted in customers (especially non-English-speaking customers) signing up for services they did not understand or want. Refunds to those customer ordered by the PUC totalled another several million dollars. This year, the PUC is investigating the marketing practices of pay-phone operators and cellular telephone companies.

Nevertheless, despite its successes, traditional rate regulation has its detractors. The Federal Communications Commission (FCC) under Presidents Carter, Reagan, and Bush has sought to reduce its regulatory involvement in dramatic fashion. At the state level, local telephone companies have staged intensive lobbying campaigns to do away with traditional utility regulation;.

Pacific Bell first proposed a modified form of regulation in 1985, shortly after divestiture. It claimed that the long duration of general rate cases imperiled Pacific's ability to respond to technological change and threatened its financial health. In short, Pacific called for a moratorium on the general rate case.

The Alternative Regulatory Framework Investigation (I 87-11-033)

The PUC twice rejected Pacific Bell's "California Plan for Rate Stability," but in 1987 it decided to initiate its own investigation into potential new methods of telephone regulation. This PUC, with a majority of newly appointed

commissioners, was persuaded that traditional rate-of-return regulation might be too cumbersome, inefficient, and without sufficient incentives for the provision of efficient and innovative telephone service. The PUC had already begun the process of loosening regulatory oversight of the long-distance carriers, a process completed for AT&T in December 1988, and was inclined to consider how it might reduce its regulatory involvement with the local telephone companies. Pending completion of this "Alternative Regulatory Framework" Investigation (I. 87-11-033), GTE California's general rate case was quickly concluded and Pacific Bell's 1989 general rate case put on hold. Also put on hold were attrition (cost-of-living) adjustments for these companies that would normally occur on an annual basis.

The PUC has divided the Investigation into three "phases." *Phase One,* now completed, dealt with immediate issues of pricing flexibility in clearly contested markets. *Phase Two*, now underway, is examining the issues of competition, new services, and rate design. *Phase Three* will consider the issue of competition in the local telephone market *after* a new regulatory structure for the local telephone companies is in effect.

In 1988, the PUC completed Phase One of the Investigation, allowing for (1) limited competition in the provision of high-speed data services in the local telephone market, (2) greater pricing flexibility for Pacific Bell's and GTE California's Centrex services, and (3) less scrutiny for special contracts negotiated between Pacific and GTE and their largest customers.

Phase Two of the Investigation is expected to be completed by August of this year, when the PUC will likely publish its decision. (A proposed decision will be circulated by the administrative law judge presiding over the Investigation sometime in July 1989.)

Phase Three of the Investigation is not yet scheduled.

A great many parties have presented different proposals to the PUC in Phase Two of the Investigation, ranging from more "flexible regulation" (a euphemism for one or another form of deregulation) to maintaining the *status*

quo. Three major proposals have been made by Pacific Bell, GTE California, and the PUC's Division of Ratepayer Advocates (DRA).

Pacific Bell argues for a three-year hiatus on general rate cases and the freedom to shift rates and make investments without close PUC scrutiny. GTE California has proposed an indefinite moratorium on general rate cases and a slightly different rate-making plan. These companies would like greater flexibility to make investment decisions and to price services closer to cost (which have yet to be established). They contend that this will permit them to install new technology, to offer new services that otherwise would be uneconomical, and to meet competition planning to "cream-skim" the local telephone market.

There are many critics of these proposals. Some are opposed because these proposals would impact their own telecommunications business. Among these are the long-distance carriers -- **AT&T**, **US Sprint**, and **MCI Communications**. Sharing this perspective are **API Alarm**, **Bay Area Teleport**, **Dun & Bradstreet** (whose Donnelley subsidiary publishes Yellow Pages and runs an audiotex service), and **Centex**, a telecommunications management firm serving small businesses. The long-distance firms are concerned that the issue of competition in the local market, which they believe should precede any lightening of regulation for the local telephone companies, has been put on the back burner until Phase II is complete. Other of these parties fear unequal competition with the telephone companies in currently unregulated markets. (**Amvox**, **Extension Connection**, and **Talking Yellow Pages**, and the **newspaper industry**, although not parties to the Investigation, have taken similar positions in related proceedings before the PUC and in federal venues.) The **California Cable Television Association** predicts that the telephone company proposals will produce a windfall for the telephone companies and allow them to cross-subsidize competitive services with revenues paid by captive ratepayers.

Other parties representing the consumers of telephone services are also critical of the telephone companies' proposals, but for different reasons. The **California Bankers Clearinghouse Association**, the **Tele-Communications Association**, **TURN**, the **Center for Public Interest Law**, and several local governments (represented at this hearing by the **City of**

Los Angeles) believe that traditional rate-of-return regulation is adequate to accomplish all of the goals set forth by the PUC when it began the Investigation. According to these parties, the burden of proof is on those who want change; the case has not been made in this Investigation, they argue. They advise the PUC not to set a precedent that the telephone companies might ask to be made permanent.

The telephone companies rebut that the current mode of regulation is inappropriate to a changing technological and market environment and only serves the special interests of their critics.

The independent telephone companies (represented at this hearing by the **California Telephone Association**) are not directly critical of the Pacific Bell or GTE California proposals, but they contend that any new regulatory scheme should allow for their special situation as small companies with few resources to accommodate radical change.

The **DRA** proposal envisions a less dramatic overhauling of the current regulatory system. DRA's proposal has not stirred a great deal of controversy (either pro or con), as it walks a narrow line between maintaining traditional rate-of-return regulation and incremental regulatory modifications. Though comprehensive, the DRA proposal lacks the sweeping scope of the telephone companies' proposals.

The Enhanced Services Proceeding (A. 88-08-031)

In 1986, the Federal Communications Commission (FCC) authorized the local telephone companies to provide "enhanced services" in addition to basic voice and data telephone service. In March 1988, federal Judge Harold E. Greene, who supervises the divestiture, permitted the local telephone companies to offer "information gateways," convenient electronic meeting points (one or more local telephone numbers) that a customer can dial to reach a variety of information-service vendors. Shortly thereafter, Pacific Bell applied for authority to offer this service in California, initiating the "Enhanced Services" proceeding (A. 88-08-031). According to Pacific Bell, information service

providers can get started more cheaply using Pacific Bell's gateway technology, rather than having to invest in technology of their own.

Pacific Bell's plans for billing and collection, program monitoring and censorship, and notice to customers of alternative gateway options are currently being contested by various parties to this proceeding. **VISA, Inc.,** wants assurances from Pacific Bell that credit cards and other billing and collection options (other than billing through the telephone company) will be available to information vendors and their customers. **Dun & Bradstreet** is concerned about a potential "electronic Yellow Pages" that Pacific Bell Directory might be offer via a gateway. (The divestiture settlement prohibits the local telephone companies from providing this type of information service.) The **Information Providers Association (IPA)**, which is engaged with Pacific Bell in negotiations regarding information services, has in the past raised important questions regarding the propriety of a common carrier -- the telephone company -- exercising control over the content of communications. The IPA and the **American Newspaper Publishers Association** were involved in last year's successful legislative effort to limit the accessibility of objectionable 976 services under state, not telephone company, guidance. **Telenet** (not represented at this hearing) questions the efficacy of Pacific Bell's gateway plans.

Via this same proceeding, the PUC has granted Pacific Bell interim authority to provide *electronic mail* and *videotex* (computer-message) services. Pacific Bell has also filed to provide *voice-mail* services on an interim basis. These trials are supposed to provide basic information regarding consumers' willingness to buy and use these services. But they also afford Pacific Bell an outstanding opportunity to gain familiarity with these new services, including operational and marketing experience. The grant of interim authority afforded Pacific Bell by the PUC, to provide these new services, is not limited by any apparent condition other than the PUC's notice that it may, in the future, alter the grant of authorization. This is has not discouraged Pacific Bell from setting forth on its trial runs.

Conclusion: Telephone Regulation and the Bigger Picture

The current PUC proceedings expose the tip of the iceberg of a much larger policy challenge: planning California's telecommunications environment for the next century. By their very nature, regulatory proceedings like the Investigation are limited by the questions asked by the PUC and the the adversarial responses provided by the various parties. The welter of claims and counterclaims does not advance the public's interest in a broader policy which recognizes the central role of telecommunications, for good or ill, in California's future.

Very few Californians know that the Investigation is taking place, let alone what is being proposed in the way of regulatory change and what is at stake for them. Public participation in the Investigation, as evidenced by turnout at statewide PUC hearings held earlier this year, has been pauce. Except for the participation of professional advocates like TURN and the Center for Public Interest Law, the public's interest is unrepresented in this decisive proceeding that will affect every Californian. There is no public consensus supporting radical modifications to current regulatory practice and the political consequences of such a change, if there was one, could be significant.

The Legislature, as the leading policymaking organ of state government, may choose another course of action. Last year the New York Public Service Commission (the equivalent of California's PUC) initiated an ambitious, long-range examination of New York's telecommunications requirements. Its intent was to understand more thoroughly how telecommunications policy could affect New York's economy and development *before* adopting possibly irreversible regulatory reforms. The Legislature could direct the PUC to craft a similar proceeding, drawing upon its own resources, the excellent thinkers and do-er's in this field who live and work in California, and a public alerted to the need for a broad consensus on these matters.

What do Californians expect from their technological future? The question begs to be answered, as the public interest deserves to be served.

Robert Jacobson
Principal Consultant
June 1, 1989

Key Questions of Interest to the Committee

1. The traditional goals of utility regulation include: (a) assuring just and reasonable rates, (b) preserving the ability of the utility enterprise to attract capital on reasonable terms, (c) preventing abuse of monopoly power and undue discrimination among customers, and (d) assuring high-quality service and adequate facilities. Are these goals inappropriate for the 1990's? Should additional goals be pursued in the 1990's?

2. Traditional rate-of-return regulation ideally links rates to costs (including the cost of capital). It is the principal method to achieve the twin goals of (a) capital attraction on reasonable terms and (b) just and reasonable rates. Is a new form of telephone regulation recommended -- or can traditional rate-of-return regulation still serve the public interest? Please restate (briefly) your position, if any, before the Public Utilities Commission (PUC) in OII 87-11-033 ("Alternative Regulatory Framework") and A. 88-08-031 ("Enhanced Services").

3. Are current regulatory procedures adequate to identify and consider, in a coordinated fashion, the full range of issues that should be of concern to policymakers? These issues include, among others:

(a) Maintaining and enhancing universal service.
(b) Improving the efficiency of the public telecommunications network.
(c) Competitive access to telephone company facilities.
(d) Conditions under which telephone utilities may compete in unregulated markets.
(e) Privacy of telephone subscribers' personal information.
(f) Consequences of activity in the telecommunications sector for state and local economic development.

4. Does the existing regulatory environment encourage the presentation of points of view that represent the interests of Californians at large? Should greater participation be encouraged? If so, how?

5. What would you recommend to the Legislature and the PUC of the 1990's as an appropriate approach to telecommunications policy?

Items

1. National Regulatory Research Institute. Telecommunications Modernization: Who Pays? September, 1988. (The NRRI, the research arm of the National Association of Regulatory Utility Commissioners, or NARUC, explains the care that must be taken dealing with investments in new telecommunications technology.)

2. International Communications Association. Adapting State Regulation of Telephone Companies to Industry Change. 1989. (The ICA, a national organization of large telecommunications customers, argues for continuing traditional rate-of-return regulation.)

3. Sam Ginn. "A Regulatory Busy Signal Blocks Phone Progress," Los Angeles Times, May 12, 1989. (Ginn, chairman of Pacific Telesis, the parent company of Pacific Bell, argues for less regulation.)

4. Julie Amparano Lopez. "New Telephone Services Fail to Connect," Wall Street Journal, May 24, 1989. (Discusses marketing acumen of the telephone companies.)

5. Bruce L. Egan. "Capital Budgeting for Fiber," Telecommunications, May 1989. (Egan, a telecommunications economist at Columbia Unbiversity, explains the lure of fiber optic cable for telephone companies.)

6. Johnnie L. Roberts. "AT&T Asks End Of Electronic Publishing Ban," Wall Street Journal, April 24, 1989. (AT&T was prohibited from entering the electronic publishing business, until 1989, by the divestiture settlement. Time's up.)

7. Joe Sharkey. "Newspaper Publishers Debate Pros, Cons of Allying With Phone Firms," Wall Street Journal, April 26, 1989. (The newspapers and their association, the American Newspaper Publishers Association, have long been opposed to telephone company entry into electronic publishing.)

8. Janet Guyon. "As Telephone Information-Service Firms Proliferate, Concern Mounts Over Abuses," Wall Street Journal, March 27, 1989. (New services provided over the telephone network, but not by the telephone company, pose an uncharted terrain for the PUC.)

9. Brock Meeks. "Free Speech Is Where You Find It," Microtimes, May 15, 1989. (Meeks, a veteran reporter on telecommunications and computers, reports on an emerging issue: Are publicly accessible computer networks like shopping malls? Are their "visitors" protected by First Amendment rights of speech and assembly?)

10. Robert Britt Horwitz. "Telecommunications and Their Deregulation: An Introduction," The Irony of Regulatory Reform. New York: Oxford University Press, 1988. (Horwitz is one of many young researchers reevaluating the wisdom of the FCC's and states' deregulatory policies. His findings are not salutory.)

11. Mireya Navarro. "Powerful groups weigh in against Pac Bell," San Francisco Examiner, June 4, 1989. (A fair summary of the positions of various parties in the PUC's current investigation of telephone regulation.)

1

NRRI 88-11

TELECOMMUNICATIONS MODERNIZATION: WHO PAYS?

prepared for the

NATIONAL REGULATORY RESEARCH INSTITUTE

by

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EXECUTIVE SUMMARY

The study has been motivated by the fact that telephone utilities are spending increasing amounts of capital to modernize the basic telecommunications network infrastructure that is used to provide both regulated and unregulated services. The modernization of embedded telecommunications plant and facilities confronts regulators with significant policy challenges, because the timing of the replacement of plant rarely coincides with the cost recovery of the investment in either the old or the new facilities. Moreover, changes in the industry that have led to increased "below-the-line" business activities using common (rate base) plant have also led to a potential mismatch between the parties who pay for the new plant and those who enjoy the benefits of services produced by - and profits derived from - that new plant. Finally, a policy of accelerated plant modernization leads to increased retirements of plant prior to the date at which such retirements would have been orginally expected based upon normal mortality curves for the facilities. This, coupled with the investment cost in the new plant, increases the effective capital costs for the new plant, at least in the short term. The increased capital costs must be weighed against two potential benefits associated with the more modern facilities: decreased maintenance costs and additional and/or improved services.

The dilemma for regulators in responding to the pressures for modernization of facilities is that, while the underlying economic theory is clear and easily understood, an assessment of specific capital decisions is rarely straightforward. The introduction of new technologies often brings with it the availability of new services along with cost efficiencies in the provision of existing services. There is seldom agreement among all parties as to the relative merits of the new services for different classes of customers or as to the benefits of the operating efficiencies that should be attributed to existing services. As the telecommunications industry evolves, it is apparent that new facilities will be used both to furnish existing services more efficiently and to provide new services, some of which may be furnished on an unregulated basis. Regulatory authorities are called upon to determine how costs attributable to new facilities should be allocated between existing and/or "above-the-line" services and new and/or "below-the-line" services. The cost allocation affects the rate base, and hence the rates, that customers pay for regulated services. It influences the price that a telecommunications utility can justify for a potentially competitive service, and it affects the economic viability of the modernization decision itself. Thus, a regulator's choice among many options becomes a policy decision of enormous significance both for customers and for the competitors of the regulated telecommunications firms.

Two extreme views of the response to the "who pays?" question exist. Some would advocate that only those who use new network features should be assigned responsibility for the cost of the new facilities. "Basic" service, as it is defined today, would bear none of the costs of modernization. Under this scenario, the concept of basic service would never expand to include additional features and benefits that become available through the more modern facilities. At the other extreme, the cost of all network enhancements would be borne by the general body of ratepayers because all would ultimately benefit from access to a state-of-the-art infrastructure. While this view permits an upgrading of the definition of basic service as the network evolves, it

also requires state regulators to coordinate the utilities' regulated and unregulated costs to ensure that neither ratepayers nor competitors are disadvantaged by whatever cost allocation policy is adopted.

State regulatory commissions have long taken the position that modernization activities must be justified based upon demonstrable improvements in operating efficiency, either in the short run or over the longer term. Modernization for its own sake has not been allowed. The cost/benefit analysis typically relies on a "discounted cash flow" study, such as the Bell companies' CUCRIT, that compares the costs of maintaining embedded resources with the costs of replacing the older plant with more modern facilities. Among the factors that can be included in the analyses are the savings in operating expenses anticipated with the newer facilities and the additional revenues generated through sales of new services that becomes possible only with the newer equipment and systems in place.

Questions of attributing benefits of more modern plant between basic regulated services and competitive or potentially competitive services had not arisen until until very recently. In a proceeding before the Public Service Commission of the District of Columbia (DC PSC), regulators confronted the issue of how to allow the Chesapeake and Potomac Telephone Company (C&P) to compete for business customers with a digital Centrex offering. The DC PSC fashioned a plan that would allow C&P to develop "Individual Case Basis" rates for Centrex service for specific customers in exchange for assurances that the risk of recovering the investments made to satisfy those customers' needs would be borne by the shareholders and not by the general body of ratepayers. Thus, the DC PSC has established a principle that, when the utility gains flexibility in pricing and marketing new services in competition with other firms, the risks and responsiblity for recovery of the investment needed to furnish that service should be shared in proportion to the risk between the general body of ratepayers and the shareholders.

The California Public Utilities Commission (California PUC) has also recently reviewed modernization activities of Pacific Bell. The California PUC Staff has recommended a penalty in the form of a rate reduction against Pacific Bell because it found its modernization projects to be unreasonably risky. Pacific Bell responded to the Staff recommendation by suggesting that the Staff had not adequately considered the benefits of modernization such as maintenance savings, productivity improvements, and additional revenues. These factors could have and should have been included in the discounted cash flow analysis used by Pacific to analyze its modernization program. Thus the California PUC may question whether there are benefits associated with Pacific Bell's modernization program that cannot be translated into quantifiable factors, and if so, how the policy issues associated with thse intangibles can be adequately addressed.

Regulatory commissions will be required to assess modernization projects involving facilities that are used to furnish both regulated and unregulated services. A mismatch of costs and benefits from these projects can occur if costs and revenues are not consistently allocated between the ratepayers and the shareholders. A mismatch can also occur if there is a change in the regulatory status of one of the services furnished using upgraded plant subsequent to its acquisition. Finally, the cost of capital of a regulated firm may change as the firm takes on increasingly risky activities. Each of these potential cost/benefit mismatches arises because the telecommunications utility is no longer providing only regulated services. Since it is neither possible nor desirable, given the present state of the industry, to return to an environment where regulated utilities offer only regulated services, the policy challenge is to devise a method to reduce or eliminate these potentially significant cost/benefit mismatches.

As a practical matter, the sharing of risks and responsibility between ratepayers and shareholders must be accomplished by an allocation of investment between "above-the-line" and "below-the-line" activities. The first principle for this allocation is one with which regulators are already familiar: Regulators have traditionally taken the position that economic benefits to ratepayers must exceed the additional costs of modernization if the modernization project is to be approved. Since tangible benefits from reduced operating expenses and increased sales of new services can be quantified, this threshold standard should be maintained.

On the other hand, ratepayers should not be required to fund a portion of plant that is either initially or ulitimately dedicated to non-regulated activities, *even if they would benefit from the cost savings attributable to the modernization standing alone*. Thus, a cost allocation should fairly divide the investment between plant that is used for regulated services and resources that are intended for unregulated activities.

To ensure that the investment is not overallocated to regulated services, the utility should not be permitted to reassign "spare" facilities that had originally been allocated to regulated activities to an unregulated business, without compensating the regulated services at a level that is comparable to the cost that would have been faced by a competitive firm acquiring those same additional facilities. There are several ways to determine the level of this compensation. One is to reallocate the investment retroactive to the date on which the facilities were installed, with all carrying costs for the investment also charged to the unregulated activity. Because this may result in an unreasonable penalty if the reallocation occurs long after the initial investment, it may be necessary to cap the length of time for the reallocation. Alternatively, investment could be reallocated only prospectively, with a premium payment made to the relevant regulated capital accounts to recognize the incremental cost that the unregulated activity would have paid if it were otherwise required to acquire the facilities on a stand-alone basis.

This study examines basic questions of allocation of the risks and responsibilities for recovery of capital investment as the telecommunications industry evolves. The question of "who pays?" for more modern facilities has become much more complex as the traditional telecommunications utilities have expanded their opportunities for competitive activities using the common telecommunications network infrastructure. The report attempts to strike a balance among the sometimes conflicting interests of basic ratepayers, more sophisticated consumers of telecommunications services, competitors of the traditional telecommunications carriers, and the regulated firms themselves. Regulators can best assure that the stakeholders who benefit from modernization bear the cost of that activity by:

- Requiring the utilities proposing modernization programs to provide a cost/benefit analysis to support the program that clearly identifies the costs and the benefits both for ratepayers and for shareholders;
- Developing an allocation procedure that assigns the costs associated with modernization consistent with the distribution of the benefits, and also encourages regulated firms to use their best efforts to accurately assess the impact of the program; and
- Monitoring the impact of the modernization program and providing for mid-course corrections to ensure that the allocation of costs continues to track the distribution of benefits.

Successful implementation of this policy will mean that as a nation we will continue to enjoy high quality, low cost telecommunications services with the assurance that the costs and efficiencies associated with a modern integrated infrastructure will be equitably distributed among all stakeholders.

Adapting State Regulation of Telephone Companies to Industry Change

(2)

Intl. Comm. Assn. (large users) 1989

Executive Summary

This White Paper was prepared by the International Communications Association to express its views concerning the future regulation of telephone services at the state level. The ICA is the largest and broadest-based association of telecommunications users in the United States. As such, the ICA sees an urgent need to respond to increasing pressures from telephone companies and their advocates for fundamental changes to long-standing regulatory procedures and the public policy objectives they embody.

These challenges prompt a reexamination of the past role and performance of traditional regulation. Since regulatory oversight has proven to be a flexible and effective tool in the past, regulators should continue to play a leading role in promoting the best use of the nation's telecommunications resources.

- The U.S. public switched telephone system has made great strides forward under the traditional system of rate base/rate of return regulation. The quality, availability, and usage of telephone services has increased dramatically over the past century, and telecommunications has assumed an increasingly crucial role in the economic and social structure of the nation.

- These benefits have not come at the expense of the nation's telephone companies. The dominant carriers have a history of steady growth and robust financial health, which has actually improved since the breakup of the Bell System in 1984.

- Most proposals to reduce regulation can be traced to the telephone companies themselves. So far, these proposals benefit the carriers far more than consumers. Virtually all of the plans submitted by telephone companies move in the direction of lessened public oversight of their business practices. Acceptance of these proposals would create increased opportunities for carriers to further their own goals at the expense of the public welfare.

- While the proposals advanced by the telephone companies are not acceptable as such, they do raise issues that regulators need to confront in order to successfully adapt to changes occurring within the industry. These changes include:

  Major gains in transmission capacity, digitization, and network intelligence that are allowing carriers to offer many new capabilities.

  New technology, particularly fiber optics, that is pushing the costs of service downward and the efficient size of a provider upward.

  Development of alternative technologies for some telecommunications services and several "niche" markets for specialized communications needs.

- Despite these developments - indeed, perhaps *because* of them - the monopoly nature of the local exchange is essentially unchanged. In fact, the monopoly power held by local telephone companies will actually *increase* as interactive information services and other new offerings proliferate, since they all must pass through the local exchange "bottleneck."

- Regulators need to find appropriate responses to these industry trends. Above all, telecommunications regulation should permit the benefits of industry development to be shared equally by carriers and consumers. This will require that regulators establish balanced policies in the areas affected by industry change:

  Competition. Regulators need to employ objective standards to assess the competitiveness of any market proposed for altered regulatory treatment, on the basis of its potential for sustained, effective competition. Anecdotal evidence and speculative economic theories that invoke potential competition as a market force do not justify abandoning regulatory safeguards.

  Pricing. Inadequate pricing policies leave dominant carriers free to engage in monopolistic pricing. Tariffed prices should be tied to underlying costs of service or some other stable standard. The "just and reasonable" ratemaking principle should be the benchmark against which any trial of alternative regulation is evaluated. This requires that regulators continue to collect cost and earnings data to serve as a baseline for evaluating alternative regulatory methods.

  Cost Allocation. Reducing regulation for selected services gives a carrier the opportunity to subsidize those services by improperly allocating costs. Moreover, ratepayers have been financing network modernization programs that will steadily lower carriers' operating costs for years. A misallocation could work to deprive ratepayers of those gains for which they have already paid. Carriers should be required to detail how costs will be allocated *before* a service is considered for reduced regulation.

  New Services. To qualify for relaxed regulatory treatment, "new" service offerings need to demonstrate a substantially new feature, function, or benefit to customers; otherwise carriers could simply repackage existing offerings to circumvent tariff or pricing restrictions. Services expected to assume a key role in the public network or in the nation's economic infrastructure - new or otherwise - should in any case be kept under protective regulation.

> *Defining the Public Interest.* Some telephone companies are attempting to impose their own doctrine of the public interest in telecommunications services. These companies would like to limit the public interest, and thereby regulatory oversight, to traditional switched voice service - leaving all other services, including many (such as data services) that are becoming increasingly important to the economy without regulatory protection. In reality, the public utility role of the local telephone company will be expanding over the coming decades, as the public *telephone* network evolves into a comprehensive *information* network.

The regulatory process has proven to be an effective and resilient tool during the past century of progress in the telecommunications industry. As telecommunications services take on an even greater role in driving the nation's economic growth, regulators will have to become even more vigilant to ensure that this critical resource is managed wisely. To remain effective, regulators need to cooperate with both consumers and providers to develop appropriate policies to respond to today's regulatory challenges. An uncritical acceptance of the regulatory "reforms" promulgated by special interests would not only jeopardize the universal, high-quality telecommunications infrastructure that regulation has helped to build, but could also threaten the future growth of America's increasingly information-based economy.

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A Regulatory Busy Signal Blocks Phone Progress

By SAM GINN

Californians are justifiably proud of their state as the cradle of the electronic revolution. That revolution is ushering in the Information Age, an era of unlimited communication that will surpass the Industrial Age in its impact on global development.

But five years after divestiture, California is hamstrung by a regulatory process that doesn't account for burgeoning competition and overlooks the time lag involved in implementing new technologies. We are trapped by an arcane process that serves neither consumers nor businesses.

California's crucial telecommunications infrastructure—the highways on which information travels—is woefully lagging in parts of our state. We trail some of our commercial rivals such as Japan, which plans to spend $100 billion to modernize its infrastructure by the year 2000. We're losing ground to more than 36 states that have revised their regulatory framework and stepped up commitment to modernize their telecommunications networks.

About 242 communities in California don't have enhanced 911 service. While some people can dial 911 and have their home address flash on the screen of an emergency operator who can direct police or other rescue services to the scene, others don't have this system.

In Humboldt County, Bakersfield, Morro Bay, and even parts of Sacramento and the San Francisco Bay area, businesses don't have services such as "call forwarding" and "conferencing calling." New businesses will not locate in communities hobbled by horse-and-buggy communications. What is at stake are jobs and the future economic health of our state.

No one in these technologically impoverished communities will have the opportunity to use any future services such as monitoring of the sick at home via telephone connections, access to electronic libraries or special services for disabled people and those not fluent in English.

Outmoded switching technology is the culprit. Simple enough to solve, one might think. Yet, using traditional regulatory criteria, it will be a long time before we will be able to economically justify modernizing the network in those communities.

Virtually every telecommunications service, with the exception of dial-tone to the home, is competitive. But telephone companies in California can't price their services accordingly. Instead, they must endure lengthy proceedings to obtain permission from the California Public Utilities Commission to raise or lower prices.

Can we recover from this telecommunications deficit? The answer is emphatically yes. Our success will depend on our ability to introduce a forward-looking regulatory policy that provides an incentive to telephone companies to increase operating efficiencies and enables them to build a communications system second to none.

The California Public Utilities Commission has an opportunity to approve soon a plan submitted by Pacific Bell that would go far toward providing Californians a feature-rich telecommunications network and more efficient regulatory process. The plan was attacked by the California Cable Television Assn. at recent hearings.

Among the association's arguments is that Pacific Bell's hidden agenda is to enter the cable television business. Pacific Bell has no intention of providing cable programming but would seek to provide distribution capability to cable operators.

Pacific Bell's California Plan for Rate Stability does not propose deregulation, but a different form of regulation. It would lead to lower or stable charges for most users and improved service. If it is approved, Pacific Telesis stands ready to invest more than $200 million a year to bring the state's network up to standards within three years—an investment that we are not allowed to make under the current regulatory scheme.

Under the plan, the Public Utilities Commission would still regulate all future rates. The plan would freeze residential rates through 1992 and expand the free calling area and make TouchTone service free. It would allow us to lower some rates to business customers to meet competition, while gradually raising other business rates that do not cover our costs.

The plan would substitute a simpler process for the 78-year-old system of endless legal proceedings that minutely examine costs (the current rate case has dragged on four years). The commission would set a benchmark rate of return, or profit level. If the telephone company operated so efficiently that it exceeded that level, the extra profit would be shared equally by the public and its shareholders. If Pacific Telesis failed to earn the benchmark rate, it would absorb the shortfall and not ask for rate relief.

Regulatory reform is a "win-win" situation. When the providers of telephone service have incentives to improve efficiency and increase service, everyone gains. If the regulatory process isn't changed soon, many of us will continue to be denied the full range of services technology can offer, and California will be hard-pressed to preserve its place as a leader in the world economy.

Sam Ginn is chairman and chief executive officer of Pacific Telesis Group.

LA TIMES, 5-12-89

New Telephone Services Fail to Connect

Analysts Blame Poor Marketing, Buyer Apathy

By JULIE AMPARANO LOPEZ
Staff Reporter of THE WALL STREET JOURNAL

The regional Bell companies hope their latest generation of customized calling features will produce hefty profits. But so far, they have generated more yawns and shrugs than ringing endorsements.

Known as "class" services, the new features can accomplish a host of tasks, such as forwarding only "preferred" calls, displaying the phone numbers of incoming calls and giving distinctive rings to calls from certain numbers.

"We're giving customers a personal secretary," says F. Duane Ackerman, a BellSouth Corp. vice chairman. "We think the services will be extremely successful."

But skeptics abound. Many people say the features—aimed mainly at residential customers—aren't very useful and are hard to master. Some services anger callers. And marketers say the Bell companies' typical marketing approaches may not be suited to the new products.

Low Penetration

"The Bell companies feel this is their technological gift to the world and that the world should be happy," says David Simon, a telecommunications consultant in New York. "Then, they can't understand why more people don't want the services."

The Bell companies, faced with a mature telephone market, see class services as one of their best hopes of generating a big new revenue stream, and they have been upgrading their networks to make the services available. But the early results have been mixed at best. Bell Atlantic Corp.'s New Jersey Bell subsidiary has made class services available to more than 1.3 million customers since it started rolling out the features in early 1988, but only 4% have signed up. Southwestern Bell Corp. began testing the services last July in Muskogee, Okla. Despite an ad blitz and presentations in shopping malls and other local spots, only 7% of customers have bought any class services.

The Bell companies will need to sign up about 25% of their customers for the services to be profitable, says Jack A. Grubman, a PaineWebber Inc. telecommunications analyst. For the services to have "a material impact" on earnings, he adds, penetration would need to hit about 50%.

The Bell concerns haven't approached that level of penetration with an earlier generation of optional services, so-called custom-calling features. After more than a decade, only 28.8% of Bell customers have call waiting, the leading custom-calling service. Only 10% have call forwarding, and just 7.4% have three-way calling.

The Bell companies blame regulation: state agencies have limited how much the concerns can earn, and because most are at or near their profit ceilings, they haven't pushed those services hard. But New York and Vermont have adopted regulations easing the profit limits, and other states are likely to follow. As they do, the phone companies will have more incentive to boost profits.

Still, class features strike many people as being a hard sell. Fredric Saunier, a marketing communications consultant and contributing editor for the trade magazine Telephony, calls the newest services "really nothing that anybody needs."

Joan Patsy, an accounting aide in Muncie, Ind., agrees. She notes, for example, that the Bell companies pitch call return, which automatically dials the number of the last incoming call, as the end of the mad dash to the phone. "But an answering machine records the person who called you," Ms. Patsy says. "And you can decide whether you want to talk to the person. With call return, you can't do that."

Answering machines also can be used to screen calls, serving much the same function as caller ID—which shows the phone number of each incoming call—and call block—which routes calls from specified numbers to a recording that says, "The party you are calling is not accepting calls at this time."

Bell officials say the class services are more effective than answering machines at screening and catching calls—and can serve other uses besides. "If there's just one or two people you don't want to hear from, call blocker would screen just those calls," says Joleen Meyer, a Southwestern Bell product-management official. Also, she says, call return is more reliable than an answering machine because it doesn't depend on the caller leaving a message.

Some critics question the Bell companies' marketing tactics. So far, the companies have relied mainly on bill stuffers and direct-mail fliers, with less emphasis on TV, radio and print ads.

That's the wrong way to sell these services, marketers say, because they are suited to narrower markets than the Bell companies are used to targeting. Robert Morris, a telecommunications analyst with Goldman, Sachs & Co., says bill stuffers may be a convenient way for the companies to send a message, but they aren't terribly effective because they aren't market-specific: "Usually, they get thrown in the trash without even being read." Instead, he says, the Bell companies should identify and make their pitches to specific markets, such as people working at home who might want different rings for business rather than personal calls.

The message of the Bell companies' current marketing efforts—such as Ameritech ads focusing on the "special powers" of the star and pound keys and New Jersey Bell's urging to "look at what your phone can do now"—also is wrong, marketers say. Steven Permut, a Yale University marketing professor and telecommunications consultant, criticizes such ads for overemphasizing "the 'gee-whiz' element" and not showing how the features can make life easier.

The Bell companies, says Mr. Permut, should go beyond terse descriptions of the services and portray more people using them, or in situations where they might benefit from them. So far, only BellSouth has used clear examples, he says. One BellSouth ad shows a woman—without call return—coming home with two bags of groceries and dashing to the phone so she doesn't miss a call. "If you don't show clear benefits," Mr. Permut says, "people won't pay extra for it."

Mr. Grubman of PaineWebber questions the Bells' pricing strategy. Generally, they charge $3 to $5 a month for one service; some charge less for additional services. Mr. Grubman says the companies "overestimate how much a consumer will spend." He suggests charging low per-use fees to win customers who see themselves using the services infrequently.

The services themselves have caused problems, in some instances frustrating customers trying to use them. Jamie Resnick, a computer programmer in Elizabeth, N.J., says he gave up trying to figure out how to program his cousin's phones to give incoming calls from certain numbers different rings. "These days, no one has time to figure out all these commands," he says. "It's too much frustration."

Help on the Way

Some companies are trying to make the features easier to use. BellSouth, for example, provides recorded instructions as part of the services to take consumers through the commands, and many companies offer toll-free help lines.

Caller ID, meanwhile, has angered some callers who object to having their telephone numbers displayed—without their consent—to people they call who have the feature. "What happened to my right of privacy?" asks Lee Aiges, who owns a consulting business in New York and has an unlisted number. "The only way to preserve my privacy now is to use a public phone." Consumer groups are challenging caller ID before regulators in New Jersey and New York, and the Pennsylvania attorney general's office has asked regulators there not to approve the service until privacy issues can be fully debated.

Pacific Telesis Group in San Francisco plans to offer a service that will allow callers to block their number from appearing on caller ID devices. But New Jersey Bell, which says caller ID "enhances the privacy of the called party," doesn't plan to offer a blocking service. Other companies say they will study the privacy issues before deciding whether to offer caller ID.

Despite all the problems, there seems little doubt that the Bell companies will keep pushing their new services. Bruce S. Gordon, a Bell Atlantic marketing vice president, says the companies can't fret over the older, custom-calling services, or else "we'd never go forward." Bell Atlantic, he says, is applying the same principle to the class services that Procter & Gamble Co. uses to promote a new detergent. "Procter & Gamble has six different detergents," he says. "Each has a market segment. P&G doesn't wait to see how one is doing before going after a new market."

New Services, Cool Response

Glossary of the Bell companies' new services

Call return: automatically dials the number of the last incoming call. Also known as return call and automatic callback.

Call block: shunts incoming calls from specified phone numbers to a recorded rebuff.

Repeat dialing: redials the last number a customer dialed. Also known as call queue.

Distinctive ring: lets a customer specify numbers from which incoming calls will have a distinctive ring. Also known as call selector and priority call.

Preferred call forwarding: lets a customer forward calls from specified numbers. Also known as select forward and selective call forwarding.

Caller ID: displays numbers of incoming calls before a customer answers the phone.

Call trace: allows customers to track down number of last incoming call.

Percentages of customers who have signed up for the new services in the following markets:

	Muncie, Ind.	Muskogee, Okla.	Northern Bergen County, N.J.
Total residential phone lines	33,276	22,800	48,778
Call return	16.4%	8.0%	3.8%
Call block	1.4	4.0	3.0
Repeat dialing	3.4	5.0	1.4
Distinctive ring	3.9	6.5	1.0
Preferred call forwarding	N.A.	3.0	.5
Caller ID	N.A.	N.A.	2.3
Call trace	N.A.	1.0	N.A.

N.A.=Feature is not available

NOTE: Muskogee figures are estimates for year-end 1989

Sources: Ameritech (Muncie), Southwestern Bell (Muskogee), Bell Atlantic (Bergen County)

WALL STREET JOURNAL
May 24, 1989

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Capital Budgeting for Fiber

Many observers see telcos and CATV squaring off in a fiber-to-the-home battle. However, as the author points out, there's more to this issue than meets the eye.

■ Bruce L. Egan

A review of the communication industry's trade press indicates some confusion regarding telephone companies' intentions to deploy fiber optics in the public network. The confusion is often couched in terms of a "battle" between cable television and telcos over the future provision of entertainment video to the home. If the telcos "lose" the legal and regulatory "battle" and somehow direct provision of video services is denied, then according to the traditional argument, telcos will not aggressively deploy fiber to the home since it will not be financially prudent to do so.

This interpretation of the situation is erroneous. Telcos view fiber in the network as a primary means to remain competitive in the future, regardless of the current regulatory and legal restrictions on the direct provision of video services. Being first with fiber is very important to them, as it represents a robust business investment strategy *vis a vis* strategies of rival communication service providers. Although growth in the basic telephone business is slow, providing fiber should help position telcos to at least share in more high-growth service markets by having high-quality capacity in place to meet the future needs of large customers and vendors whose services telcos may currently not be allowed to provide directly.

In addition, there appears to be money enough to do it. Consider that the entire net capitalization of telcos in 1987 was about $200 billion and total spending for new construction was about $30 billion. The average accounting life of network plant is in the neighborhood of only 10 years. (Not only is capital spending high, but almost all of the funds to support it are internally generated — no borrowing.) In fact, the recent rate of capital spending and depreciation for telcos rivals that of the high-growth cable television industry. Thus, fairly rapid modernization of telephone plant is already underway and most of the new plant will be fiber or at least fiber-compatible.

Yet there are the nay-sayers. Many industry observers point to the massive amounts of money required to get telco fiber to the home. Cost estimates vary greatly, depending on the source, from between $1500 to $15,000 per subscriber. This means that the entire cost can be as low as $150 billion or as high as $1.5 trillion! However, the most oft-quoted numbers are in the range of $1700 to $2000. This would put the total bill at about $200 billion.

But is it really that unthinkable? In the context of both revenue and cost, of course not. Rome wasn't built in a day, and the same is true for fiber networks. On a net present value basis, $200 billion worth of construction is only $30 per month per subscriber over 10 years and only $40 per month per subscriber over 5 years. Furthermore, current expenditures per household for electronic communications services, including telephone, cable, and over-the-air radio and TV, total about $100 per month and that figure is rising. If one were allowed the luxury of abstraction, then clearly if providing public fiber networks were a priority, there would be enough money to do it.

In reality, the story is a bit more complex. The telco capital budgeting process is a combination of many cost and demand factors. However, the flexibility of the process reveals why it will get started and, in fact, will likely accelerate.

Realizing the magnitude of costs to deploy fiber to the home, telcos recently have concentrated on hybrid fiber/copper deployment scenarios where the subscriber loop plant, dominated by aerial and buried cable, will be utilized via electronic/optical conversion devices. Such hybrid scenarios should develop sufficiently to lower the fiber deployment costs significantly by retaining and using the existing copper loop and cable television coax plant. This is especially good for customer acceptance since existing customer-premises equipment (CPE), CPE interfaces, and premises wiring may stay intact. The new hybrid approaches will provide some flexibility in selecting deployment alternatives. There is similar flexibility on the financial side. Large-scale and capital-intensive projects like fiber deployment are long-lived and construction intervals are extensive. This simple investment perspective is sometimes

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overlooked by those who wish to deal in sensationalism. The total cost of a fiber telco network is often quoted as if the project requires a huge lump sum financial commitment. This, of course, is not the case at all.

Being first with fiber is very important to the telcos........

By definition, the annual cost of a large total expenditure occurring over an extended period of time for projects with a long useful life is relatively small. In other words, total cost should not be confused with annual cost. Investment for fiber is a project which has any number of acceptable deployment strategies. The timing and construction intervals become strategic decision variables and may be varied according to business conditions. No annual expenditure is sunk until it is committed. Along the way, construction may be postponed or stopped altogether. The cost stream is flexible due to the spatial distribution of network plant. Strategic deployment in market niches is possible and depending on business and regulatory conditions, certain subprojects may be completed and others may not. Network investment cost streams are more flexible than many other expensive projects where, for example, only one large plant is contemplated.

There are a number of possibilities on the revenue side as well. Currently local telcos receive about $25 per month per subscriber, which is expected to grow over the next 10 years. With what limited evidence there is to date, cable television operators are willing to pay about $8 per month per subscriber for use of the telco loop plant. Based on these cursory numbers alone there appears to be significant revenue potential to support recovering the cost of fiber deployment. There is also significant revenue potential from new service vendors and broadcasters. Currently, television advertising averages about $25 per month per household (however, a large portion of this currently goes to program production costs). Broadcasters desiring to use the fiber distribution network would presumably have to pay for it and the same is true for advertiser-supported cable television firms. In addition, many new market opportunities may be available to vendors of non-telecommunications services over fiber, such as real estate and video shopping malls. In other words, the revenue potential of fiber networks is measured not only in terms of what customers are willing to pay for service, but also what vendors are willing to pay to get access to customers. In sum, there appears to be significant increases in current subscriber revenue available to telcos with fiber distribution networks.

In conclusion, if it is true that network integration is more cost efficient than many distribution networks, and therefore the total per-customer cost is less than the status quo, then clearly financing and capital recovery for fiber deployment is a reasonable proposition. The real issue is the time horizon of the capital expenditure stream, which may be altered to match the present value of revenue streams. In any event, telcos will aggressively pursue fiber as long as they are financially able to do so. For now, at least, cash flow available for construction is at an all-time high. □

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THE WALL STREET JOURNAL MONDAY, APRIL 24, 1989

AT&T Asks End Of Electronic Publishing Ban

Analysts Expect Prohibition, Set to Expire in August, Will Be Allowed to Lapse

By JOHNNIE L. ROBERTS
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK—American Telephone & Telegraph Co. asked a federal judge in Washington to clear it to enter the electronic publishing business.

AT&T requested that a ban barring it from electronic publishing be allowed to lapse, as scheduled, in August. If the request is granted, AT&T could provide a variety of information on-line, such as financial and securities data, videotex and news. It would be a potential competitor against such major electronic publishers as Citicorp, Reuters, Dun & Bradstreet Corp. and Dow Jones & Co., publisher of this newspaper.

Analysts predicted that the ban would be allowed to expire. Moreover, they speculated, AT&T's subsequent entry would have the potential to help attract the long-elusive mass market to the industry.

AT&T made the request Friday in a motion submitted to U.S. District Judge Harold Greene, who continues to enforce the 1982 decree that broke up the Bell System. The ban, imposed by the decree, prevents AT&T from using its own network to engage in electronic publishing.

The ban was an outgrowth of Judge Greene's concern that mammoth AT&T could quickly dominate the industry. Another concern was whether electronic publishers would have alternative networks to AT&T's for distributing their information on-line.

But under the decree, the ban is scheduled to expire after seven years—on Aug. 24, 1989—unless opponents of AT&T's entry into the market can prove that competitive conditions warrant prolonging the prohibition. AT&T's motion, made under a provision of the decree, is believed to be the first official move to eliminate the ban.

In its filing, the telecommunications concern said that there are many alternatives to AT&T's transmission network, including hundreds of regional long-distance concerns and such national long-distance carriers as MCI Communications Corp. and US Sprint Communications, a joint venture of United Telecommunications Inc. and GTE Corp. "It is beyond serious dispute that these carriers offer ample alternatives to all of the AT&T (long-distance) transmission services used by electronic publishers," AT&T said.

AT&T also maintained in the motion that competition is healthy. The leading electronic publishers, it said, are "large and financially strong corporations," including Citicorp, Dow Jones and Reuters. In addition, Prodigy, a joint videotex venture of International Business Machines Corp. and Sears Roebuck & Co., is expanding nationwide. AT&T cited a recent report enumerating some 500 U.S. vendors offering more than 3,350 on-line databases compiled by about 1,500 database publishers.

An AT&T spokesman said the company doesn't have any specific products ready for introduction if the ban is allowed to expire. But the company has shown a keen interest in the field in the past. In 1987, it entered a joint venture with Telerate Inc. to offer a service that allows international money traders to execute trades electronically. Telerate is 67%-owned by Dow Jones & Co. In addition, AT&T was a potential bidder for Quotron, the stock-quotes concern eventually acquired by Citicorp.

The ban posed a problem for AT&T in the joint venture with Telerate and in making a bid for Quotron. Reuters Information Service Inc., a unit of Reuters Holdings PLC, challenged the venture on the grounds that it violated the ban. But the Justice Department rejected the challenge. Because of its concern about the ban, AT&T decided against bidding for Quotron.

Some analysts expect that the nation's newspaper publishers, long opposed to AT&T's becoming an electronic publisher, are likely to challenge the current efforts. "Maybe a compromise will be worked out as to what AT&T can do," said Robert Morris III, telecommunications analyst with Goldman Sachs & Co. He and other analysts predicted Judge Greene will allow the ban to end.

In any case, Mr. Morris expects AT&T to rely on internal development rather than major acquisitions as its vehicle for entering the business. He added that the company has been spending some $2.5 billion a year on research and development, with an emphasis on development of communications software. "I would think that the way AT&T will go is more through joint ventures, where it would work with established databases and bring its software enhancements," he said.

Experts said that AT&T's communications prowess could open the way to a mass market for electronic publishers. "One of the big challenges of the industry has been that it has just been hard to use the information," said Mr. Morris. "With the right mixture of software and information, that should open the door much more widely to the consumer."

If AT&T finds wide and attractive uses for information delivered electronically, "you could very easily see that the industry could take off," said Brnell Wright, vice president, electronic communications practice, for the consulting firm Link Resources.

AT&T's motion doesn't involve the ban on electronic information services, including on-line publishing, by the seven regional Bell phone companies that were born in the breakup.

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WSJ 4-26-89

Newspaper Publishers Debate Pros, Cons of Allying With Phone Firms

By Joe Sharkey
Staff Reporter of The Wall Street Journal

CHICAGO—Only two decades after they decided television was their mortal enemy, newspaper publishers are suddenly looking suspiciously at an old ally, the telephone.

The question many of the people who run the U.S. newspaper industry are pondering here at the annual convention of the American Newspaper Publishers Association is this: If Congress and the courts give telephone companies the green light to enter the information-services business, should newspapers welcome them and supply the basic information product in a mutually rewarding partnership?

"On the surface, a partnership is appealing," said George W. Wilson, president of the Concord [N.H.] Monitor and a member of the ANPA's telecommunications task force. "Newspapers have information; telephone companies have distribution channels. We're both mature businesses that could use new revenue streams. Why not work together?"

While the questions of advantages and disadvantages are complex, he said, there is a basic worry for the publishers. "How secure can we ever feel in a business where we cannot exercise any real control over the technical and marketing systems on which it relies?" Mr. Wilson asked.

Electronic publishing isn't a big field yet, but newspapers see in it potential for new revenue in offering audio and on-line computer services ranging from direct-response advertising to sports reports and capsule movie reviews. With traditional print advertising growth rates slowing and readership declining, many publishers see electronic publishing as a way to increase market penetration while also establishing more direct contact with potential new readers for their newspapers.

The ANPA said yesterday it would lobby hard to block legislation about to be introduced in Congress that would allow the seven regional Bell companies to enter the business of directly selling information over phone lines. On another front, American Telephone & Telegraph Co. is in federal court asking that a ban barring it from electronic publishing be allowed to expire, as scheduled, in August. Newspaper groups oppose lifting the ban.

Both initiatives are given good chances of succeeding, and newspaper publishers are beginning to confront the complex problem of how to deal with an unprecedented phone company presence in the information-generating business.

"Watch the phone companies," Frank A. Bennack Jr., president and chief executive officer of Hearst Corp., warned his colleagues at a crowded session on telecommunications.

Not to worry, says one regional Bell company, Southwestern Bell Corp. The company has been aggressive in staking out a position in information services since a federal court ruled last year that the Bell companies could begin offering "gateways"—electronic and organizational conduits for the transmission (but not the origination) of information.

Early this month, Southwestern Bell began a yearlong trial of a "gateway" system in Houston that offers both audio and videotex services supplied by others, including Hearst's Houston Chronicle. The company has "seeded the market" with 30,000 low-cost computer terminals for reception of the videotex services, said Stuart M. Katz, the company's national sales manager for gateway services.

Previous newspaper-industry ventures in videotex have failed, Mr. Katz said, because the hardware was too expensive. "You cannot have a gateway where the entry-level terminal is a $2,000 PC," he said. Nor, he said, will customers pay a fee for the telephone call, adding that the call can be subsidized by advertising. He said Southwestern Bell estimated that the terminals used in its trial can probably be sold in volume for under $100 apiece.

"A gateway is just an alternative channel for your information," Mr. Katz assured the publishers, adding these enticements: "You can get consumers to call in and find out what's happening on the soaps tomorrow. And then you add a tagline saying for further information pick up tomorrow's Houston Chronicle."

While some publishers said they were favorably impressed by the opportunities Mr. Katz outlined, most expressed wariness and said they adamantly opposed lifting restrictions to allow the phone companies to go beyond gateways and generate information services, whatever the enticements. "That's a genie best left in the bottle," said one industry official.

The phone companies have argued that restricting them from providing information is a violation of the First Amendment, and that the information-services field is sufficiently competitive. Among the major electronic publishers are Citicorp, Reuters, Dun & Bradstreet Corp. and Dow Jones & Co., publisher of this newspaper, which has a 67% stake in Telerate Inc. Also, 39 U.S. newspaper companies already have their own local telecommunications services.

Most publishers concede phone-company entry into the information business is inevitable. "The flood of new electronic products and services that [the regionals] are creating will become nothing less than tomorrow's system for distributing information to every American home," said Mr. Wilson of the Concord Monitor.

As Telephone Information-Service Firms Proliferate, Concern Mounts Over Abuses

WSJ 3-27-89

By Janet Guyon

Staff Reporter of The Wall Street Journal

Quick! For a chance at a trip for two to Hawaii, call 540-0100 and answer this: Who is the hostess on television's "Wheel of Fortune"—Barbara Walters, Valerie Harper or Vanna White?

That was part of a lengthy message greeting New York employees of NBC News when they answered their phones one day recently. Those who dialed the 540 number of Hollywood Calling, a phone-message concern based in Reno, Nev., would have been given an address for entering a contest. They also would have been charged $5.95 on their phone bills.

Hollywood Calling is one of a burgeoning number of information-service companies—purveying everything from soap-opera updates and horoscopes to other callers' anonymous confessions—that charge people to call them. Cousins of phone-porn and gab lines, such companies are expanding rapidly, especially in large metropolitan areas along the East and West coasts. Just last month, American Telephone & Telegraph Co. began selling new 900-prefix numbers that enable callers nationwide to interact with the services.

But as the industry grows, consumer groups and state agencies are voicing concern about the marketing tactics of some of the operations. And in several cases, states have stepped in to curb abuses.

How Legal?

Some services, such as weather and time information, can be useful, concedes Charles Donaldson, a New York state assistant district attorney who has investigated a number of services operating in the nation's largest phone market, New York City. "But mostly what you've got right now" he says, "is a bunch of trivial stuff and some things whose legality is somewhat questionable."

Setting up in the business is relatively easy. In New York City, a concern simply asks the phone company for a 540 number (976, used for nearly all such services elsewhere, is now reserved in New York for brief messages about things like time and weather) and then pays $1,230.24 to cover installation and other charges, plus $69.10 a line for up to 25 lines. There is also a monthly charge of $18.30 a line. Services can generally charge callers whatever they want, with the phone company taking a nominal cut for handling the billing and collection.

Consumer agencies say that regulations vary widely from state to state and that many abuses fall through the cracks. In California, for example, current regulations don't require that charges be disclosed during the call or that callers be warned they have so many seconds to hang up before being charged.

However, some action has been taken. Last month, New York Attorney General Robert Abrams forced International Shoppers Spree Inc. of Baltimore to shut down automatic dialers that were randomly calling numbers in the New York City area with a recorded solicitation message. Tying up phone lines with an automatic dialer is illegal in New York.

The state was also concerned that the service's operator, Joel Katz, was using high-pressure tactics to persuade people to call his 540-GOLD number, for which they would be charged $49.95. Mr. Katz led consumers to believe he was offering a premium "gold" credit card, the state argues in a settlement agreement, while he was actually offering only the right to buy goods through a catalog.

Under terms of the settlement, the attorney general ordered refunds to consumers who believed they had been misled, fined Mr. Katz $1,000 and required him to pay $1,000 in costs for the investigation. Efforts to speak with Mr. Katz were unsuccessful.

The New York attorney general's office is also investigating Robert Spanvill, an entrepreneur who runs Delphi Corp. and operates the $89-a-call Broker Elite Cash line. Mr. Spanvill says the service tells callers, principally money managers, about potential clients who have recently received $100,000 or more in cash.

The office says it grew suspicious of possible 540 abuses by Mr. Spanvill last fall when he placed a "Live Rent Free" ad in local newspapers. Callers to the 540 number given in the ad were charged $3.45. A second ad, which also included a 540 number that cost $3.45 to call, listed a $60,000-a-year administrative-assistant job. The state contends that the first ad was merely aimed at finding someone to house-sit Mr. Spanvill's apartment and says it had doubts that the job in the second actually existed.

Both ads have since been pulled, Mr. Spanvill says, because the positions are filled. Mr. Spanvill acknowledges having conversations with the attorney general's office (which declines to specify the nature of its investigation), but he insists that his services are completely aboveboard.

Hollywood Calling was the subject of yet another investigation in New York, but the state found nothing illegal. Last October, however, the Pennsylvania attorney general sued the firm in state court in Philadelphia, alleging violation of the state's Consumer Protection Act. The state claims the solicitation message, which had reached out to almost every household in Philadelphia, didn't clearly disclose charges. It wants Hollywood Calling to refund charges of $50,000 a month for the first 10 months of last year.

James Beeson, a partner in Hollywood Calling, which has revised its recording and continues to operate in Pennsylvania under a preliminary injunction, calls the allegations "ridiculous." He says that his 540 service has given away as many as 75 Hawaii trips in about eight cities, adding that when people call they get other, free phone numbers to call for free merchandise such as a camera or recipes. "The products we offer are always worth more than the call," he says.

Since the new information services began appearing on the West Coast four years ago, California's Public Utilities Commission has received steady complaints, and its regulations have been under continual review, says a spokeswoman. The agency recently asked Pacific Telesis Group to impose new rules that would, among other things, require certain disclosures about charges.

Burden of Policing

With little action from the state, the burden of policing the services in California has fallen on city attorneys where the services operate, says Consumer Action, a San Francisco-based consumer group. Officials in Santa Monica, for example, have filed lawsuits in state court there against two services that charge $2 for job and rental-housing listings copied from local newspapers. The city contends that the services need licenses to operate.

For their part, the phone companies say that they, too, are concerned about fraud and shady tactics. But they clearly want the services to expand. AT&T says that in the few weeks its new 900 service has been available, customers have requested more than 600 of the numbers. The telephone giant is counting on such services to increase its long-distance phone business.

Meanwhile, most local phone companies are dealing with consumer complaints by enabling customers to block calls to the services. But such blocking can also hurt the business of legitimate services.

"It's kind of a flaky market these days," says James Garvey, manager of the information services of Newsday, a New York-area newspaper that sells a time and weather service. "Call blocking has really affected call volume."

Free Speech Is Where You Find It

Pakistani Airlines, Flight 1006—I'm en route to Afghanistan via Peshawar, Pakistan, to cover the war. It strikes me as odd that as I am about to romp through the Hindu Kush with 18th century warriors who routinely shoulder 20th century weaponry, the spectre of free speech haunts me even here.

As I write, the Afghan president, Nijibullah, has declared a state of emergency that has essentially stripped the citizens of Kabul of any and all basic human rights—foreign journalists notwithstanding.

The state of emergency suspends a series of constitutional rights, including protection against confiscation of property, freedom of expression, freedom of assembly and petition, freedom from compulsory labor, privacy of correspondence and telephone conversations, and foreign travel.

"That's all very interesting, Brock. But get to the point."

OK, OK. The point is, although you expect such drastic measures from a regime infamous for its human rights violations, you don't expect some of the same issues to play in the heartland of America. But they are. Welcome to the war.

Battleground 1990

The issues of free speech and search-and-seizure are under attack in the main streets of urban and suburban life: the shopping mall. It is a quirky kind of guerrilla war that is taking a heavy toll on the First Amendment rights of ordinary citizens.

And the connection with telecommunications is that bulletin boards and computer conferencing systems are the shopping malls and main streets of the 21st century. Such electronic systems are the digital metaphor to the analog world of validated parking and 103 stores under one roof. And free speech abounds, for now. But it might not later.

For example, in case after case, activist groups seeking to gain signatures from shopping mall patrons have been told that the activity is illegal. The shopping mall owners claim these groups are operating on private property and have no rights to carry out such activities without their approval.

"But surely these groups have taken legal action to protect their rights to exercise freedom of speech?" you ask.

Certainly they have. And with all the fervor such constitutional issues raise. But the courts have sided with the mall owners.

In 13 states bringing these issues before the Supreme Court, nine have favored the mall owners, finding that, according to their state constitution's provisions for free speech and related activities, such as petitioning and passing out leaflets, the guarantee of free speech doesn't apply to malls.

Copyright © 1989 by Brock N. Meeks. Brock Meeks is a San Francisco-based journalist. He's just completed an assignment for the San Francisco Chronicle in Afghanistan, where free speech is decided with a Kalishnakov, not a cursor.

Electronic Main Street

It seems improbable that someone could be sued for simply passing out copies of the Bill of Rights to passers-by. But it's happened. Ask Keenen Peck, a Milwaukee lawyer—he's been sued twice for doing just this at two different shopping malls. His crime: disturbing a place of business.

When Peck went to court, the courts sided with the shopping mall owners and basically told Peck, "Leave your constitutional rights in the car when you go shopping."

It's not a great mental leap to imagine a BBS sysop pulling the same type of action on an especially provocative user, say one that uploads copies of the Bill of Rights or text files urging the overthrow of the American government or revisionist holocaust "history" written by some hair-brained anti-Semitic group. Impossible, you say? No. And the similarities are scary. The shopping mall of the '80s replaces the broad, casual main street of yesteryear. Also gone is the "village green" where people used to congregate for anything from a Sunday picnic to an ad hoc concert. Shopping malls now play host to a score of community activities. BBSs and computer conferencing systems (especially those such as CompuServe and Prodigy) do the same.

For example: informal socializing, "under one roof" shopping, contests, all take place in shopping malls and on hundreds of electronic systems.

In shopping malls the owners exercise complete control of the "content" that gets presented to the patrons. The same applies to the electronic world: the sysop or system administrator completely controls content.

The shopping mall that sued Peck for distributing the Bill of Rights also sued a dance troupe for distributing anti-nuclear leaflets, yet the mall owners later allowed military recruiters to set up displays of military vehicles, such as armored personnel carriers. ("Look at the tanks, Daddy!")

The same type of action occurs on various computer conferencing systems. On CompuServe Information Services (CIS) system your rights of free speech are terminated as soon as you start to mention the benefits of a competing system. The system administrators of CIS see such activities as intrusions that they have a right to bar. After all, they say, CIS is private property.

"We pay for system upkeep and provide security," says a CIS spokesman. "If there's a problem or disturbance or disaster, we have to take care of it and pay for it. Certainly we have the right to decide what goes on our system and what does not."

To sharpen his point, the CIS spokesman noted, "There are plenty of free BBSes that people can use if they aren't happy with CIS."

But what if those sysops also decide to play the heavy hand? Is there any protection? (No.) Are we then destined to roam the ethernet looking for a sympathetic outlet for our discussions? (And thereby end up "preaching to the choir"? No thanks.)

In shopping malls the owners exercise complete control of the "content" that gets presented to the patrons. The same applies to the electronic world: the sysop or system administrator completely controls content.

In 1980, the U.S. Supreme Court deferred to the states on the issue of free speech in shopping malls. Bottom line for the courts: First Amendment doesn't protect speech in shopping malls—largely because its restrictions apply to the federal government and not to the owners of private property.

So, the big court cops out, but leaves this loophole: a state has the power to offer free speech protection in a shopping mall (or electronic system) if it chooses.

The California legislature lost a big opportunity to assure these rights when it dumped ACA-36 in the trash last year.

Round Two

California isn't the only state grappling with these issues, although it is the only state to attempt the electronic free speech issues.

In Washington the Supreme Court decided that malls function by design and purpose as community business centers, and that owners of property open to the public should have reduced expectations of privacy. (Recognize that last phrase? Memorize it—it's likely to become an anthem of free speech advocates.)

That decision upheld the rights of citizens to gather signatures in Washington shopping malls. Small victory. However, the court went on to say a mall owner has the right to "reasonably regulate" free-speech activities.

So, make sure you only exercise free speech in shopping malls where you know the political leanings of the owners.

Right.

In Wisconsin the high court likened shopping malls more to "old-fashioned department stores"

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than municipalities. According to the Wisconsin court, a shopping mall "concerns itself with one facet of its patron's lives—how to spend money." The court added, "Many other areas are more public and therefore more appropriate for the exercise of free speech."

If you didn't jump on that last sentence, you're not paying attention.

But what is "public?" Just how public are BBSes? How public are computer conferencing systems that charge for their services?

No one is exactly sure. Much hinges on the definition of the word "private." There is no single acceptable definition.

That means that a sysop or system can define the dos and don'ts in ad hoc fashion. One system says "No foul language here"; another system says, "No mention of other competing systems."

The procedure is fairly straightforward: you don't like the rules, take your cursor elsewhere. That seems acceptable, but why should I not be able to pay my money and speak as I want?

What happens when civic governments move more toward an online environment? What happens when electronic democracy becomes a reality instead of just grist for the columnist's mill?

What happens to free speech issues in those environments? Do we have to wait until the fight comes to our doorstep before we wake up and do something?

That's what's happening in shopping malls all over the country. People are fighting for free speech, trying to push through legislation. There isn't a lot of hope.

But in the electronic arena we don't have to wait. We can address the issue before it actually becomes an issue. And while we still have the right to do so.

And that's a right the some 15 million people below me, in Afghanistan, will never know. But they don't have a choice. You do. And the cursor's in your court. ■

(c) Robert Britt Horwitz. Oxford Univ. Press, 1988.

CHAPTER 1

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Telecommunications and Their Deregulation: An Introduction

The telecommunications revolution, we are told, has arrived. Telecommunications used to mean the telephone, a mature, rather dull, and highly regulated industry dominated by the staid Bell System. For most of us, the technology of the telephone was so good and reliable, and its uses so set and inflexible, that it was functionally forgotten. For corporate users, telecommunications represented just another mundane cost of doing business. Telecommunications also encompassed broadcasting, a more glitzy endeavor than telephone to be sure, but one primarily characterized by a remarkable stability of three commercial television networks that aired mostly imitative and inoffensive entertainment programs, along with one poorly funded public network.

Today the very term telecommunications may be too confining. The once stable, noncompetitive businesses of telephone service and equipment manufacturing have become dynamic and highly competitive. Telephone technology has merged with that of the computer to vastly enhance the capabilities of both. The resulting fusion, sometimes labeled "information technology," has become a vibrant, burgeoning industry, reconfiguring business practices and permitting corporations to slash operating costs and automate the workplace. Some government policy-makers have pronounced information technology the United States' most important industry. Likewise, broadcasting has been so transformed by satellites, the abundance of cable television, and videotape technology, that the traditionally limited television system seems nearly a thing of the past. There are now sports channels, news

channels, movie channels, "adult" channels, Christian channels, Spanish language channels, and so on.

While many of these changes reflect a grand profusion of technological innovation, perhaps the more interesting phenomenon is the less apparent transformation of the state—deregulation—which has accompanied and abetted this technological "revolution." The changes in telecommunications have emerged as much from changes in their regulatory treatment as they have from technological innovation. This book examines the framework within which the telecommunications industry has been structured, and how that framework changed. It seeks to answer the question: how and why were American telecommunications deregulated?

The American telecommunications industry is being deregulated after more than fifty years of close government oversight. In broadcasting, some of the changes are fundamental. Commercial broadcasters, once subject to many "public interest" regulatory controls, such as a requirement for public information programming, an obligation to ascertain the broadcast needs of the community, and recommendations on the maximum amount of advertising, are no longer constrained by such rules. The famous "Fairness Doctrine," which obligated broadcasters to air issues of controversy and to be balanced in that coverage, is now officially moribund. The period of license tenure for a radio frequency has been extended from three years to seven; for a television frequency from three years to five. The ceiling on the number of broadcast stations a single corporate entity may own has been raised from a total of seven AM, seven FM radio stations, and seven television outlets, to twelve of each. By the mid-1980s talk echoed in the Senate Commerce Committee and at the Federal Communications Commission about complete First Amendment protection for any and all "publishers," print or electronic. The aim of such proposals is to completely dismantle any remaining regulatory controls over broadcasting, particularly the rules which require broadcasters to operate as "public trustees."

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Ancillary broadcast services, long restricted by regulations favoring conventional broadcasting, have been given a green light. The most important of these was cable television. For years, regulations hindered the expansion of cable television and restricted the type of signals and programs cable operators could purvey. These restrictions began to be dismantled in the mid-1970s. Cable has grown quickly since. Historic restrictions on pay television were removed, and new programming sources have emerged. By the late 1970s the FCC went so far as to promote new broadcast services.

Common carriers such as the telephone system have experienced even greater changes. Long considered a "natural monopoly," the telephone system was closely regulated under the watchful eye of the Federal Communications Commission and state public utilities commissions. Regulatory controls made competition impossible. In exchange for monopoly status, telephone companies were obliged to extend service to all. Through the control of telephone rates, regulatory policies facilitated internal cross-subsidies to expand telephone service and keep particular rates low. The telephone system was united by the giant, vertically integrated American Telephone and Telegraph Company (AT&T), operator of the only long-distance network and of local telephone service in most major metropolises. But, beginning as early as the late 1950s, the FCC allowed a certain amount of competition in specialized business services. Liberalized entry extended to domestic communication satellites in the early 1970s, and, most important, to long-distance telephone service by the late 1970s. In 1982 the structure of regulated telecommunications was massively transformed by the break-up of AT&T. A divestiture agreement between AT&T and the Justice Department severed AT&T of its local telephone service companies. AT&T, historically confined to the provision of regulated telecommunications services, was now free to compete with computer giants such as IBM in global information technology markets. The break-up of AT&T has become the single most important event in the deregulation of American industry.

The Context of Deregulation

Yet telecommunication is not alone in experiencing a fundamental change in its regulatory treatment. It joins the ranks of several other industries that have been wholly or partially deregulated since the late 1970s. These include commercial airlines, railroads, trucking, intercity busing, banking, and (to a far lesser degree) oil and natural gas. Given the widespread growth of the regulatory state in the twentieth century, how are we to understand this phenomenon of deregulation? Deregulation runs against the traditional understanding of government regulation as a means of rationalizing the economy and/or of safeguarding the public interest. We commonly think of government regulation as the modern means of coordinating highly complex social activities in ways that the market cannot. One traditionally accepted argument is that capitalists, acting on their own, pursuing the logic of profit maximization, cannot adequately safeguard the conditions which allow their industry—when taken as a whole—to flourish. Some businesses are regulated because their inordinate market power enables them to abuse other businesses and/or the public. The coercive, regulatory power of the state limits the choices of individual capitalists in the long-term interest of both the industry and the public. Is deregulation, then, a gross betrayal of the public interest, a strategy on the part of capital to reappropriate the power it once lost to democratic reforms?

Or is deregulation a response to the dubious efficacy or even failure of government action? Government interference in the economy is claimed to irreparably disrupt the allocative beneficence of the self-regulating, self-equilibrating market. Indeed, regulatory agencies often are said to be "captured" by the regulated parties, which then utilize the state apparatus for private ends. Regulatory agencies protect businesses from competition. Does deregulation represent the "coming to senses" of an increasingly bureaucratized state apparatus, dismantling itself in favor of more workable market controls?

In another popular account, the deregulation of *telecommunications* is taken to be a consequence of the revolution in technology. In this view, new technologies such as cable television and satellite delivery overwhelmed the traditional formulae of broadcast regulation. The advent of digital encoding (a method of breaking down information into a code of binary numbers) and the melding of the computer with telephone switching caused the dissolution of the legal boundary between the regulated telecommunications industry and the unregulated computer industry. In other words, the "information revolution" caused or necessitated deregulation. This idea

is a variant of technological determinism: it sees technology as self-generative and social change as technologically driven.

In my view, all such theories of deregulation are decidedly incomplete. For deregulation can only be understood in larger contexts. Telecommunication is just one of several American industries to be deregulated since the mid-1970s. Hence its deregulation cannot be explained with reference to internal telecommunications issues or technological factors alone. Deregulation went beyond telecommunications, but was confined to a specific type of industry under a specific type of regulatory control. This points to the need to look toward regulatory structures.

Deregulation was a political process, whereby the economic and political problems enveloping certain industries (but not others) turned a surprisingly heterogeneous political coalition against continued regulation. Joined within that coalition were two political logics usually diametrically opposed to each other—conservative free market economic theory and a left-liberal theory of political participation. Each "logic" attacked regulation from the standpoint of its own theoretical position. Liberals and public interest groups, seeing in traditional regulatory agencies evidence of "capture" by the very firms under regulation, came to advocate deregulation as a solution to entrenched corporate power. Conservatives and free market economists, seeing in regulatory agencies vast bureaucracies whose arbitrariness engendered economic inefficiency and artificial protectionism, also came to advocate deregulation. In various of these industries, the empirical example of an unregulated service provided the ideologically diverse regulatory reform coalition with a powerful model that legitimated competition as a practice which fulfilled the values of both efficiency and equity. The industries under regulation fought hard for continued regulation, but could not overcome the politics of reform.

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It is only when the phenomenon is situated in this context that one can grasp one of the great ironies of contemporary deregulation. The prevalent business-inspired rhetoric of "getting government off the backs of the people" notwithstanding, deregulation has most strongly affected those regulatory agencies whose actions historically have been *least* odious to business. The agencies long criticized as having been "captured" by their regulated clients and serving those clients' narrow interests are precisely the agencies which are deregulating. Deregulation has affected primarily the industry-specific regulatory agencies created during the New Deal, such as the Civil Aeronautics Board (CAB) and Federal Communications Commission (FCC). Some industries, like airlines and trucking, were deregulated over the hostile and vociferous objections of the major corporate players and powerful unions of those industries. In contrast, the agencies universally reviled by business, such as the Occupational Safety and Health Administration (OSHA), the Environmental Protection Agency (EPA), and the National Highway Traffic Safety Administration (NHTSA), though cut back and to some degree subverted under a hostile Reagan Administration, have not deregulated. In short, the conditions were not there for a heterogeneous political coalition to support the deregulation of the so-called "social" regulatory agencies. But they were there for deregulation of price-and-entry regulated infrastructure industries.

The industries that have undergone deregulation—airlines, trucking, railroads,

telecommunications, banking, oil, and natural gas—have something very important in common. They are "infrastructures," the basic services which underlie all economic activity. They are central to the circulation of capital and the flow of commerce. Historically, regulatory agencies have exercised administrative controls over infrastructure industries as part of the state's effort to construct a national arena for commerce and to stabilize the essential services upon which commerce depends. The type of regulatory controls exercised over these industries are known as "price-and-entry" controls. Agencies determined how many and which firms would compete in a given market, and set the basic prices that firms could charge. They substituted administrative decisions for market controls.

The deregulated industries share another characteristic. With the exception of the Interstate Commerce Commission, which began regulating the nation's railroads in the late 1880s, all were brought under regulation around the time of the Depression and New Deal. The agencies are industry-specific—each agency has jurisdiction over a particular industry only. While the main goal of New Deal regulatory agencies was to safeguard commerce, they also secured basic social equity. The "obligation to serve," a principle rooted in the old common law, was an essential feature of the regulation of infrastructure services.

I argue that the regulation of telecommunications, like that of other infrastructure industries, did serve the "public interest." However, the notion of the public interest embodied in the policies of the key government player, the Federal Communications Commission, was so conservative and narrow, and its range of available regulatory options so constrained, that these policies did indeed protect the principal parties of the telecommunications industry, as many critics have charged. Traditional regulation of telecommunications exhibited a typically New Deal cautious guardianship over industries and firms deemed central to commerce. The public interest character of the regulation of infrastructure industries for the most part was exhibited in that facilitation of commerce.

The regulation of infrastructure industries has been inherently conservative in other respects. The nature of price-and-entry regulatory structures is to construct operating boundaries and barriers to entry. In theory this permits existing firms to provide services essential to commerce wittout experiencing the destabilizing effects of competition. In short, price-and-entry regulation creates cartels. In so doing, the regulatory structures also facilitate socially valued "cross-subsidy" arrangements. For instance in telephony, long-distance rates supposedly were used to keep local rates low in order to encourage the universal expansion of the telephone network. Similar cross-subsidy arrangements were established in all infrastructure industries brought under regulation. However, because of these very arrangements, there always exist incentives for certain classes of consumers—primarily large corporate users—to drop out of or "bypass" the regulated system, and for would-be entrepreneurial entrants to service those users. In periods of high, sustained inflation, regulation generally exacerbates bypass incentives. The agencies grant the regulated industries price hikes which, under traditional cross-subsidy arrangements, hit large corporate users proportionately more. Technological innovations—particularly in telecommunications—provide potential bypassers with additional

incentives and with the means to drop out of the regulated system. Dissatisfied corporate users and potential competitors may form an alliance that pressures the regulated industry in the regulatory arena.

The regulatory agency generally responds to technological innovations and bypass demands as unwelcome challenges to the organizational "settledness," or even to the integrity of the agency itself. The agency often responds to such challenges conservatively, clinging to its tried and true formulae and policies and acting to safeguard the regulated system. The regulated parties also act to thwart challenge and to protect the status quo. It was this conservative dynamic of protectionism that aroused the ire of both left-liberals and conservative free market ideologues in the period of the late 1970s, a period when the political agenda had shifted from regulatory activism to one that questioned the efficacy of regulation.

Regulation: Elements of a Theory

This book examines regulation and deregulation through the prism of American telecommunications. Most studies of American communications focus on either broadcasting or telephone, rarely on both. Conventional studies tend to be either economic or anecdotal histories of the respective industries, with an occasional bow to law and regulation. Or, they are policy analyses, steeped in the byzantine complexities of agency decisions, but bereft of a larger theoretical context. Yet the interrelation between the telephone and broadcast industries is not only important for an understanding of the process of regulation, but central to how deregulation came about in telecommunications. At another level, studies that look only at the deregulation of telecommunications miss the links to other deregulated industries—and hence miss the broad reasons for the deregulation phenomenon. This book examines both broadcast and telephone industries. It looks at regulation and deregulation in other industries. It situates the analysis of regulation and deregulation within the theoretical context of the relationship between the state and the economy in the American setting.

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Telecommunication is a particularly interesting infrastructure because it not only is crucial for commerce, but also constitutes the public realm of ideas and discussion, and hence implicates the range of issues surrounding freedom of speech. This leads to two important subthemes. The first relates to telephony, and involves the tensions surrounding the benefits and drawbacks of a regulated monopoly infrastructure in a capitalist economy. The second relates to broadcasting, and deals with tensions among private ownership of the means of communication, the notion of a free and diverse marketplace of ideas, and the First Amendment quandary of regulatory controls.

As should be clear already, this book analyzes deregulation as the consequence of a mosaic of forces, of structures in interaction over time. The key piece in that moving mosaic (if such a mixed metaphor is permitted) is the nature of regulation itself, for it is through and in and against the traditional price-and-entry regulatory structures that the interplay of economic, technological, legal, and ideological forces took shape. The interplay of those forces constituted the conditions upon which political choices came to be made.

The importance of regulatory structures might be appreciated by contextualizing the role of technological innovation. An important factor in telecommunications deregulation, technological innovation was not an independent, abstract force, but a concrete dynamic situated within entrepreneurial opportunities, political discourse, and, most important, regulatory constraints. What is important about technology was how specific innovations reconfigured the internal balance of entrepreneurial interests—a balance created and maintained within regulatory policies and formulae. This dynamic of technological change *within* regulatory constraints became crucial, for example, as the FCC attempted to meet the demands of large telecommunications users for better service and freer options. The small policy changes initiated by these users' demands chipped away at the AT&T monopoly and the regulatory formulae which legitimized that monopoly. They inadvertently set in motion additional forces which culminated in the break-up of AT&T.

Hence I argue that an adequate understanding of deregulation must rest upon a historically rooted theory of regulation that accounts both for the genesis of agencies and for actual agency operations. Regulation emerged in the twentieth century as a political institution to address new, systemic economic and social problems. Regulation in many ways is the hallmark of the modern "interventionist" state. It is part and parcel of the dynamic of national development by private enterprise but directed in some fashion by the state. The long regime of regulatory oversight of infrastructures provided a rational foundation for economic growth and development—within a capitalist economic framework, of course.

To begin to address the question of deregulation, one must understand why regulatory agencies arose, what they do, and why they traditionally regulate particular kinds of industries such as telecommunications. The key is the role of the state in a capitalist economy. And this role lies at the heart of the question of the meaning of that ubiquitous, but maddeningly vague term of regulation, the "public interest." In all state action, of which regulation is one, the definition of the public interest is crucial; it is a sort of black box whose meaning or representation is the terrain of struggle.

The emergence of regulatory agencies constituted the building of *national* administrative structures in a state which had been institutionally localistic and court-centered. For much of the 19th century, the dispersed structure of American state power permitted an active judiciary to direct the course of economic development. Judicial activism facilitated the establishment of quasi-infrastructural services in the early part of the century, largely by means of eminent domain law and the granting of exclusive franchises to the builders of bridges, roads, or canals. Once the infrastructure was in place, judicial action favored business risk-taking (and consequently capitalist economic growth). With the exception of land grants and certain other subsidies, the economy was established by mid-century as a sphere largely beyond political intervention. This pattern changed by the 1890s, because the triumph of laissez-faire had created a general crisis of social control. Regulatory agencies grew in response to the needs and great changes fostered by the rise of the large national corporation.

But regulatory agencies are not of a piece. Central to my theory is the notion that agencies have different functions and different scopes of activity, which generally

correspond to the historical conditions surrounding their creation. The particular nature of inter-business and wider political conflicts dictated the emergence of three different *types* of regulatory bodies, generally corresponding to three historical periods of origin.

Progressive Era (approximately from 1900 to World War I) legislation created regulatory bodies largely in response to popular political activism. These bodies were designed to relieve the economic and social instability caused by the large corporation and its tremendous transformation of social and economic life. These agencies were concerned mainly with the *general* character of economic activity. The antitrust division of the Department of Justice (formed in the aftermath of the Sherman Act) and the Federal Trade Commission (established along with the Clayton Act of 1914) dealt with broad matters of monopoly and competition. The Federal Reserve System sought to control the exchange and circulation of money. The Interstate Commerce Commission, although literally an exception to this categorization (because it regulated a single industry), upon closer examination fits rather well. This is due to the absolutely pivotal importance of the railroad for the conduct of commerce in the late 19th and early 20th century.

New Deal agencies such as the Civil Aeronautics Board and the Federal Communications Commission sought to create strong price and entry controls in *specific* markets, with the purpose of establishing stable cartels. This "industry-specific" type of regulation grew in response to the anarchy of the market during the Depression, and was vigorously sought after by various industries. The form of regulatory action introduced by the price-and-entry agencies is often labeled in the economics literature "producer protection." Both Progressive Era and New Deal regulation established federal political structures which functioned in two interrelated ways. First, by providing an extra-market policing function, regulatory agencies helped to rationalize corporate capitalism. Second, regulatory agencies provided an administrative framework within which important interest groups, primarily large corporations, could bargain, settle conflicts, and legally collude under state imprimatur.

The agencies of the 1960s and early 1970s, established in large part in response to liberal reform movements during and just after the Great Society, dealt with the *social* impact of businesses, not with their economic behavior *per se*. These new agencies were to regulate *all* industries, not specific ones. In contrast to the producer orientation of the Progressive Era and New Deal types of regulation, the Great Society agencies were oriented largely toward the values of consumers and the interests of those left out of producer-oriented interest representation. The Environmental Protection Agency and Occupational Safety and Health Administration are the best known of the "social" regulatory agencies.

However, the origin of an institution is different from the set of reasons and structures by which that institution operates or is maintained over time. I argue that there is a fundamental distinction between genesis and operationality. Although regulatory agencies should be differentiated according to the temporal political alignment of social and economic forces reflected in their creation, and according to their function, all regulatory agencies are situated within the same field of institutional power, and all regulatory agencies are united under the rubric of administrative law. Similar forces of institutional constraint, bureaucratic organization, and procedure affect all agencies.

Regulatory agencies constitute a new structure of federal political power in the American political system; they represent a mixture of legislative, executive, and judicial functions, able on the one hand to be flexible and informal and on the other hand to formulate hard and fast rules. In theory this flexibility permits regulatory oversight to be continuous and substantive. But regulatory agencies do not fundamentally alter the traditionally dispersed system of political power in the United States. The agency is generally the weakest player situated in an already constituted terrain of political power—including the pragmatic fact of actual functioning of the industry brought under regulation. Precisely because regulatory agencies do *not* centralize political power—agencies cannot direct economic production and they must vie with the many other layers of institutionalized governmental power at local, state, and federal levels—"bureaucratism" is endemic to them. This bureaucratism is seen in numerous time delays, in wrangling over jurisdiction, and in the multiple hearings at various institutional levels which any proposed regulation undergoes. The forces which engender bureaucratism in regulatory agencies push agencies to regulate conservatively.

Regulatory agencies may properly be seen as a mechanism of rationalization in advanced capitalism, but they are only occasionally successful at this. Their overall lack of power means they might serve as a forum to allow oligopolistic industries to police themselves, or, alternatively, they might punish some corporations for "externalities" (indirect, or spillover effects of business activity, such as pollution), but they usually are unable to act as planning bodies. Institutional and organizational factors are of critical importance in understanding how a regulatory agency actually operates. This relation between the originally conceived function of a specific regulatory agency and the bureaucratic constraints that mold its actual operation must be considered in any analysis of regulation.

Telecommunications as Infrastructure

Why are some industries, like telecommunications, regulated while others are not? Put a different way, why are some industries considered to be imbued with a public function or affected with a "public interest?" Notwithstanding the fact that some (perhaps much) regulation at first glance seems to serve private, rather than public interests, this is not true of *all* forms of regulation. Certain industries, and certain types of industries, appear historically always imbued with something larger, something more general than private interest. This "something" is what we intuitively understand as the public interest.

Telecommunication constitutes one of the four essential modes or channels that permit trade and discourse among members of a society, the other three being transportation, energy utilities, and the system of currency exchange, or money. Transportation, energy, and telecommunication industries provide the services upon which all economic activity (beyond the level of self-sufficiency) depends. Money, at bottom a representation of value and the means of exchange of value, also is

crucial for economic intercourse beyond the level of barter. These services are "connective" institutions. They are the channels for trade and discourse which bind together a community, society, or nation. They are central to the circulation of capital and literally constitute both the foundation and the limit for the overall economic functioning of a society. This is why transportation, energy, telecommunications, and currency systems are called infrastructures. They are the structures below or underneath.

As I suggested earlier, the construction and maintenance of infrastructures usually have been the responsibility of governments. A central contention of this study is that infrastructure industries are always the focus of direct state intervention, whether by way of promotion, subsidy, or regulation. This has been true in the Anglo-American context since 13th-century English common law courts declared certain kinds of occupations to be possessed of a special status—the so-called "common callings." Even in the United States, where the liberal tradition has meant that energy, transportation, communications, and even financial services—like all other capitalist enterprises—are private commercial ventures, government has been closely involved in their creation, maintenance, and oversight. In the 19th century, the state's involvement rested in acts of promotion and subsidy, and the extensive use of eminent domain law in the effort to establish quasi-public infrastructural services. In the 20th century the state's involvement has been the imposition of regulation and the establishment of complex systems of administrative control over these services.

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Both governmental assistance and the imposition of regulatory controls were central to the establishment and ongoing operation of the American telecommunications system. State actions helped private corporations establish telecommunication services. Throughout its early years, the telegraph industry received critical infusions of federal and state subsidies. Congress legitimized telephony as a "natural monopoly," and established regulatory oversight to facilitate both the expansion of the nationwide telephone network and the reduction of business risk. Federal intervention facilitated the emergence of radio in the United States, first by constructing a patent pool among the major corporate patent holders of radio technology and later by engineering the formation of the Radio Corporation of American (RCA). The Federal Communications Commission, established in 1934, was given a wide mandate to oversee wire and wireless communications. The FCC attended to the public interest in telecommunications largely by protecting the existing structures of telephony and broadcasting (and the corporations which provided those services). Federal regulation stabilized the chaotic use of the radio airwaves for commercial broadcasters and oversaw a system of guaranteed fair rate of return for wired common carriers.

The legal principle upon which state intervention in these industries has rested is the commerce clause of the Constitution: "The Congress shall have Power . . . to regulate Commerce with foreign Nations, and among the several States. . . ."[1] This is important. If there is a *general* concept of the public interest informing state intervention into infrastructure industries, it is a commerce-based concept. State intervention in infrastructure industries generally has meant the creation of a national trading area where goods and services can circulate freely. To facilitate the actual circulation of goods and services, government imposed *common carrier* regulatory controls on the means of circulation.

As it emerged in transportation law in the late 19th century, the main principle of common carrier law was that a carrier must allow nondiscriminatory, that is, fair and equitable, access to its service at just and reasonable prices. Nondiscrimination would ensure that carriers would *serve* the needs of commerce rather than inhibit commerce. Part of the provision of nondiscriminatory access to their services meant that common carriers were mandated to interconnect their lines with other carriers. Most often, common carriers were characterized by economies of scale and were granted monopoly franchises. Among other things, such franchises granted the right to take private property for public use, through eminent domain. These legal tools facilitated the construction of an overall network. Regulatory oversight would ensure nondiscriminatory service and "fair" rates. Regulation thus took advantage of certain efficiencies deriving from the monopolistic organization of capital while presumably protecting against the abuses that monopoly power could bring. The key to common carrier law—and the regulation of infrastructure industries generally—rests in the fact that it satisfies the contradictory demand for a unified plan of national development within a system of private property.

Telecommunications and the Public Interest

But state support and regulatory oversight did not simply help establish and protect telecommunication corporations and their services. They also secured certain broader public interest goals, goals linked to democratically based principles of fairness and equity. Telephone and telegraph companies were legally obliged to provide service to all, at fair and reasonable rates—known as "universal service." In part because of such obligations, the American telephone network traditionally was universal and efficient, and the service was comparatively inexpensive for the customer. It is significant that telephony achieved these ends as a government-regulated monopoly.

Broader public interest or equity-based values were attached to broadcasting as well. Broadcasters, though given licenses to monopolize a given radio frequency, were not to view that license as a property right. The airwaves were deemed the property of all the people of the United States, and the holders of broadcast licenses were required to operate as public trustees. Ultimately, broadcast regulation was founded upon a public domain argument, that the airwaves were a natural resource held in common—much like waterways. The state acted to protect and safeguard that commonly held resource. The public domain rationale rested upon a (now debated) scientific judgment as to the limited nature of the electromagnetic resource. Because not everyone who wished to engage in broadcasting could do so, government had to select individual licensees from a pool of prospective applicants. In a very real sense, the government endowed certain private parties with immense public benefits. Because of this, the broadcast licensee technically was deemed a "public trustee," and had to fulfill certain "affirmative" obligations.

The common carrier principle is really little more than a *commerce-based* notion of the public interest. As it was applied to telegraphy and telephony, common

carrier law meant simply the guaranteed access to the means of transmission. Even when common carriage entailed, as it did in telephony, a policy which obliged carriers to extend service to all, this also can be considered to some degree a commerce-based policy. It allowed and encouraged the expansion of communication necessary for the free flow of commerce. The fact that people were given access to the telecommunications infrastructure was essentially a logical extension of expanding the marketplace.

Nonetheless, the fulfillment of the commerce function was responsible for the wider public interest accomplishment of making the telephone essentially a public utility, available (in principle) to all citizens. In this sense, even as it facilitates commerce, common carrier law embraces principles broader than commerce. The obligation to serve and not to discriminate among customers—rooted in the old common law—clearly embody principles of social equity.

There is another way in which commerce is not the only fundamental principle which underlies the regulation of telecommunications. Telecommunication is a peculiar infrastructure because it is a primary medium for the circulation of ideas and information, a realm where, in principle, political life can be discussed openly in accordance with the standards of critical reason. The regulation of telecommunications is more complicated and interesting than that of transportation, for example, precisely because in principle it safeguards the democratic right of freedom of speech.

There *is* a historical and logical—but uneasy—connection between the capitalist orientation to the market (that is to say, contractual freedom, lumped under what I have called the commerce principle) and wider civil freedoms (for our purposes here, the principle of freedom of speech and the creation of a "free marketplace of ideas"). After all, classical liberalism sought to carve out spheres of behavior free from control by the state. This primarily entailed the freedom to fashion contracts and engage in commercial activity. Contractual freedom rested upon the legal privilege granted an individual to *autonomously* regulate his/her relations with others by his/her own transactions.[2] This is why contracts are, in a sense, private law-making. The recognized autonomy of the individual in contractual behavior logically extended to the individual in other spheres of conduct, including the sphere of speech and ideas. Indeed, for a time the bourgeoisie's historic struggle for contractual freedom went hand in hand with the struggle for individual rights of speech and print. In Europe, the bourgeoisie promoted the development of a public sphere in opposition to the traditionalist and hierocratic forms of feudal authority. The Bill of Rights to the United States Constitution, cast within the natural law theory so intimately connected to the bourgeois revolution, protected speech and press from governmental intrusions. Both in Europe and America, the spread of private, partisan newspapers and journals in the late 18th and early 19th century constructed a sphere of public opinion which mediated between society and the state.[3]

The abstract connection between early capitalism and free speech had a concrete form as well. The marketplace in early capitalism often was both the site for the circulation of commodities *and* the site where public discourse took place. Central to the theory of freedom of speech are the notions that only in a free and open

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"marketplace" of ideas can a citizenry exercise democratic prerogative, and only in such an open marketplace can "truth" prevail.[4] The liberal separation of the state from the private realm of ideas was indeed essential to the creation of an independent public sphere. But this separation facilitates a democratic public sphere only to a degree, a fact that underscores one of the great tensions between liberalism and democracy. Just as concrete factors affect competition in the *economic* marketplace, the marketplace of ideas is greatly affected, if not essentially determined, by the available means of communication. The public sphere constructed by assembly in marketplaces and by a profusion of partisan newspapers is far different from a public sphere constructed by and within great and often centralized institutions of mass communication.

The liberal model of freedom of speech stops at the limit of commerce. The model assumes that a democratic public sphere will emerge consequent to the unimpeded, private actions of speech-entrepreneurs. But the results of the state's noninterference in the public sphere is much less clear when the means of communication are complicated, consolidated, and not generally accessible. The public sphere constituted by media of electronic communication greatly extend the public sphere and vastly expand the amount of information available, but at the same time create difficult problems of power. Because access to the modern public sphere was (and is) restricted to those with the capital to own a newspaper or operate a broadcast station, this mode of communication is essentially one of expanded *monologue*, with only indirect feedback mechanisms. While those with wealth can disseminate their views, the First Amendment "right" of most citizens is merely to listen and read. Yet a free marketplace of ideas implies *dialogue*. In short, the nature of the media of communication and the terms of access to them greatly affect the actual marketplace of ideas. If we take the liberal theory of the marketplace of ideas seriously, the limited access to centralized media constitutes a limit on self-government and substantive free speech.

The dilemma of broadcast regulation was this: how to safeguard the use of an important, technologically scarce, medium of commerce while maintaining the separation of the state from the private realm of ideas, *and* at the same time also facilitate a democratic public sphere? The solution was for a regulatory body to license would-be broadcasters, and suggest (not impose) broad and vague (not specific or concrete) principles of public interest licensee behavior.

The paradox of the liberal conception of the public interest in telecommunications, as embodied both in common carrier law and in broadcast regulation, is that it is inescapably bound to the commerce origin. The free speech function of communications media was assumed protected by safeguarding the commerce function of the telecommunications infrastructure. Because a free market in ideas is assumed to result from the absence of government interference, there has never been a viable ideology of positive government action to facilitate the exchange of ideas. The FCC assumed that a diversity of owners of broadcast media would result in a diversity of ideas. And yet the commerce-rooted imposition of common carrier law in telecommunications did indirectly serve broader free speech interests. Because of the commerce function of the telegraph and the telephone, access to those services was to be nondiscriminatory. The nondiscrimination principle indirectly served free speech

interests by establishing the separation of the control of the means of communication (the "conduit") from the content of the traffic which went over those lines. Although less clear-cut and far less complete, the common carrier principle also applied to broadcasting. The broadcaster was legally obliged to air programs on controversial matters of public policy and to be balanced in that coverage. When a broadcaster permitted a candidate for public office to use the airwaves, that broadcaster had to open the frequency to all candidates.[5] These obligations might be considered quasi-common carrier in nature.

Deregulation and the Public Interest

I argue that it is largely a commerce-based concept of the public interest which underlay the traditional system of telecommunications regulation. But regulation had powerful equity-based ramifications as well. Universal telephone service came to embody a principle that access to information and to the means of communication is part of being a citizen. Universal telephone service allows individuals to be part of the fabric of national life, if only due to a legally embedded principle of mandatory access to the equipment at cheap rates. Likewise, the scarcity rationale for the regulation of broadcasting created a public interest goal beyond the technical problem of allocating the electromagnetic spectrum, to wit, that the diversity of viewpoints and speech opportunities is crucial to a good society and a democratic polity. The principle of keeping content distinct from conduit, embedded in antitrust and regulatory "separations" policies, is, in a sense, a technologically rooted protection of freedom of speech. Separations policies constructed institutional boundaries between communications services: broadcasters were kept distinct from common carriers, telephone companies could not engage in telegraphy, AT&T could not enter the data processing industry. Notwithstanding the original commerce-based intentions underlying the system of telecommunications regulation, broader conceptions of the public interest came to be attached to that regulatory system *post hoc*.

Yet, historically, the application of the conceptions of "universal and nondiscriminatory service," the "marketplace of ideas," and "diversity of viewpoints" was always tremendously problematic in the traditional regime of telecommunications regulation. Indeed, as the ensuing chapters will show, regulation barely secured these broader ends of equity and fairness. Sometimes, in attempting to secure such public interest ends, regulation actually sabotaged them. The irony is that these broader notions of the public interest were "attached" to specific technologies and, further, to the regulatory protection of such technologies. As the technologies themselves change and the separation between them becomes more problematic, the broader notions of the public interest lose their material and legal moorings. This underscores the other great irony of deregulation. Liberals and public interest groups backed deregulation in large part because they saw "regulation as usual" as a form of regulatory "capture." The dissolution of regulatory protectionism and the forces unleashed therefrom served, however, to undercut the historic connections between particular telecommunications technologies and the broader notions of the public interest. The broader public interest goals became subsumed and redefined under the ideological rubrics of technological expansion and unbridled competition.

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The deregulation of various industries underscores an important contemporary transformation of the concept of the public interest which goes well beyond the technological changes in telecommunications. I have noted that it is the New Deal, industry-specific, price-and-entry agencies which are deregulating. Traditional economic regulation created, at one and the same time, a complex system of producer cartels and service-based entitlements. Congress established the price-and-entry regulatory agencies to bring order, or "rationality," to various industries during the Depression. Such agencies were given authority over a single industry which was burdened by some destabilizing condition. Railroads, trucking, and airlines were beset by too much competition; telephony was burdened with problems of monopoly; radio broadcasting suffered from an absence of general technical operating rules; speculative banking practices undermined financial institutions. Regulatory agencies established how many and which firms could enter into business, set general pricing levels, and formulated rules specific to the operation of an industry, such as which routes a certain trucking firm would service or which radio frequency a licensee would inhabit.

In fulfilling the goal to stabilize these various industries, the price-and-entry regulatory agencies created structures of mutual benefit—or cartels—among the major interests (often including organized labor) in any particular industry. Industries and markets were "saved" precisely by not permitting marketplace controls to function freely. Regulation substituted administrative rationality and informal political decision-making for market rationality. Price-and-entry regulation constituted a form of state intervention which not only stabilized certain key industries but, in the process, fulfilled certain broad New Deal social policies as well. Regulation brought order to these industries, fixing stable market shares and prices. In so doing, it facilitated the broad unionization of those industries (which could be seen also as fulfilling the Keynesian macroeconomic goal of stimulating aggregate demand). Lastly, such regulation constructed a sort of service-based entitlement system. Regardless of profit potential, buses, trucks, and airlines had to serve out-of-the-way areas; local telephone service was made cheap and universally available; broadcasters had to fulfill (however nominally) the obligations of a public trustee. Regulation compelled that rates be skewed to facilitate the expansion of service. This generally entailed internal cross-subsidies that favored poor and out-of-the-way customers. In short, regulation constructed a reasonably stable system of mutual compromises and benefits to major corporations, organized labor, and even consumers. Deregulation undermines this complex set of benefits.

Deregulation serves to dismantle the easy functioning of regulation-enforced cartels. It permits the resurgence of competition and the anarchistic play of market forces. How such a political phenomenon could come to pass is very surprising, because the regulatory *control* of competition brought business certainty and relatively assured benefits to the parties of the various cartels. It is not generally in the interest of the major beneficiaries of an arrangement to seek alteration of the arrangement. Indeed, as if to underscore this point, the powerful interests of the deregulated industries generally opposed deregulation. Another factor favoring maintenance of the regulatory status quo is the bureaucratic nature of the regulatory agency itself. It is often asserted that regulatory bodies, like most bureaucratic

organizations, tend not to shrink or dismantle themselves. Indeed, a frequent criticism aimed at regulators and agencies is that they try to expand their purviews and budgets. With deregulation, however, regulators surrender their expertise to the workings of the market. More shocking still, some agencies actually initiated the deregulatory process themselves.

A key cause of deregulation is the divergence over time of administrative rationality and economic rationality. Regulatory structures and formulae tend to reflect an internal balance of interests within a regulated industry. This is largely because the basic business and functional institutional patterns are set *before* the advent of regulatory controls. Regulation usually recapitulates these patterns and applies the coercive authority of the state to make them work. Over time, changes in the larger economic environment and technological innovation may alter the balance of interests in and around a regulated industry, but the regulatory structures and formulae may not adapt to these changes.

In theory, the informal, discretionary nature of regulation permits an agency to adapt to new circumstances. In practice, regulation tends to be conservative. In the case of the FCC, the Commission clung to familiar definitions and policies long after their applicability had become ambiguous. The agency, beset with many problems and conflicts, often clings to established rules and policies. Regulatory rules may make administrative, but not economic sense. Moreover, if the regulatory arena becomes too contentious, if the struggle between interests is too basic, the agency experiences additional pressures to become more formalistic. Regulatory delay and irrationality reach a point where business decisions are made uncertain. Regulated parties flee the regulatory arena for relief. New policy forums may then disrupt the settledness of regulatory conservatism.

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To describe this process in historical terms, the liberal-left regulatory activism of the Great Society period not only produced new regulatory agencies, but pushed the older agencies to become more open to democratic (or at least non-industry) demands. The traditional regulatory arena, long protective of (if sometimes also bothersome to) the major regulated interests, waxed inordinately contentious and politicized. This phenomenon pushed agencies to become more formalistic, more prone to time delays and drawn-out judicial challenges. In a period of high inflation, regulatory activism helped modify rate increases such that large service users paid a higher proportional share of the "cross-subsidy." These pressures magnified the economic incentives for large users to bypass the regulated system and for new entrepreneurs to offer unregulated services that would sidestep the regulated industry's delicate system of producer cartels and service entitlements. In response, the traditional regulatory agencies enacted new rules to thwart such bypass.

Corporations, reeling under new obligations, costs, and time delays imposed by the new social regulatory agencies, counterattacked. They formed lobbying groups and foundations, and commissioned reports decrying the "overregulated" society. Corporations attempted to tie the decline of US economic productivity to excessive regulation. One effect of this corporate attempt to alter the reigning political discourse was to open up a greater space for the analyses of academic economists of regulation, who had been writing about the inefficiencies of regulation for years. In a strange sort of way, the corporate effort succeeded *and* failed. With the backdrop of a crisis in public institutions consequent to Watergate and the economic "stagfla-

tion" of the 1970s, corporations largely succeeded in transforming a generalized populist dissatisfaction with government (including regulation) to a critique *of* regulation. But the regulatory agencies most affected were not the new social regulatory agencies so reviled by business. Rather, they were those agencies most criticized by academic economists—the New Deal price-and-entry agencies.

Notwithstanding the usual conservatism of regulation, political dynamics and technological innovation and changes in political culture can alter the conservative tenor of "regulation as usual." By the mid-1970s an ideologically diverse political coalition—including free-market economists located in key positions in the Ford Administration, historically pro-regulation liberals such as Senators Edward Kennedy and Philip Hart, and consumer advocate Ralph Nader—had emerged to reform regulation. Early reform stirrings coalesced around commercial airlines and the Civil Aeronautics Board. Despite vociferous opposition from the airline industry and nearly 40 years of CAB precedent, commercial air transport was deregulated. Early successes with airline deregulation (lower prices and reputedly higher efficiency) created further political impetus to deregulate other transportation carriers and other infrastructure services.

Telecommunication was affected greatly by the general environment of deregulation, yet in some ways both broadcasting and common carriage had already experienced changes which made them ripe for the deregulation impulse. The regulation of broadcasting had long been characterized by the protection of the conventional services of AM radio and VHF television from competitive entry. Although the FCC formulated various structural and content controls on broadcasters, their efficacy in securing "public interest" broadcasting was dubious. The broadcast reform movement set out to change this.

The broadcast reform movement (the communications "wing" of the many liberal activist consumer groups of the Great Society period, consisting of a loose coalition of liberal, often minority-group organizations dedicated to altering the broadcast system) utilized three identifiable strategies in the late 1960s and early 1970s. The most widespread of these was that of conducting challenges to the license renewals of existing broadcast stations. Petitions to deny license renewal were filed on the basis that such stations had not fulfilled their obligation to broadcast in the public interest. Reform groups were greatly assisted in this endeavor by the judicial expansion of legal "standing." This expansion enabled parties without property interests to argue before regulatory agencies. The second strategy entailed a call for the right of limited, but mandatory citizen access to broadcast frequencies. This included demands for airtime to respond to "controversial" advertisements, such as cigarette ads. Last, the reform movement initiated (or at least picked up and gave loud voice to) a new discourse on the potential of "new technologies" to alleviate the endemic problems of broadcasting. In particular, this discourse focused on cable television as a technology that could create a "wired democracy," able to transcend the limited and commercial system of conventional broadcasting.

License renewal challenges and access demands caused short-term but severe regulatory problems for broadcasters, and caused them to flee the regulatory arena toward Congress for relief. Congress took up broadcast industry demands for license renewal relief in hearings which by 1976 became bound to the broader (ultimately unsuccessful) effort to rewrite the Communications Act. At the same

time, the broadcast reform movement's "new technologies" discourse, resonating with the material interests of non-broadcast entrepreneurs, slowly pushed the FCC away from its traditional policies of protection. Broadcast deregulation emerged from an unexpected combination of new technologies and mutually contradictory rules designed to protect conventional television broadcasting. The advent of satellite-delivered programs to cable operators caused contradictions in the regulations designed to restrict cable television. The subsequent inadvertent relaxation of conflicting regulations provided the FCC with a real-world case for judging whether broadcasters were, in fact, being injured by cable. When broadcasters could not show that they were injured by the relaxation of specific cable rules, the FCC, now taken with the general notion of regulatory reform, relaxed more of the rules. In addition, a crucial court case in 1977 established that certain other FCC rules designed to protect broadcasters were unconstitutional. By the late 1970s, the FCC had moved from the New Deal cautious guardian model of regulation, to one which worked actively to liberalize entry in the broadcast business.

The common carrier area had been dominated by a vertically integrated AT&T monopoly which was protected by the FCC. AT&T controlled long-distance telephony, was the local service monopolist in most metropolises, and supplied all of its equipment needs through its own manufacturing subsidiary. By the mid-1970s, however, the internal balance of interests in the industry had shifted—partly due to the entrepreneurial opportunities created by technological innovation and partly to economic incentives to bypass the regulated system. Again, technology is not an independent, abstract force, but a dynamic situated within contexts of entrepreneurial opportunities and regulatory constraints. Underlying this shift were two important factors: one, longstanding antitrust problems over AT&T's vertical monopoly, and two, the needs of a powerful community of large telecommunications users which was inadequately served by AT&T and wanted freedom from AT&T-imposed options.

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AT&T, so adept at providing universal telephone service, was always suspected of using its vertical monopoly to internally manipulate its prices in order to raise profits. Such antitrust considerations resulted in the 1956 confinement of AT&T to the provision of regulated common carrier telecommunications only. The large, vertical monopolistic structure also was responsible for the company's inability to satisfy the more specific needs of large telecommunication consumers in the post-World War II period of business expansion. In response to the demands of these large users, the FCC opened special small parts of the Bell monopoly's operating environment to competition. These small entry "liberalizations" were permitted only because AT&T could not serve specialized users adequately. They were not intended or envisioned to open up AT&T's monopoly. Nevertheless, the FCC could neither foresee nor control the consequences of its actions. Entry liberalization encouraged the emergence of new technologies and new players into telecommunications common carriage, notably in "private lines" (special lines dedicated between two points, used increasingly for data carriage) and "terminal equipment" (telephone instruments and switching systems). Over the years, these new players (particularly the MCI Corporation) and large users would push continuously at the borders of the Bell System with new technologies and new services.

Such developments had two inadvertent but serious ramifications. First, they raised serious issues of public policy regarding the appropriate boundary between regulated and unregulated activities. And second, they placed AT&T's rate structure in potential jeopardy. These antitrust and liberalized entry matters became inexorably intertwined in the mid- to late 1970s. In 1974 the Justice Department filed an antitrust suit against AT&T, charging that the company had used its regulated profits to practice predatory pricing in competitive markets.

Faced with new competitive players and unclear regulatory boundaries, AT&T found its external operating environment and its policy arena, both for decades remarkably stable and certain, becoming increasingly unstable and uncertain. By 1976, partly at AT&T's urging, and partly the result of the deregulation environment, the policy-making arena opened to include Congress in an attempt to rewrite the 1934 Communications Act. Soon, however, all branches of government were engaged in efforts to formulate new national telecommunications policy—a process likened by AT&T's Chairman Charles L. Brown to "nothing less than a three-ring circus."

What began as a complex antitrust case in 1974 inadvertently became by 1981 a closed policy forum within which various economic and political concerns could be joined. In the context of Reagan Administration Justice Department negotiations, the need to solve pressing contradictions in domestic telecommunications common carriage could be reconciled with large users' demands for telecommunications options, with AT&T's desire to be freed of regulatory barriers, with national security considerations, and, finally, with the growing concern to protect and enhance American global interest in information technology.

The transformation of the concept of the public interest posed by the deregulation of these industries involves a shift away from a concern with stability and a kind of social equity to a concern with market controls and economic efficiency. In this regard, the deregulation of telecommunications commands particular attention. For, again, it involves not only the usual issues of political economy in the spheres of commerce and antitrust, but is characterized centrally by issues of public utility and free speech as well.

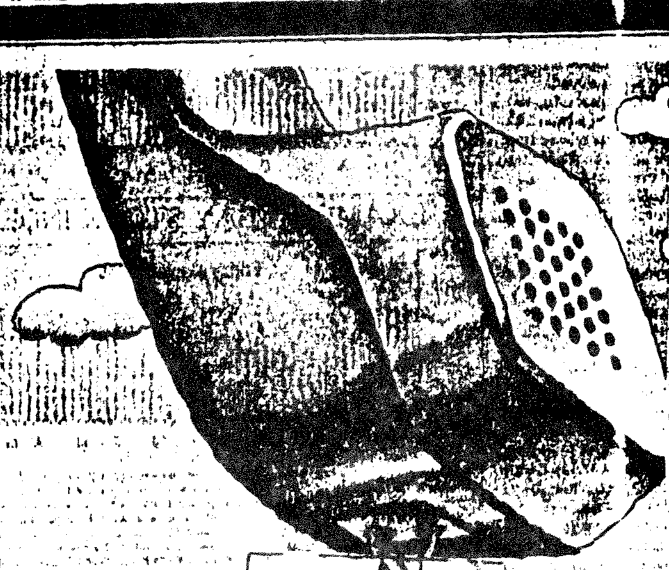
The divestiture of AT&T, and the relaxation of regulatory controls over broadcasting in particular, pose important questions about the nature of the modern public sphere. The foreseeable outcome of the divestiture of AT&T is increasing telecommunications options for business and the decline of the principle of universal service. The deregulation of broadcasting threatens to collapse the First Amendment's protection of messages to mean complete freedom for media owners only. Diversity and a free marketplace of ideas are declared to be delivered by the unfettered market. Telecommunications deregulation thus creates a distinctly modern political and philosophical paradox: how to guarantee meaningful freedom of speech in an age of information abundance. There are also basic questions about deregulation's effect on commerce. Given that a planned and stable telecommunications infrastructure was crucial to economic development and the free flow of commerce, will the opening of that infrastructure to competition secure similar results?

San Francisco Examiner
BUSINESS

Powerful groups weigh in against Pac Bell

Major customers, consumer advocates fight utility's bid for deregulation

By Mireya Navarro
EXAMINER CONSUMER AFFAIRS WRITER



WHAT DO the Department of Defense, a national burglar alarm company, MCI Telecommunications Corp., California's cable television industry, banks, consumer groups and the city of Los Angeles have in common?

They're all against Pacific Bell.

The eclectic opposition revolves around a Pac Bell proposal that state regulators are now reviewing and are expected to vote on by fall. At the heart of the proposal is Pac Bell's request for looser state regulation, a fundamental change that both customers and competitors fear could have far-reaching effects.

There are some eye-catching benefits for phone users: a four-year freeze of basic residential phone rates (now $4.45 for measured service and $8.35 for flat-rate service), free touch-tone service ($1.20 a month), expansion of flat-rate local calling areas to a 12-mile radius from an 8-mile radius.

Company officials say the plan provides for modernizing some switching equipment, increasing ef ficiency, and lowering or stabilizin rates for most customers.

Pac Bell is not alone in its desir for relaxed state regulation. Tele phone companies in other state have sought similar changes, an some have won it. Industry observ ers say the move is spurred by in creased regulatory flexibility at th federal level, competition in som phone company services, and new market opportunities created b new technology.

"It's not a telephone business anymore, it's a communications business," says Gail Garfield Schwartz, deputy chair of the New York Public Service Commission, which has already implemented alternative regulation for New York Telephone Co. "The natural monopoly is shrinking."

But Pac Bell's plan, which would be in effect for four years and then be subject to review, has been attacked on several fronts.

The opposition includes large business users, such as banks and government entities, upset about proposed rate increases; current and potential competitors such as MCI and the California Cable Television Association that worry about anti-competitive behavior from the phone company if regulation is relaxed; and consumer advocates trying to protect the interests of basic phone service customers.

The California Public Utilities Commission, which since 1987 has been investigating ways to adapt regulation to changing market conditions, last year gave Pac Bell the authority to change rates — within an approved price range — on competitive services such as Centrex, a call switching service for business customers, and high-speed digital private line services, which are used to transmit large volumes of data.

Pros and cons

Pacific Bell's proposal	Consumer groups' response
Freeze residential rates	Rates can be cut
Less state regulation	Strong regulation is needed
Split 50-50 excess profits	100 percent to ratepayers
$750 million for equipment upgrade	Expense not justified
Increase some business rates	No rate hike without adequate cost studies

Ending a monopoly

As part of Pac Bell's proposal, the five-member PUC will also consider whether to end the company's monopoly as the only provider of service for short-distance toll calls within its market area: for example, on calls between San Francisco and San Jose.

Long-distance phone companies, such as AT&T and MCI, want

[See PAC BELL, D-12]

◆ *PAC BELL from D-1*

Pac Bell seeks easing of rules

to handle these calls too, and the competition is expected to bring prices down. Pac Bell wants the change, charging that some long-distance carriers already cover a segment of the toll-call market at unregulated rates.

But first, the PUC will decide on an alternative rate-setting approach. The commission is looking at Pac Bell's request as well as plans submitted by GTE California, a phone company mostly serving Southern California, and the Division of Ratepayers Advocates, the PUC's consumer staff.

State legislators, in turn, are looking at the PUC. Both the Senate and the Assembly are conducting studies and hearings on the planned regulatory changes.

"We're concerned that the process for arriving at an answer has not been a long-range planning process," says Robert Jacobson, consultant to the Assembly Utilities and Commerce Committee, which has scheduled a hearing Tuesday on the issue.

"It's been a matter of each party advancing its own interest. That's a very tough way to plan for the future," he says.

Specifically, Pac Bell wants to:

- Change the way the PUC sets phone rates. The PUC now looks at Pac Bell's costs and expenses and determines the amount of revenue needed to cover these costs and still provide a fair return.

Capping residential rates

Instead, the company wants to freeze residential rates, increase some business rates, and be allowed to change prices for competitive or optional services without prior PUC approval but within a price range set by regulators. The company also wants to increase to 14.5 percent from 13 percent its allowable return on equity, and to split any excess earnings 50-50 with customers.

(Under existing regulation, excess earnings are reflected in future rate reductions.)

- Offer new services within 40 days even when there's opposition to their introduction. George Schmitt, Pac Bell's vice president for state regulatory affairs, says opposition can now hold up a new product "almost forever."

Among the new services on the horizon for 1990-92: voice mail, a phone-answering service built into the telephone, and caller identification, which reveals the caller's phone number to the person receiving the call.

- Invest $750 million to replace outmoded switching equipment and go with fiber optic cable in parts of its telephone network.
- Increase rates for some business services. Pac Bell says rates for these services are priced below cost. For example, the cost of installing analog private lines used by alarm companies would increase by 1,000 percent. Banks could see the monthly service charge for their automated teller machine networks almost double.

Pac Bell officials, however, say small businesses would experience about a 15 percent annual increase in monthly service fees.

Company officials argue that the proposed regulation would do away with lengthy and expensive proceedings, would do nothing to diminish the power of the PUC and would encourage cost-cutting and efficiency since they would not seek rate increases if earnings fall below the benchmark rate of return.

Responding to competition

Pricing flexibility, they argue, would allow them to respond quickly to competition, particularly once the short-range toll market opens up, and to retain large business customers. The $2.5 billion-a-year toll market is the single biggest source of revenue for the company.

Critics agree that the current regulatory framework could be improved but they say it has served consumers well and that there is no need for a major overhaul. A major concern is the proposed elimination of the current annual PUC reviews — with a more comprehensive triennial review — that provide a forum for customers and competitors to voice their concerns.

The company is also proposing to consolidate, reducing by about half, the reports it files with the commission.

"The advantage of the rate case is that the utility comes before the commission and the burden is on the company to justify its rates," says Mark Barmore, attorney for the consumer organization Toward Utility Rate Normalization (TURN).

"Otherwise a party has to file a complaint or the commission has to start an investigation. It's a very large institution and to get the ball rolling is very difficult."

Many opponents see the plan as a scheme that would reduce oversight at a time the company is poised for growth and costs are down because of technological advances. Pac Bell, a subsidiary of Pacific Telesis Group, last year had a net income of $1.23 billion on revenues of $8.75 billion.

Both consumer advocates and competitors want the PUC to ensure that the company doesn't offer competitive services below cost to capture market share and then compensate for the loss by raising prices on basic phone service. They are also concerned that ratepayers may end up paying for failed new services.

Further, there are also calls to study the competition in the various markets Pac Bell wants to enter, and the cost of services the company wants to price higher.

Critics question Pac Bell's past

Underlying the concerns is the question of whether Pac Bell deserves less oversight. In recent years, the company has gotten into trouble with the commission over abusive sales techniques, investment practices and a personnel training program.

Last week, Pac Bell quietly settled a class-action complaint accusing the company of charging customers for touch-tone service that wasn't provided. The company agreed to refund $5 million to about 150,000 customers in rural areas.

"If you look at their recent history, the last three or four years are pretty indicative of what they're capable of doing if given the opportunity," says Barmore of TURN.

Even Pac Bell's concessions under the plan, which the company says translate into savings of $2.20 a month for residential customers, haven't been well-received.

The PUC's consumer staff, for instance, says rates should come down by $200 million to $300 million because of declining costs in the telecommunications industry. Push-button service costs the utility virtually nothing, staffers note, and without it customers couldn't use many of the services the company sells or plans to sell.

"They're doing a sales job," says Bill Thompson, project manager of the Division of Ratepayers Advocates.

Pac Bell's Schmitt describes the plan in simple terms:

"I'd still be clearly the predominant provider of the wire under your home; I'd still be the majority market share holder of local toll calls; I'd have products in the market place that I don't have today. California would have a network that's as good as anybody else's in this country."

GTE's proposal is similar to Pac Bell's but it proposes price caps. The PUC's consumer staff proposes a rollback of rates, annual rate adjustments and safeguards against cross-subsidization.

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Informational Hearing
of the
Assembly Committee on Utilities and Commerce
State Capitol, Room 437
Sacramento, California
Tuesday, June 6, 1989

"Don't Hang Up!: The PUC and Telephone Service in the 90's -- Regulation, Deregulation, or Reregulation?"

CHAIRWOMAN GWEN MOORE: In 1910, after years of strife between the utilities and their customers, the people of California, by initiative, created the California Public Utilities Commission [PUC] to create order and protect their common interest. Now, the Public Utilities Commission is engaged in one of its most important assignments ever: Determining how to regulate California's telephone companies in the 1990's.

In December, the PUC significantly lightened the regulation of AT&T, the largest long distance carrier, as it had done earlier for MCI, U. S. Sprint, and the other long distance carriers. Now, the local telephone companies are petitioning the PUC for their own lightened regulation.

But there is a bigger issue. That issue is how telecommunications services will be provided in California in the last years of the 20th Century and the first years of the 21st.

Our hearing today is convened to discuss what our state's telecommunications policies should be. Ever-changing federal policies and new techological possibilities require that we reassess our state's policies on a regular basis. For that reason, I'm asking the

witnesses, who represent almost every active player in telecommunications arena, to concentrate their testimony on the Big Picture: The policies that they recommend for the future. Among these is the appropriate role of the Public Utilities Commission. I don't want to reiterate the proceedings now before the Public Utilities Commission except as they point the way to the future.

As Californians, we all have a big stake in our telecommunications policies. They will determine, more than we can imagine today, how we will live our lives tomorrow. Can we build a social concensus for the 21st Century, for the "Information Age?" Can we afford not too? [Prepared Remarks, See Attachment A].

With this purpose in mind, I will call forward the first witnesses.

I'd like first to come forward the representatives of Pacific Telesis and General Telephone. Their requests may shape what our "Information Age" looks like, depending upon what the PUC does. The Public Utilities Commission can come forward at this time, also.

Terri Murray, Bruce Jamison, and Tim McCallion.

I'd like for you to tell us what your vision is and what you see changing. Those of you who follow, I want you to tell me what's wrong with what they are proposing.

MR. BRUCE JAMISON: Madam Chair and members of the Committee, my name is Bruce Jamison, executive director for State Regulatory representing Pacific Bell. I plan to discuss, within the context of the preliminary remarks that the Chair outlined, the well-balanced nature of our proposal; second, the issue of deregulation

and the fact that Pacific is not seeking deregulation, and third, respond to concerns about our proposal, that business rate increases which are below cost should move towards cost over time, gradually and predictably, and that those increases will not result in increased revenues for Pacific.

However, I'd first like to correct an error in the paper that was circulated by the Committee prior to these hearings. Included in that paper was a statement that the Commission has twice rejected Pacific's proposal. That's not true. I have addressed that subject more fully in my written remarks. [See Attachment B].

The first question in the list of questions that the Committee sent to the various parties today listed a set of goals for regulation: assuring just and reasonable rates, preserving the ability of the utility to attract capital and reasonable returns, preventing abuse of monopoly power and undue discrimination among customers, assuring high quality service and adequate facilities. Stated differently, these goals are very similar to the goals that the Commission outlined in the notice that convened the proceeding that is in progress today: The OII on changing regulation for local exchange companies.

Pacific's filing responded to that order. Ours was one of the few proposals that covered all aspects of the issues outlined in the Commission's order rather than aiming only at the narrow self-interest items one by one. My prepared remarks contain a summary of that proposal.

Hearings in Phase II were extensive, covering some 61 days of hearing room time, with 20 parties and 43 witnesses

providing testimony in those proceedings. Public participation hearings were held in San Diego, Santa Monica, Long Beach, Pasadena, San Francisco, San Jose, Fresno, Sacramento and Redding. Now, the parties have filed briefs in this proceeding, and we're waiting a decision by the Commission.

In those briefs, parties identified some concerns about the Pacific's proposal. First, there was concern about our proposal to, in effect, lower the rate charged on residential service by including touchtone in that service and expanding the local calling area. Some of the other parties in this proceeding opposed that, saying it should go lower. "Those rates should be lower." Other parties opposed said, "Those rates should go higher." This very range of opinion, I think, is a good indicator that we have made a balanced proposal.

CHAIRWOMAN MOORE: Let me ask you a question. Under your proposal, in the future,there will be no room for those kinds of hearings, for the next four years. If it was good for this process, then what's wrong with it for the future?

MR. JAMISON: The Commission always has the option of convening an OII order instituting investigation on any subject that it chooses.

CHAIRWOMAN MOORE: Part of your proposal, as I understand it, is to freeze rates for four years. What reason would they have to issue an OII?

MR. JAMISON: I'm sure many subjects might cause the Commission to want to examine issues in the telecommunications industry. Some of those might have pricing implications. Those procedures are still well intact.

Second, there was a concern about the need for safeguards and about the adequacy of regulatory oversight. Let me reiterate Pacific is not seeking deregulation. We believe adequate safeguards are available. Under Pacific's proposal, any rate increase that would come about as a result of principals adopted in this proceeding would have to be approved by the Commssion. "Flexibility bands" that Pacific has proposed would have to be approved by the Commission on an individual basis.

CHAIRWOMAN MOORE: Once the range of the bands are approved, is any further approval necessary by the Public Utilities Commission?

MR. JAMISON: No. If the Commission approved a flexibility band for a particular service, within that range we could move the price. We are proposing, for existing services, that the highest price could be no higher than the current rates as they are today or as they're determined by the rate proceeding that has to follow this particular part of the OII.

With all of these PUC approvals required and integral to our plan, this is clearly not the plan for a business seeking deregulation. I would reiterate, Pacific is not seeking deregulation. We don't believe that's appropriate.

Some parties, the cable industry in particular, have attempted to conduct hearings in the OII and in the press, distorting and mischaracterizing Pacific's proposal. There have been expressed concerns about our proposal that business rates are below cost and should move towards cost over time. It is important to note, however, that those rates would not result in any new revenues for

Pacific. They will be offset by reductions to the long distance carriers for the services that they receive from Pacific, to connect to our network. I believe that those long distance carriers probably will flow those reductions through to their customers, many of whom are the very same customers that would see increases in the below-cost rates that Pacific currently provides.

A major intent of our proposal -- and let me stress that the PUC still has to review those rates and the costs associated with those rate increases -- is that if any services are to continue to be priced below cost in this changing, more competitive communications environment, it should be reserved for residential services.

That is not everything that is contained in the proposal, but I have tried to hit highlights. I have attached a summary statement of the proposal to my prepared remarks.

CHAIRWOMAN MOORE: What's good for the consumer in your proposal?

MR. JAMISON: First, the inclusion of touchtone in basic service for the residential customers as we move into an era of more and more information services provided by many, many providers...

CHAIRWOMAN MOORE: You know how I feel about that. It doesn't cost you any money to do it, so what's the big deal?

MR. JAMISON: We're talking about the revenues. We receive over $100 million a year from that, and we're proposing that be included...

CHAIRWOMAN MOORE: We are talking about moving close to cost-of-service. If you are telling me that it doesn't cost any

more to cost that service than rotary, then we ought not to have been paying that anyway.

MR. JAMISON: Today, the way regulation is practiced, the Commission allocates the revenue requirement across a variety of services, expecting some to provide contribution to support others. Touchtone provides contribution, and it is one of those very services that keeps rates or basic services low today. We're proposing that the customer should no longer pay for that. I think that is a separate issue.

CHAIRWOMAN MOORE: Okay, but I don't consider that a gift. Go on, give me another one.

MR. JAMISON: Extension of the local calling area is an important item.

CHAIRWOMAN MOORE: I think that is important.

MR. JAMISON: We're proposing that what is now Zone 2 be included in the ZUM (Zone Usage Measurement) areas: Zone 2 toll, a second band of toll in the non-ZUM, be included as part of the local calling area for both residentials and business.

CHAIRWOMAN MOORE: But isn't that something you took from the consumers when you went to ZUM in the first place?

MR. JAMISON: No. In fact, I think quite the contrary the ZUM bands use to be multi-message-unit bands years ago. Those were created primarily because of the ...

CHAIRWOMAN MOORE: Multi-message units used to be spread over a much wider area. I remember the people went nuts when ZUM went into effect.

MR. JAMISON: That's correct, but the multi-message unit function was a replacement for toll, not the other way around. In fact, the ZUM rates are tied to the toll rates in that they are today currently pegged at 50 percent of the toll rate.

CHAIRWOMAN MOORE: So, you're telling me that what's good for the consumer in that package is : First,f you're going to give them touchtone service, which doesn't cost you any more to provide than rotary; and second, you are going to give them a wider calling area which is similiar to what they had before you went to ZUM.

MR. JAMISON: No. They didn't have it before we went to ZUM.

CHAIRWOMAN MOORE: Okay.

MR. JAMISON: Regardless what touchtone costs Pacific to provide, the fact is that the customer will see a net reduction in their bill. If, for example, you have touchtone at home, we figure on average -- know averages are risky to deal with -- but in the case of touchtone, that is $1.20 a month that the customer will no longer be paying.

CHAIRWOMAN MOORE: So, you're saying that basic service now drops to $7.20?

MR. JAMISON: No. Basic service stays at $8.35, but it will include touchtone service as part of it instead of touchtone being an extra charge.

CHAIRWOMAN MOORE: Instead of it being $9.45 or whatever, now your monthy bill will be $8.35?

MR. JAMISON: Yes, and on top of that, on a broad average basis, residential customers will see about a $1.00 reduction because of the expansion of the local calling area.

CHAIRWOMAN MOORE: What we're talking about is almost a 25 percent reduction for residential callers. Is that what you're telling me?

MR. JAMISON: Right. When you roll that all up together.

CHAIRWOMAN MOORE: So, the package for residential customers represents about a 20 to 25 percent reduction in costs. That is what's in it for the consumer?

MR. JAMISON: There are other things in it for residential customers, as well. For example, in the area of flexibility, Pacific has asked for services that are priced above costs. I am speaking primarily of toll services; we would like flexibility in that arena. We believe we are going to have to respond to competition in the future. It hasn't been authorized on a wide scale yet, but authorized on some incidental basis. By having flexibility there (and we're only talking about downward from current rates), I would expect that customers will see lower toll rates as a result.

CHAIRWOMAN MOORE: Who picks up the slack as we go down?

MR. JAMISON: That's part of this whole package: Should we reduce rates through the flexibility proposal? That's a risk to us.

CHAIRWOMAN MOORE: Are you telling me your shareholders may eat your flexibility?

MR. JAMISON: To the extent that we confront competition and that requires us to lower rates, or we lower rates

because ... In some cases you may be able to make your money depending on the price elasticities.

CHAIRWOMAN MOORE: But, there are other groups you can shift the cost to. Is that not true?

MR. JAMISON: I don't see how, since we aren't proposing to raise rates except those business rates tied specifically to a program whereby the long distance companies are going to have the rates they pay to us reduced.

CHAIRWOMAN MOORE: Okay. General Telephone, is your program just like Pacific's?

MR. TIM MCCALLION: No, it is different. Morning, Chairwoman Moore and members of the Committee. My name is Tim McCallion and I'm director of Revenue and Earnings Management for GTE California. Additionally, I was GTE California's policy witness in the Commission's Alternative Regulatory Framework proceeding.

As you requested, I will limit my remarks to describing the features of our plan. Our plan is significantly different, from both the proposal presented by Pacific Bell and the proposal presented by the Division of Ratepayer Advocates [DRA].

GTE California is seeking a change in regulation. We are not seeking deregulation of any services that are currently regulated. There are several features of GTE's proposal which I will briefly described. I might want to add that we have given to the Sergeant of Arms a very short background paper which describes our plan in slightly more detail. [See Attachment C].

First of all, under our proposal, we would divide the services that we offer today into two categories which I refer to as Category I and Category II.

The first category would consist of the majority of the telephone services, the majority of the services which are required for customers to have what I refer to as "POTS," plain old telephone service. That would include the residential network connection, the single-line business connection, the multi-line business connection, intraLATA toll calling and access services.

Category I services would be subject to an index. In the future, prices for those services or the overall revenues we get from those services would only change based upon this index. This index would have two components. One component would recognize inflationary changes which occur and the other component would give recognition productivity improvements in the telecommunications industry. As we discussed at hearings before (and this has been discussed at the Public Utilities Commission). Productivity in the telecommunications industry has been improving in recent years. Therefore, there would be an adjustment to our Category I index to recognize the productivity improvement.

CHAIRWOMAN MOORE: Does that means you would go before the PUC for that recognition?

MR. MCCALLION: We would hopefully have the PUC adopt a productivity factor in their Phase II order.

CHAIRWOMAN MOORE: So, it wouldn't be something that they would review. It would be a standard that they would establish. When you achieved that, then you would automatically be

able to increase your rates or get your bonus for your productivity. Is that the deal?

MR. MCCALLION: We would be able to adjust rates either upwards or downwards only based upon that standard. Another aspect of our plan which you started getting into...

CHAIRWOMAN MOORE: Let me ask this, if you had a minus productivity, then would you reduce your rates?

MR. MCCALLION: Yes. If the inflation and productivity netted out negative, which certainly it could, we would have to reduce the rates for our Category I services.

CHAIRWOMAN MOORE: How are we going to know you did that? Trust you?

MR. MCCALLION: We would make a filing to the Public Utilities Commission at the beginning of each year to reflect the change based upon the index.

CHAIRWOMAN MOORE: So they would see whether you were productive. This change can only occur once a year?

MR. MCCALLION: Yes. It is an annual adjustment.

CHAIRWOMAN MOORE: Mr. Bald?

MR. JIM BALD: Under your plan, do you foresee the business community sharing in these productivity improvements and whatever lower rates might be available because of that?

MR. MCCALLION: Under our plan, all of our customers for these Category I services would share in that productivity improvement. That is the productivity improvement that is built into the index. The adjustments would be made to those services in Category I. That doesn't capture all of our services -- in a minute I

will describe which ones it doesn't capture -- but it is the majority of the services. The single-line business customer and the multi-line business customer would also receive the benefit of that productivity improvement.

CHAIRWOMAN MOORE: Would that be a shared benefit, so to speak? You would share whatever the productivity improvement was? In other words, you would give so much to the customer and your shareholder would get so much? Is that what we're talking about?

MR. MCCALLION: You anticipated the next step of our plan. The next step of our plan is a sharing mechanism. That is, if the company's earnings are above the benchmark rate-of-return established by the Public Utilities Commission, we would share the earnings above that benchmark on a 50/50 basis between the company and its customers.

CHAIRWOMAN MOORE: That sounds familiar. Is that like yours?

MR. JAMISON: Yes, it is. I did not try to include every item in our proposal. Those items are included in the attachment to my prepared remarks. The concept of sharing above a benchmark is a key item in our plan.

CHAIRWOMAN MOORE: Let me ask you to differentiate that kind of approach from rate-of-return, what we do today. How does that differ?

MR. MCCALLION: First of all, in today's environment the staff of the Public Utilities Commission, the Division of Ratepayer Advocates, and other participants take a very close look at our

revenues, our expenses, our investments and go through an account-by-account line item review. They review the wages that we're paying to our employees. They review how fast our operators are answering telephone calls, and therefore, how many operators they feel we need. They review our instruction program to see if it is beneficial to the ratepayers.

Under our proposal, that account-by-account, detailed review would no longer be necessary, because utilizing the index will provide us with a bucket of dollars within which to operate. As long as we operate within that bucket of dollars, there is not the necessity to make any of these adjustments.

CHAIRWOMAN MOORE: No. My question was, when you earn over your rate-of-return, how is the money adjusted? I think the Division of Ratepayer Advocates better tell me that all of that goes back to the consumer as oppose to a 50/50 share. Is that correct?

MR. MCCALLION: Not necessarily. During the rate case proceeding, we are adjusted down to our authorized rate of return. In the years between the rate case proceedings, the Commission has an "attrition mechanism" to where they impute some productivity to us today. Based upon our recent rate case order and the one that came out a few years ago for Pacific Bell, if the company achieves more than the amount of labor productivity, we are required to give 50 percent of that additional savings back to the ratepayers, and we get to retain 50 percent of it. In the past, prior to this order, in the years between general rate cases, the companies were permitted to retain 100 percent of any additional productivity during those lag

years. So, we now have actually a little bit less incentive than we had in the past to improve our productivity in those years betwen rate cases.

MR. JAMISON: There is a key difference between the way ratemaking is practiced today and what is proposed by Pacific and somewhat similarly by General. Today, revenue figuring is only forward ooking. There is no backward reaching except for the productivity element that Mr. McCallion mentioned. So, if Pacific does well in a year, the Commission does not take it away nor can it. It can only base rates on forecasts of the future and set rates going forward. Those two items are important to understand relative to Pacific's proposal We are proposing now to put the company at risk. Based on forecast, but based on actual outcomes, whatever that benchmark is set to be, if it is exceeded, that outcome is shared 50/50 -- in effect a reach-back provided to the customer. It also provides an incentive for Pacific to do better.

CHAIRWOMAN MOORE: How does that differ from a bill that I seem to remember that called for an annual ratecase?

MR. JAMISON: As I recall, it described a procedure very similar to which exists today. That can't be accomplished in a year or two years or three years.

CHAIRWOMAN MOORE: That's not true. It reduced the review of the day-to-day, micro-management kinds of things. It looked at the big ticket items. Very similar to the things you are describing here, fas I recall.

MR. JAMISON: I don't recall it that way.

CHAIRWOMAN MOORE: Let's hear from the Division of Ratepayer Advocates. What's wrong or what's good about what they are telling me?

MS. TERRI MURRAY: First, let me introduce myself to the Committee. I'm Terri Murray, director of the Division of Ratepayer Advocates [DRA]. (Prepared Statement, see Attachment D). In terms of what you heard from Mr. Jamison and Mr. McCallion, I would agree they have both accurately described the differences between current rate-of-return regulation and the proposals. The Division of Ratepayer Advocates is perhaps a little more enthusiastic about what we have accomplished in the past, under traditional rate-of-return regulation, then either Pacific or General. But we, too, agree that the changes in the telecommunications industry, technology, federal policy and judicial action do call for some modification of our traditional framework.

We are concerned, perhaps for somewhat different reasons than the two companies that are represented here today, that ratepayers may subsidize the entrepreneural adventures of the local exchange companies by paying development costs for projects intended for competitive ventures. An example is the $20 million -- plus that ratepayers explicitly picked up for Project Victoria. We are concerned about the risk of cross-subsidization of new and competitive services in a mixed marketplace where there are both monopolies...

CHAIRWOMAN MOORE: $20 million on Project Victoria?

MR. JAMISON: In the evidentiary hearings, the DRA's own witness pointed that, had that money not been spent, it would

have become profits to the business and not reduced rates to the ratepayer. That is a mischaracterization. In fact that is one of the ways regulation works today that demonstration that there is not this reach-back.

CHAIRWOMAN MOORE: Was the research done with the subsidization from Pacific Telesis or in Pacific Bell?

MR. JAMISON: It was done in Pacific Bell.

CHAIRWOMAN MOORE: How do you get to the shareholders out of Pacific Bell?

MR. JAMISON: Had the research taken place, that would have made more money available as dividends to our owner, which is, of course, Pacific Telesis.

CHAIRWOMAN MOORE: So it came out of the shareholder's pot and there is a clear paper trail to the shareholder's pot.

MR. JAMISON: That's correct, because had it not been done, it would not have resulted in lower rates. It would have resulted in higher profits.

CHAIRWOMAN MOORE: Why are you so confused on that, DRA?

MS. MURRAY: I think the confusion here (because I agree with Mr. Jamison) points to a problem, and that was my point. In the existing regulatory framework, between ratecases, there is no way to reach-back and pick up access earnings that might be there. They become available either as shareholder profits or to finance potentially competitive ventures. I certainly did not mean to suggest that Pacific Bell had done something that was impermissible under

our existing regulatory framework. I simply pointed out that there are problems with traditional rate-of-return in a mixed marketplace, this being one example.

CHAIRWOMAN MOORE: Do you have some suggestions?

MS. MURRAY: We do have some suggestions for that and for some of the other problems that we see in traditional rate-of-return. DRA has put forth a proposal in the investigation that we think more fairly balances the needs of ratepayers and shareholders than the plans you have heard thus far. One key element of our proposal is to move competitive services into a separate profit center -- to isolate them, in terms of cost accounting, from the regulated monopoly side of the business.

CHAIRWOMAN MOORE: Isn't that being done already?

MS. MURRAY: We think that it could be done. We have not thoroughly gone through the kind of cost allocation procedures that would be necessary to totally separate those services from the monopoly side of the business. That is part of our goal to separate it out completely; to draw that line. That is not an easy thing to do, but we hope to do so through our proposal.

CHAIRWOMAN MOORE: How do you regulate them if you can't tell? Not DRA in particular -- where's Pete Arth, the Public Utilities Commission? Is someone here from the Commission? Welcome to the table. You can help us to better understand this. Terri is representing the Division of Ratepayer Advocates. So, we need someone from the Commission.

MR. PETE ARTH: Could we start over again?

CHAIRWOMAN MOORE: Give him a hint, Terri,to what I want to know.

MS. MURRAY: Let me, while Pete is gathering his thoughts, just run down...

CHAIRWOMAN MOORE: He doesn't know what the question is.

MR. ARTH: I actually was listening to the testimony. It seems like you're looking for an assurance that was missing from Terri's tesitmony.

CHAIRWOMAN MOORE: First of all, I would assume the PUC has been watching to be sure there is no cross-subsidy. We kept being assured that that's the case. Now, we are being told that there's no way to really make that determination, and that is a problem. In the past, I have always been assured that it wasn't a problem, and it was being taken care of. So, is there a problem with cross-subsidy?

MR. ARTH: I think that is one of the core questions in the proceeding, and you are going to hear from all of those who give the obvious answer "yes" that there is a problem. Will it be adequately addressed in either of the local exchange company proposals? Is it necessary to have the protection of the DRA or shall we do away with the hands-on, full regulation that has traditionally existed to detect these sorts of problems? The answer on behalf of the Commission is yes, there is a potential and yes, it is being addressed. The commitment is there, to do whatever comes out of this proceeding.

CHAIRWOMAN MOORE: Let me ask you one of those "Are-you-still-beating-your-wife?" questions." I have always been

assured in the past that cross-subsidy wasn't a real problem. That was clear. We have talked about different accounting procedures over the years, and you always disagreed with Sylvia Siegal that cross-subsidy and the utilization of ratepayer funds is not a problem.

MR. ARTH: I'm not going to preempt what Terry is going to tell you. Obviously, one of the problem is the resources available to the Ratepyer Advocates and the major customers to go after the paper trail, to be able to detect, prosecute and remedy what's going on. That is certainly one of the keys: whether it is or isn't a solvable problem.

CHAIRWOMAN MOORE: Okay. Go ahead, Terri.

MS. MURRAY: A second element of our proposal would index rates on the monopoly side of the house to automatically assure that all cost decreases get passed on to the ratepayers without regulatory lag. In that sense, there are some similiarities between our proposal and that of General Telephone. We do look at inflation and productivity indices. The significant difference there is that we have proposed to look at those indices on a company-specific basis. We recognize the different starting points that each of the companies comes from and recognize the unique cost differences in a manner more similiar to the traditional regulatory framework.
Their own customers are entitled to benefits if there are, indeed, very large productivity increases.

CHAIRWOMAN MOORE: That more closely resembles the General proposal than it does Pacific's. Pacific, what's wrong with Terri's proposal?

MR. JAMISON: What Terri didn't describe in the DRA's proposal is a mechanism which has yet to be laid out. It depends on building an index based on factors within the business rather than on industry-wide or statewide factors. To the extent that you build an index that is ...

CHAIRWOMAN MOORE: But, your proposal wouldn't allow for that, if I understand your residential proposal. Yours is a flat freezing of the rates.

MR. JAMISON: That's true, except if the company were to exceed the benchmark rate-of-return, whatever that was set at, and there were monies to be returned to the customers, it would be up to the Commission to determine which customers those should be flowed to. We have said clearly that those customers are the residential customers. So in effect, you get the same return. I think you get a similiar outcome under each of those processes.

CHAIRWOMAN MOORE: Only if you exceed your rate-of-return. For years you have been telling me that you are barely making it.

MR. JAMISON: That's true.

CHAIRWOMAN MOORE: If you never get to your rate-of-return, the likelihood of there being any benefits to the ratepayers is almost null. Right?

MR. JAMISON: No, that's not true. On the other hand, under current regulatory process, if we don't meet the authorized rate-of-return, we have every right to come back in and ask for rate increases. Our proposal takes away that right.

CHAIRWOMAN MOORE: Okay.

MS. MURRAY: Let me just add a comment on that last remark. It is not DRA's perception that the Pacific proposal eliminates their right or option to return to the Commission if they are under-earning. It was my understanding that is an option kept open explicitly. There is nothing binding Pacific or any other company operating under such a plan to come back to the Commission

Going on with the DRA proposal, I think one element of great interest to all customers is our proposal to decrease local exchange company rates, upfront, to reflect a fair return. In order to conduct this proceeding, as well as to handle the large volume of telecommunications related caseloads in the past few years, it has been some time since we formally reviewed Pacific Bell's rate-of-return. As the briefing papers prepared by the Committee reflect, Pacific is now earning quite a healthy return. We believe that to get a plan like this started off in a way that would be fair to all parties concerned, we should get a start-up revenue requirement that reflects current reality <u>before</u> we start indexing or freezing rates. A rate freeze is no great benefit to residential customers, if a rate decrease is what they are entitled to.

CHAIRWOMAN MOORE: Mr. Bald?

MR. BALD: Can we have a clarification from somebody? Pete, can the PUC come back in under this proposal or are you prevented from doing so?

MR. MCCALLION: Under GTE California's proposal, we could not come back in for a general rate case or rate case filing. We would be allotted a certain among of dollars in which to operate, and

we would have no floor on our rate-of-return by which we could automatically come back in.

CHAIRWOMAN MOORE: Under both these proposals, the traditional rate case, as you currently know it, would be eliminated. But each does have a safety clause in case conditions change.

MR. JAMISON: That's not correct. There are three exceptions included in Pacific's plan. One, major tax legislation changes. I would remind everybody that the last major tax legislation resulted in tax decreases which were immediately flowed through. Second, major accounting...

CHAIRWOMAN MOORE: What did I just say? That there are provisions built in for when conditions change.

MR. JAMISON: The implication of the question, in my view, was not outside event such as tax law or accounting rule changes, but was a change in business conditions. A change in business conditions is not something...

CHAIRWOMAN MOORE: "Circumstances beyond your control" is essentially what...

MR. JAMISON: Business conditions, in a sense, are circumstances beyond the control of the business, and they have to cope with them.

CHAIRWOMAN MOORE: Not necessarily.

MR. JAMISON: I want to make sure we're not mixing those things up.

CHAIRWOMAN MOORE: Federal taxes or are things beyond your control. Business usually takes the responsibility for business conditionss, within its own purview.

MR. JAMISON: That is what we're proposing to do, take responsibility for that. In effect, shift regulatory risks to business risks.

CHAIRWOMAN MOORE: Mr. Hill?

ASSEMBLYMAN FRANK HILL: Maybe I could comment on that last comment of Mr. Jamison, about taking that business risk. It seems to me there is no business risk when, for years, PacBell promised that if we put all this infrastructure into place, we will see a decrease in basic customer rates. Now, what we're hearing, "We will go ahead and take the risk, but to let us freeze rates. We won't pass that benefit onto the consumer. We will give you touchtone service which doesn't cost us anything. We will extend your ZUM area. We will go from an 8-mile to a 12-mile. Undo what we took back a few years, when we went to ZUM.

It seems to me this is all about taking money that ought to be passed on to the consumers, coming up with less of a regulatory framework . "We will no longer be looking at how much we're paying people of the cost of service. Just give us some more flexibility so we can spend that money in a competitive marketplace, and have the advantage of using the monpoly subsidy against other private businesses." I don't see how else you can justify what you're trying to put together.

MR. JAMISON: In fact since 1986, there have been $975 million in rate reductions, in Pacific's rate, in large measure reflecting those very efficiencies that have already taken place.

ASSEMBLYMAN HILL: $975 million doesn't tell me anything if it ought to be $2 billion. We can argue about that, but

wasn't this whole proposal, this whole infrastructure sold on "We are going to see these continued decreasing costs;" and now, "We are walking away from that?"

MR. JAMISON: The question of whether or not there will be continued decreasing costs in the industry or specifically in Pacific Bell needs to be put in context. It is true that we have been able to had good productivity increases in the last several years. Whether or not that can be continued in the future, I think, is a very open question.

ASSEMBLYMAN HILL: All right. Tell me why we should go ahead and find out for two, or three, or four years that cost is going to continue to decrease, and that cost should be passed on to the consumer? What is the downside? Let's find out.

MR. JAMISON: I believe that is what our proposal does by saying, "Let's share based on actual outcomes." We also included in our proposal a provision to review the whole, complex mechanism in 1992.

ASSEMBLYMAN HILL: Why the proposal to freeze rates? Why don't we go ahead and drop rates and pass those on to the consumer, and see if those costs continue to drop?

MR. JAMISON: In the first instance, residential rates are already below costs. If we are going to reduce rates, and there are rate reductions pending through the surchange accounts that exist today, I believe those rate reductions should come in toll rates, not residential rates. Beyond that, it's not clear where the future will go, either from a competitive sense or from the continued productivity that everybody likes to point to, that Pacific has achieved.

By basing outcomes on actuals, by basing the return or the sharing of benefits above a benchmark based on actuals, the Commission will have every opportunity to examine how well this proposal, which we believe puts more risk and more incentive on Pacific, and works over the years. We would never make a proposal like this without including in it some opportunity for the Commission to review how the process has been working.

ASSEMBLYMAN HILL: Tell me why we shouldn't come at it from another standpoint. That is, if we are going to take -- I think the whole issue here is cross-subsidy -- if we are going to take those profits from the monopoly and use them in entrepreneural ventures. I am thinking, as an example, of an issue I am involved with, the Yellow Pages. Some of the profits from the Yellow Pages go to keep the rate base -- why don't we go ahead and say, let's take all those profits from the Yellow Pages and put them into ...? It seems to me you are arguing both ways. Why don't we take all those profits from those entrepreneural ventures and use all of them to keep the rates low? After all, we're talking about a regulated monopoly. Although I guess you guys -- it seems to me that you want the benefits of a regulated monpoly. You want a guaranteed customer base, but you also want to take some of those profits and compete out there.

MR. JAMISON: On the contrary Pacific is one of the few parties that has proposed that new, network-related services be included in the regulated accounts. To the extent that those are profitable, those services will, indeed, provide revenues to help keep other rates low. I would add that the DRA proposal is a mixed bag, in effect saying, "Pacific, you bear the risk, but if you do well, share the

reward of those new products." We object to that. We're saying keep all of the new products that are related to the network in the regulated accounts.

There is another issue here that transcends whether or not those new products have a reasonable life or not. That is to the extent you put those things off, separate and unregulated, or as we call it in the industry, "below the line," you run the risk that services will not be integrated, not be part of the network. Had we had these kind of discussions back in the 1910's, 1920's, people would have argued that dial tone was an enhanced service and ought to be regulated and put below the line. If we had this discussion in 1964, people would have argued that touchtone should have gone below the line. I would remind everybody that touchtone today provides about $200 million of contribution to keep other rates low.

ASSEMBLYMAN HILL: The reality is, we are not talking about getting involved in touchtone or dialtone service. We're talking about PacBell competing in cable television.

MR. JAMISON: No, we're not talking about competing in cable television. PacBell has said repeatedly that it is not interested in competing in cable T.V.

ASSEMBLYMAN HILL: Then, tell me what the benefit to the consumer in freezing rates and going to a fiber optic network. Its sole purpose has got to be to transmit video.

MR. JAMISON: That is not the sole purpose of putting in fiber.

ASSEMBLYMAN HILL: Tell me the sole purpose is.

MR. JAMISON: If we put in fiber, we will put it in for telecommunications purposes. In fact, fiber is becoming, more quickly than anybody anticipated, the economic choice for providing service to people's homes. It will become the medium of choice for providing telecommunications services to our customers in the future. That future is coming very quickly. Fber has unique property, almost unlimited bandwidth capacity, depending upon the electronics that you put on at each end. If a cable company came to us and said, "Would you carry our signal for us?" we would want to do that on a contractual basis. We would not be in the cable business. We would do what we do best, and that is transport for somebody else. I believe the real issue that the cable people have raised is that they today...

CHAIRWOMAN MOORE: Don't keep dwelling on the cable people.

MR. JAMESON: They keep dwelling on us.

CHAIRWOMAN MOORE: We are looking at the Big Picture. Remember, Mr. Jameson? We are trying to get the "whole thing" on what telecommunications is. Everybody will get their chance. I am going to let you stay up here with me and give you a chance to refute.

Now, we are going to get through this first part of the proceedings. Terri, I think you pretty much said what the position of the DRA is. Does everybody want to have one little parting shot on what it is that you're asking for? Just a quick one sentence from each of you, and then we are going to have the people who think there is something wrong with what you're proposing or who like it.

MR. JAMISON: We're asking for regulation that is more suited the increasingly competitive environment while it recognizes that environment and which contains the safeguards necessary to ensure that all of our customers have access to the full range of services that a modern information-age network can provide.

MS. MURRAY: I think what DRA is looking for much the same thing, but accomplished in different ways -- making sure that the starting point for the entire mechanism gives ratepayers a fair opportunity to share the benefits of the information age, and not avoiding the responsibility of effective regulatory oversight in our zeal to adopt a new framework.

MR. MCCALLION: I would have to echo the remarks of both parties.

CHAIRWOMAN MOORE: That's safe.

MR. MCCALLION: Just add that what we are looking for is a change in the way which local telephone companies are regulated, to streamline the process. We feel that the plan we have put forth does provide adequate safeguards against some of the concerns that Mr. Hill and other people have raised.

CHAIRWOMAN MOORE: In the next group, I'd like to hear from Sylvia Siegal, AT&T, MCI, Bay Area Teleport, Dun and Bradstreet. We will have a revolving mike kind of thing. Bruce, why don't you come closer to me? Don't be shy, come on up.

Ms. Siegal, would you come up and take one of our "resident" seats?

MR. BALD: Mr. Jameson, is it part of Pacific's proposals to raise business rates? I can't find that in here in your prepared statement.

MR. JAMISON: We are proposing that those business services that are currently priced below-cost should move towards their costs, over time. We have hewed to that very carefully in a revenue shift that the Commission has already ordered. That is they are requiring that we lower the rates to long-distance companies that they pay access to our network. That revenue is to be shifted to some other services, within the basket of services that we offer. That forms the basis of those rate increases to businesses. I would stress again that there would be no net revenue increase for Pacific Bell.

MR. BALD: I may try and ask it again. How many business customers might be affected, and how soon, by what you just described?

MR. JAMISON: If the Commission approves the principle I just described, there will be amptjer proceeding required, either the "Supplemental Rate Design Proceeding" or Phase III. My expectation is that it might last through the remainder of 1989 or into 1990. At that point, assuming that everything led to an order by the Commission, we would see gradual rate increases for basic business rates over the next several years. Our estimate, and again, it is risky to deal in averages, but over time, this would result in, at most, a five percent per year increase to business customers. I hasten to add that this doesn't reflect the reductions they would see

because of the reduction to the long distance carriers. They would probably see reductions in those rates as well.

MR. BALD: We have been talking about how everybody is going to share in the productivity savings from the technologies. What I hear you saying is, everybody is going to share but business.

MR. JAMISON: No, that's not true. It is true we have proposed that business rates should move up. They are priced below costs today. They are not covering those costs. However, we have also said that if we hit some benchmark rate-of-return or above, then it is for the Commission to decide how that is shared. We have said, generally, that it should be spread across the customer base. To the extent that we hit that benchmark or above, we would share.

CHAIRWOMAN MOORE: Let's move on. Tell General Telephone, the PUC, and Pacific Bell, everything you ever wanted to say, in one sentence or three. Identify yourself for the record, and then tell me what's wrong with what's being proposed or what's good about it.

MR. ROBERT STECHERT: Thank you, Madam Chair and Members of the Committee. My name is Robert Stechert. I'm vice president of External Affairs for American Telephone and Telegraph Company. (Prepared Statement, see Attachment E). We appreciate the opportunity to be here today, and to address the question of alternate regulation for the local exchange companies.

Let me say at the outset that we agree with the goals that were set forth in the statement that you distributed in advance of this hearing. Those goals of regulation should continue to be the same for the future as they are today. Let me also add that we

believe there may well be other mechanisms besides tradditional cost-of-service regulation that will better serve those goals for the local exchange companies.

CHAIRWOMAN MOORE: So, you like their plan?

MR. STECHERT: We don't like this plan, however.

CHAIRWOMAN MOORE: Now, wait a minute. That's a little inconsistent. Bruce is trying to figure out what you're saying.

MR. STECHERT: I think there are a number of aspects to both Pacific'sand General's plan that do make sense and which should be adopted. However, there are some frailities with those plans, about which we have considerable concern about.

First of all, we think that any alternative form of regulation should insure that rates would be lower than they would be under continued cost-of-service regulation. We don't believe that will be the case under Pacific's plan. Indeed, for the access charges that we interexhange carriers pay to Pacific and General Telephone, we believe that our rates would likely be higher under the plan proposed by Pacific than under continued cost-of-service regulation. That means that the long-distance charges that we charge our customers would also likely be higher than they would otherwise be, because our customers would have to bear the cost of the access charges that we pay to the local exchange company.

CHAIRWOMAN MOORE: Everything in their program is designed to be able to give you break. I think Ms. Siegal has a problem with that. Given that, I don't understand what your problem is. If there is anybody that they are being good to, it would appear that the long distance carriers are those people.

MR. STECHERT: I don't think so. What they said is, they'll freeze existing rates at current level, and have downward flexibility from there with respect to the access charges they charge us. That doesn't mean that those access charges wouldn't even be lower than that if we continue under cost-service-regulation. In fact, we believe the expansion of the local calling area and the free provision of touchtone service to local ratepayers, that the revenue that they are giving up in doing that will be reflected in higher access charges to the interexchange companies. That means higher charges to our customers for long-distance service.

CHAIRWOMAN MOORE: So, you think there won't be a reduction? There has to be some reduction in the long-distance service.

MR. STECHERT: There will be reductions, Madam Chairwoman, as much as there would be if we continued under the current arrangement.

CHAIRWOMAN MOORE: But you still take a risk. You don't know what those costs would be, because you only get what is perceived. Even, if it were demonstrated in a regular rate case, they can still retain it in the same manner. So, there is no guarantee either way.

MR. STECHERT: There's no guarantee, but we believe the risks are greater under the plan that Pacific proposes than under the current arrangement.

Secondly, Pacific's plan would share access earnings with ratepayers. But they limit that sharing to local exchange customers, not the interexchange carriers who pay access charges.

CHAIRWOMAN MOORE: You are already getting a discount. So, why do you want to get greedy?

MR. STECHERT: We are not getting a discount. In fact, we are paying more for access charges than the cost of providing those services to us.

CHAIRWOMAN MOORE: But, you will. You have been getting a gradual reductions every year. I mean, don't give me that.

MR. STECHERT: Only for part of the access charges that we pay. There are a whole series of access charges that we pay to the local exchange companies. Only some of them are coming down and they are not at costs or even close to costs at this point.

CHAIRWOMAN MOORE: Just like your said, some of the services have to pay to subsidize other things.

MR. STECHERT: We don't believe that is necessary. We believe the services could be cost based. Long distance ratepayers, people who make calls long-fdistance within the state, ought to pay cost based rates, as should local exchange customers. We don't think it is fair to limit the sharing to local customers and deny those same benefits to long-distance customers.

Finally as far as Pacific's plan is concerned, we don't believe it contains requisite safeguards to ensure against cross-subsidization of competitive ventures in which Pacific might engage, with revenues obtained from the provision of monopoly services. We think the plan should be revised to ensure that there is adequate safeguards to prevent that kind of inappropriate cross-subsidization.

As far as General Telephone's plan is concerned, we believe it is better than Pacific's, that is moves rates more towards

costs. But again, we think there are frailities with General Telephone's plan. There are certainly monopoly services that General Telephone provides which are included under its so-called, "Category II" competitive services.

In conclusion, DRA's plan comes closer to providing an alternate scheme of regulation that we could support. However, DRA's plan is unusually complex. If we are going to investigate an alternate form of regulation, one of the principal factors of such a plan should be to streamline regulation and get away from the regulatory inefficencies and delays that exist under cost-of-service regulation today. We don't think that DRA's plan will make much progress towards that kind of reform. We think it needs some considerable changes if it is to be adopted.

CHAIRWOMAN MOORE: Thank you. Why don't we go to MCI? Don't repeat anything that AT&T has said. If there is something you want to add, then feel free to do so.

MR. STEPHEN P. BOWEN: Thank you, Madam Chair. My name is Steve Bowen. I work for MCI in Washington. I am a senior attorney. (Prepared Statement, see Attachment F).

Generally, we agree with the points that AT&T has made this morning. I would add a couple of things that were not addressed in AT&T's statement here or in their testimony in the case before the PUC.

First of all, no one has mentioned that the purported benefits to interexhange carriers, reduced access charges realized through increases in business rates, are entirely independent of their plan as it stands. Those reductions in access charges were awarded

by the Commission before either Pacific or GTE filed their plans. There is really no reason for either local exchange company to claim credit for lowered access charges to interexchange carriers.

Second, without going back over points Mr. Stechert just made, I would suggest to this Committee that every one of the goals that both Pacific and GTE has spouted in this case can be accomplished by a less radical means than proposed in their plans. What's missing in both Pacific's and GTE's plans is the recognition that we have to get back to basics in the regulation of local exchange companies. We have to get back to looking at where is the bottleneck? We all know it is there some place. Where is the bottleneck. What services use it, and how do you regulate a company with one foot in the monopoly world and one foot in a world which has become competitive? That's a very difficult task to undertake.

I would suggest that the solution is not, as both Pacific and GTE propose; to simply walk away from regulation as it stood in the past. MCI believes there are aspects of that regulation which have not worked very well. We don't suggest that three or four year rate cases work very well. But there are ways to refine that process, far short of the walking-away proposed by Pacific and GTE.

We also concur with the statements of Mr. Hill: Both Pacific and GTE face significantly declining costs.

(INTERRUPTION: COMMITTEE ACTION ON AB 901)

CHAIRWOMAN MOORE: Go ahead.

MR. BOWEN: I was addressing the question of whether the costs of local exchanges are declining or not, and if they will

continue to do so in the future. We believe, based on our knowledge of how networks are built and deployed, that there is a substantial likelihood that costs will decline in the future, both for switching and for trunking. It is not surprising to us that both local exchange companies propose to walk away from regulation at a time when we think they will face declining costs. I think it is something that anybody would do, given a chance to do so.

Our fundamental problem is that the Commission's order of things in this case is, in essence, is "the cart before the horse." Local exchange companies are asking for flexibility to price services when there is no competition. The result of doing so would be to allow the local exchange companies to lock in, through pricing plans and price flexibility and so forth, the very same customers who would most benefit from competition introduced properly. We think it is very important for the Commission to recognize the proper timing that is required here, and to not grant flexibility to local exchange companies for pricing services and in advance of opening up the LATA's to competition and the benefits it could bring.

I was little bit disappointed during the case and during the briefs in the case to hear that there were "three plans out there." There are, in fact, more than three plans. MCI has a plan which, while we don't call it anything fancy like "CPRS," is an attempt to address the need change regulation. We believe that the important thing the Commission should do right now is to look at what people call "rate design" issues. How do you prevent local exchange companies from cross-subsidizing services, which they claim are competitive, with monopoly revenues? It is a great difficult task.

The kinds of tools that are available are cumbersome, and little used. Costing has been the chiefone. People hate costing. The Commission's eyes glaze over when you mention the word "costing," let alone the eyes of people who don't do this for a living. We have tried to come up with a solution which we believe is effective and simple.

Our solution would require that you look behind the tariffs of local exchange companies. Look at the pieces that make up their network; that is, the building blocks. Those are far fewer in number than the actual tariff items: You've got a loop, you've got a switch, and so forth.

CHAIRWOMAN MOORE: Why do you want to dictate how the locals -- I mean, what's in it for you?

MR. BOWEN: What's in it for us is a desire to compete on a fair basis. We have no problem at all with competiting head-to-head against anyone under appropriate and fair rules. Right now, the rules will not likely be fair. The plan that we proposed is designed to address that unfairness. If you are a carrier like MCI that basically buys at wholesale, being asked to compete with the retailers, the local exchange companies, is not fair and should not be allowed. The retailers can pay less for the same service that we have to buy and they can charge us to buy that service. We're trying to make sure that everybody pays the same thing for the necessary bottleneck, monopoly input, which is switched access in the case of toll service.

The way it works is that everybody pays the same charge, whether you are MCI, AT&T, GTE or Pacific. That particular

situation does not now exist in California. Until it does, there is a serious potential for what's known as "price squeezes." It is very easy, when you have to buy the service from Pacific and GTE, for them to squeeze you between their retail rates and our wholesale rates of access.

CHAIRWOMAN MOORE: All right. Why don't we hear from Bay Area Teleport? In a couple of sentences, give me your concerns.

MR. LARRY KAMER: Thank you, Madam Chair and Members of the Committee. My name is Larry Kamer. I'm representing Bay Area Teleport.

Bay Area Teleport is a private provider of high-speed digital network services operating in 11 counties in Northern California.

The concerns we have raised before the Commission have been echoed in part by the DRA, AT&T and MCI with regard to the safeguards we believe must be imposed before any kind of rate flexibility is granted. We have been quite aggressive in pursuing those safeguards at the Commission.

I'd like to look more to the future and see if I can lay out a couple of new thoughts.

The existence of our firm suggests that the increasingly sophisticated needs of business and government have given rise to the large number of metropolitan area providers around the country, all privately funded, to meet these needs. We are quite concerned, obviously, that the flow of capital which is now available to those private networks will be reduced if the risks are judged to be too

great for investing in that area. We're hoping that the Legislature and the Commission do not propose or promote policies which gives undue, advantage to monopoly providers in those services.

What do we think the Legislature ought to do? We believe that the concerns that have been raised by Assembly Members Hill, Wright and Nolan of this Committee, and many, many others in the Legislature on both sides of the aisle who have written to Commissioner Wilk about this case, are absolutely on target, raising legislative concerns about the possibilities of cross-subsidy and anti-competitive behavior as a result of this case.

But beyond that, the Legislature needs to continue looking at the way the Commission handles cases. We're not faulting any individuals or any organizations for promoting their causes and views, under the rules, as aggressively as they can. We do think that in the long-run we need to have effective review, judicial review, of the CPUC decisions. That is why we support Assemblyman Floyd's Assembly Bill 338. We believe that, at some point, ex parte contacts have to go, which is why we support Senator Rosenthal's SB 1125. We believe that new legislation is called for to require the Commission to identify substantial evidence as the basis of its findings and facts of its decision. We proposed an amendment to AB 338. It doesn't look like that is going to happen this year, but we do think that it is a legitimate interest for this Committee and other legislators. With that, I'll stop. I have provided you with a written summary of our remarks. (See Attachment G).

CHAIRWOMAN MOORE: All right. Let's hear from Ms. Siegal.

MS. SYLVIA SIEGAL: Thank you, Madam Chair and Members of the Committee. Sylvia Siegal, executive director of TURN [Toward Utility Rate Normalization], on behalf of residential and small business customers.

As I sit here listening to all of the testimonies, there are common threats and common objections. I guess it is up to TURN to provide the proper solution, and I'm happy to do that.

For your information, Committee members, TURN has been overly active. I never see our hard-working telephone attorney, sitting there in the audience. We have been overly active in our -- sometimes I want to put a "b" in front of it -- and COP, in the new enhanced program that is coming up. In the AT&T case, we have just appealed to the California Supreme Court, because we don't believe in that kind of flexibility that gives them carte blanche. In the special contract proceeding, workshops under the supervision of the PUC can go on interminably. We have been active in modernization settlement. We objected strenuously to DRA's settlement on this very important and costly issue.

CHAIRWOMAN MOORE: I am not going to let DRA get away with that, and I will come back to that at some point.

MS. SIEGAL: We don't let DRA get away with much, but sometimes they do. After all, there are more of them than there are of us.

CHAIRWOMAN MOORE: Okay.

MS. SIEGAL: Basic to all the testimonies I have heard today, are pleadings for cost studies. In our testimony, we proposed that before we do anything, there should be a stand-alone cost study

of the telephone system. Once and for all we can determine what, if any, subsidies flow from basic exchange customers to enhanced services, to long-distance -- to any of the other vertical services currently in effect and being proposed. Without this study, you're just shooting in the dark, and you are shooting away our money present and future.

Mr. Hill is gone, but if you are listening on the squawk box, Frank Hill, you are absolutely right. It is still a decreasing-cost industry. Particularly in the economic environment of California, which assures continued growth of population and a fantastic growth in traffic, PacBell and all the other telcos [telephone companies] in the state can do nothing but make money. The question is, how much and how should they share?

Frankly, I'm not willing to share with PacBell, or General, or any of the telcos their "excess profits." As has been mentioned since divestiture, PacBell and General have earned tremendous profits. Since divestiture they have had to give back around $800 million because of excess earnings. I see no reason for them to share in excess earnings when customers are entitled to have it all returned -- 100 percent, not 50 percent. You're earning it because the unlimited capacity the customers have paid for, the intrastructure, is allowing you to exploit new services and heavier traffic.

The truth is, Members of the Committee, that neither fiber optics or digital switchers are really required to transmit voice communication. That can be done even with crossbar switches, which we have in some of the rural areas. But PacBell is asking for

another huge down-payment from the customers, the venture capitalists of the telecommunications system. They are asking for another huge hunk, $640 to $750 million, for modernizing the rest of California in order to allow the telco both to connect and to exploit present and future information products.

There is no question that PacBell is on the brink on a great information reformation. The question in the customer's mind is, do we need it all now? I submit, ladies and gentlemen, that we don't need it all now. We ought to go, as they say in Italy, poco a poco, "little by little." Implement whatever it is based on economic studies, on studies of actual competitive services, on the outside field of what customers would want to buy.

In the packet you have an article that is very telling, from the Wall Street Journal, indicating the hot prospects of the New Jersey Bell Company. I heard the chairman there testify the other day, on cable television that they had 20 new products. But then, a couple of days later, I read that the saturation level is only 2.4 percent for the total package of 20 new products. That indicates to me that the customers are really not so hot for all of these new products.

I don't want to be a wet blanket. The telcos accuse me of being a wart on the wheel of progress or worst things or whatever. It tain't true.

I just want to point out to you that, for example, customers in France were given monitors provided by the state telcos to access whatever enhanced services the Minitel wanted to bring on line. Their saturation level isn't as great as it should be. I

think there is a lot in the marketplace right now, coming on line or maybe developing, that we ought to look at closely. We ought to look at it carefully before we pull even one little string in terms of regulation.

Now, I'm the one who's always yakking. I was going to say something else, but I respect this forum. I'm the one who's always yakking about regulation and how weak it is in California, and believe me, it is getting weaker. In spite of that, I don't think this is the time to pull the string on regulation. I think this is the time to improve it, and I think we can. The complaints you hear about three-year rate cases are not the fault of the participants, except the telcos who feel compelled everytime somebody challenges a piece of their testimony to offer four or five more witnesses that will take another two to three months to hear and examine. That kind of nonsense has to stop. I think there are ways of limiting fairly any excess that the parties project. I think we have a marvelous staff of administrative law judges who can control the proceedings. I think they ought to be permitted to do so.

I think some of the proposals that has been put forth miss a lot of other problems that have not been solved and should be looked at immediately. One of them is the business about SPF to SLU, which is strictly an arbitrary measure based upon arbitration...

CHAIRWOMAN MOORE: Let's go back to this proceeding.

MS. SIEGAL: I think we ought to reinvestigate the whole SPF to SLU access charge which is adding cost to basic exchange customers.

CHAIRWOMAN MOORE: You're saying that there are still some problems that need regulatory oversight.

MS. SIEGAL: There are a lot of problems that need regulatory oversight.

The question of cross-subsidies is a very serious one. But you can't get anywhere until you have a basic cost study of stand-alone local service. Then you can start addressing these other problems. That ought to come first. That's the absolute predicate. Thank you.

CHAIRWOMAN MOORE: Don't go away. Let's go to the next. Dun and Bradstreet?

MR. JOHN P. MACDONALD: Thank you, good afternoon. I'm John P. MacDonald, vice president and associate general counsel for the Reuben H. Donnelley Corporation, a Dun and Bradstreet company. [Prepared Statement, See Attachment H].

It is my understanding that the focus of this hearing is on the adequacy of telecommunications regulation, with a particular concern for proceedings currently underway before the California Public Utilities Commission. We are participants in both the Alternative Regulatory Framework proceeding and the Enhanced Services proceedings. We also have formal and informal complaints pending before the Public Utilities Commission, and have opposed specific telco bills and market test filings before the Federal Communication Commission [FCC]

In each of these proceedings, we have expressed the same concerns. The holder of the local exchange monpoly franchise has both the ability and the economic incentive to leverage its

monopoly power into adjacent competitive markets. Absent legislative enactment authorizing an enlargement of the telephone company monopoly franchise, such expansion of monopoly power should be aggressively denied.

The divestiture of AT&T addressed the monopoly power that AT&T possessed ...

CHAIRWOMAN MOORE: I'm not going to let you read. Why don't you just give me the things that are of concern to you? I think Mr. Hill touched a little bit on it when he got to the Yellow Pages. We are trying to get a synoposis of what your concerns are the future, and what impact that has on your business in particular.

MR. MCDONALD: Given the changes that are occuring in telecommunications, we see the need for increased regulation, not decreased.

CHAIRWOMAN MOORE: Why?

MR. MCDONALD: The ability to cross-subsidize from one business to another and the innerconnection of the business themselves. We have talked before about the ability of the telephone company to deny access or control product development. All of those things become more integrated in today's world. To turn a regulated monopoly loose, on what otherwise are competitive businesses, it just asking for trouble.

CHAIRWOMAN MOORE: Okay. I apologize to you for coming up and not getting the full benefit of your testimony, but I do want to give everybody a chance to talk. Although you have not had a long opportunity to speak, if you have written testimony, I want to

encourage you leave it and it will be published in its entirety in the transcript.

I am going to give each of you (DRA, PacBell & GTE) a shot at responding to what has been said, but you only have four sentences. There has been an awful lot said. I want to hear a little bit of rebuttal, but not a lot.

MR. JAMISON: In three sentences. First, we aren't seeking deregulation. We are seeking a change in regulation.

CHAIRWOMAN MOORE: Isn't it funny that everybody in this room believes that you are?

MR. JAMISON: Well, I would suggest that they read our proposal.

CHAIRWOMAN MOORE: You think they haven't?

MR. JAMISON: I think they have mischaracterized it. (These responses don't count as my three sentences.)

CHAIRWOMAN MOORE: All right. Touch'e!

MR. JAMISON: Secondly, Ms. Siegal talked about the need to do it "little by little." I would suggest that replacing switching machines that are 40 or 50 years old is doing it very little by little.

Third, people have recommended "Let's not have any flexibility for Pacific before we have entry." I would point out that, our proposal said, we want the principle flexibility adopted. Any specific flexibility for services, such as toll, would await a separate application or would become part of the Supplemental Rate Design or Phase II proceeding in this case. I think that is an unfounded concern on the part of MCI.

CHAIRWOMAN MOORE: Let's hear from General Telephone. Do you want to make a comment?

MR. MCCALLION: It will be very short. I also want to reiterate and respond to the gentleman from MCI: We not proposing a walk way from regulation, but rather to change regulation. I keep hearing those remarks over and over again. I know the parties who are making them just don't understand our plan or are deliberately trying to create a misrepresentation of our plan.

A couple of the other points were brought up relative to targeting our sharing to particular customers. The reason we did that was to make sure that our end users benefit from efficiency gains. It wasn't to deny a benefit to AT&T, but rather to make sure that the end users in fact get the benefit, and also to somewhat cushion the impact to our local residential and business customers of long-distance rate reductions that are going on today (as Ms. Siegal and Mr. Stechert talked about, relative to SPIF to SLU). Its was definitely by design to make sure the end users did receive those benefits.

MS. MURRAY: Just a quick word about the chargs of "fairness to the ratepayers" and "complexity." We have tried to balance those competing needs, giving our priority to the ratepayers' interest, but recognizing the need for a streamlined regulatory process. We think we have done it correctly.

CHAIRWOMAN MOORE: Let me ask the DRA, do you consider what PacBell and General Telephone propose as aspects of deregulation?

MS. MURRAY: Not deregulation in the sense that they would eliminate the Commission's jurisdiction. Obviously perhaps more so the Pacific plan than the General plan, they drastically reduce the level of regulatory oversight. We believe that is going a little further or, in some cases, a lot further down that path than we're comfortable with; hence, our proposal.

CHAIRWOMAN MOORE: So, you would call it restricted or limited deregulation?

MS. MURRAY: We called it, in our brief, "trust me" regulation.

CHAIRWOMAN MOORE: Obviously this group at the table doesn't.

Ms. Siegal, give me two sentences about what you think of DRA's proposal.

MS. SIEGAL: Not much. I'll say more when I have more to say. I think that summarizes it.

CHAIRWOMAN MOORE: You can bank your sentences. All right, let's hear from the next groups of witnesses. Don't be redundant. If there is something that has already been said, just say they speak for you. Hopefully, we will have a chance for a little exchange for this group. I will save cable for last since it has been attacked. You will have a little more time.

<u>MS. DIANE MARTINEZ</u>: I'm Diane Martinez with API Alarm Systems. [Prepared Statement, see Attachment I].

Our view on this subject is fairly simple, believe it or not. We believe that the Alternative Regulatory Framework proceedings are a solution to something that seems not to be a problem. Right

now, the phone companies are saying that they need to have this new regulatory framework so that they can operate, but their stocks are up, their costs are done, their earnings are at a all-time high, and it is real difficult to see what the problems are unless you look at their a solution to the nonexistent problem.

In their version of a solution, they go out there and compete, but they still want to hold on to those traditional things that protect them from evil competition. Things such as limited liability. They don't want deregulation, but they want to be detariffed.

CHAIRWOMAN MOORE: You've said that the impact on the alarm system would make it almost prohibitive for you to provide your service.

MS. MARTINEZ: Absolutely. They have consistently asked for 100 percent increases on our services without even beginning to prove that are below costs, as they allege.

CHAIRWOMAN MOORE: You would be concerned about a system that would not allow some input. That 's what this this "trust-me" system would do.

MS. MARTINEZ: Absolutely. API currently has litigation against both companies because the companies have told us to trust them on their billing systems, and trusting them has just not worked out. We have the litigation to prove it. We have brought our briefs today. They are very simple, easy to read, and they bring up some very relevant points.

CHAIRWOMAN MOORE: We will include them as a part of the record. All right. Let's move on to the next witness.

MR. PETER HOWLEY: Good afternoon. Peter Howley, president of Centex Telemanagement, Inc. I think I need about five sentences, Madam Chair. [Prepare Statement, see Attachment J].

We're something different from any other company here. We are a management service company serving small businesses, 5,000 small businesses in California. We are a single point of contact for them. We try to make their lives easy and telecommunications productive.

We have made four proposals to the PUC that are critical if the interest of small businesses -- and we all understand the role they play in California and the economy -- if the interest of small businesses are to be protected under any scheme that comes out of the current regulatory hearing. I'd like to review the four with one sentence on each.

First, The local exchange company services must be available on a nondiscriminatory basis, whether they are ordered by an individual customer or by a management company like ourselves. The services offered by the local exchange company must be offered to all interested users whether they are big companies or little companies.

CHAIRWOMAN MOORE: Do you think that is not the case now?

MR. HOWLEY: Yes, that's correct. I'm more concerned about what will take place going forward than I am about today.

CHAIRWOMAN MOORE: Let's just stop right now and let's ask them: Is it your attention in the future to discriminate against businesses, whether they are big or small?

MR. JAMISON: No.

CHAIRWOMAN MOORE: General Telephone?

MR. MCCALLION: No.

CHAIRWOMAN MOORE: They say "no." Why do you think they would?

MR. HOWLEY: Let me hit my other three points and I will come back to the original point.

Second, before flexibility of any nature is put in place, an effective, timely, less costly complaint procedure must be put in place at the Commission. Centex has proposed that a workshop be held to draw up the guidelines for such a procedure. Currently, the procedure penalizes small businesses. Under any scheme that it has more flexibility, that will be even more the case for small businesses.

Third, make every element of the local exchange network available to the maximum extent technically possible, down to the smallest component. In effect, unbundle those services down to the smallest degree based on the needs of customers, not on the desire, whim, or needs of the utility or of large companies. Unbundleto the maximum extent technically possible.

And lastly, create procedures in the Alternate Regulatory Framework hearing for cost-based pricing.

The reason I have those four points...

CHAIRWOMAN MOORE: If you go to cost-based pricing, they are telling us, small business are really going to take it on the air.

MR. HOWLEY: We don't know if that is true or not without a procedure.

CHAIRWOMAN MOORE: How about the study that Ms. Siegal is advocating?

MR. HOWLEY: It is possible. But, without the procedures and safeguards that allow a view...

CHAIRWOMAN MOORE: But, if you don't know how much it costs to begin with, no amount of procedures are going to make a difference. Are they?

MR. HOWLEY: You do need to determine the cost to begin with, absolutely. That is the point of having safeguards in place, so there is a means to determine how the cost was arrived at and to assure that it was fairly arrived at.

Let me answer your original question, if I may. All of the realities today are driven by competition. When you say competition, you are really talking about big companies. It isn't purposely discriminatory against the smaller companies as much as accidentally discriminatory, in the sense that the telephone companies' focus is on protecting their business against bypass and similar concerns. Therefore, they tend to ignore smaller businesses. We feel those four items are critical as safeguards to protect the small businesses' interest in California.

CHAIRWOMAN MOORE: Thank you. Fellows and Ms. Siegal, I hope you take note of those four, because I would like you to comment on them.

<u>MR. ED PEREZ</u>: Madam Chairwoman, Ed Perez, City Attorney for the City of Los Angeles. I'd like the opportunity to submit a written statement in the future.

I want to address one point that was not addressed today. It is a legal issue. Being a lawyer, I feel compelled to raise it. That is, as a matter of law, the Commission can not adopt any one of these plans.

The California Legislature, when it created the Public Utilities Code, mandated that the Commission set just and reasonable rates after hearings. Nothing in that code allows the utilities to set them without a hearing. We believe that nothing should be done without further study. And, if the Commission does adopt one of these plans, we will seek our remedy before the California Supreme Court. (Prepared Statement, See Attachment K].

CHAIRWOMAN MOORE: Let me ask, are you going to sue?

MR. PEREZ: I don't know if "suing" is the right term, but we are going to file a petition for review.

CHAIRWOMAN MOORE: Assemblyman Murray looks like he might sue.

MR. PEREZ: Well, we will see him in court.

CHAIRWOMAN MOORE: All right, go ahead.

MR. DENNIS LOVE: Madam Chairwoman, I'm Dennis Love, president of the Extension Connection. We have been involved in the OII 84 and related matters at the Public Utilities Commission.

The Extension Connection filed a complaint back in November of '86 alleging that the utility companies were in violation of federal and state antitrust laws, and were acting in anti-competitive fashion towards the competition. We still believe that is so. There have been continuing efforts by the utilities to interfere with our particular business. We are the guys in the pits. We are

the maintenance crew. We are the technicians that go out and do the inside wire work that has been deregulated. I find it funny that our phone numbers have either been misprinted or left out completely in Pacific Bell and General directories over the last three years since deregulation of the telephone wire took place.

In the Yellow Pages book that is sitting here, I have a little thing I'd like to read real quick, and then I will get to the bigger picture.

"Have a question about your telephone service? Want something done? Call your telephone business office and ask your service representative. He will be glad to help you." Can I get one of those in there that says, "Call your Extension Connection service representative, who will be glad to help you"? There are numerous ads similiar to this throughout this book and every book in the state of California where the utilities are putting free advertisements for deregulated services and cross-subsidizing their own services. You don't have to look far, open your Yellow Pages. It is all around. The time is not ripe for more deregulation.

We're looking at utilities talking about taking risks. We created utilities originally because it was economically unfeasible for a number of companies to enter the telephone market and supply wire, switches, and everything else throughout the entire state. That's what a utility is. It's the company that does that for the community. We're talking about utility companies taking risks? That is not what we want for the people of this state, our utility taking risks. We want the basic nuts and bolts covered by the Public Utilities Commission and the legislators of the state, making sure that

we get what we're paying for. All of these special services that are being brought up because of our technology, those things are open to competition. You can not put competition and regulation in the same bedroom. If you do, somebody is going to start messing around. That is what we have going on here.

CHAIRWOMAN MOORE: I am not going to let yours go unanswered, because I'm sure they are going to respond to your comments. They are not going to mess around, I'll tell you.

MR. ZACHERY PAVLIDES: I am Zachery Pavlides. In 1978, I founded the Talking Yellow Pages, which supposedly was the first in the nation.

Pacific Bell refuse dto give me service, and I had to go to the court to get it.

CHAIRWOMAN MOORE: They refused to give you service because they felt you were competition. Is that what you're telling me?

MR. PAVLIDES: That's correct. After a settlement, which terms I am not in position to disclose due to confidentiality, I had to file a new lawsuit in 1988 which is now pending in Superior Court in San Francisco. They show conspiracy in the Supreme Court here.

These people address the financial issue of Pacific Bell and deregulation. This is a different issue. Pacific management is not to be trusted. They are acting criminally. They have with me. The position shown by their president of the Yellow Pages, who said Judge Greene allows them to stop the Talking Yellow Pages. With this kind of behavior and people, I don't think there is a flat level field to play with. That's all I have to say.

CHAIRWOMAN MOORE: Let's go to the next witness.

MR. HARRY SCHWEDOCK: My name is Harry Schwedock, and I'm vice president and chief operating officer of Amvox, Incorporated. Amvox is a nationwide voice-mail provider that has been in business for about two years. We have 41,000 subscribers, a little less than half of them in California. [Prepared Statement, see Attachment L].

We currently have a complaint pending before the CPUC with respect to what we consider to be anti-competitive monopoly abuses on the part of Pacific Bell's voice-mail activities. It is interesting that they have been in the business for just two months and, as far as we are concerned, they are already engaging in competitive activities. It seems likely to us that Pacific Bell is going to defend this on the basis of the fact they are buying services from Pacific Bell, just like any other voice-mail company has to buy services from Pacific Bell. There is only one significant difference, and the Bay Area Teleport mentioned it a little bit earlier. The difference is that when Amvox or any other voice-mail company buys services, someone has to sign a check. When Pacific Bell voice-mail buys services from Pacific Bell, nobody signs a check. A bookkeeping transaction may take place. Now, I say "may," because one of the things that led to the breakup of AT&T was the fact, which the FCC essentially admitted, that cost accounting really, didn't work as a method of regulation.

I've heard from the chairman, "Well, this is the new telephone company. This is not the old Bell system. The leopard has changed his spots." If we buy that, then we deserve what we get.

In the years since deregulation, Pacific has been required by the PUC to refund several hundreds of millions of dollars for over aggressive marketing practices, unwise investments, and essentially overcharging for service.

CHAIRWOMAN MOORE: Since it is something that continues to come up: In the current proceeding, if there is some question about your marketing, can that be looked at in an off-year, during the rate freeze?

MR. JAMISON: Yes. In fact, that kind of issue that was raised in the marketing-practices portion of the ratecase is exactly the kind of thing that a normal complaint process or investigatory process at the Commission would likely uncover. Appropriate action could be taken, of course.

MS. SIEGAL: However, the burden of proof is on the complainant, not on the company. It is pretty darn hard to dig out that information.

CHAIRWOMAN MOORE: That's the point that I wanted made. Okay. Go ahead.

MR. SCHWEDOCK: The underlying purpose of these hearings, I presume, is what is in the public interest. I don't think too many people would disagree that deregulation in the airline industry has resulted in choice, higher fares, and poor service. Deregulation in the banking industry has resulted in bail-out's that are going to cost the taxpayers of this country several hundreds of billions of dollars. You can call it flexible regulation. You can call it deregulation. You can call it by whatever euphemisms you want. What the telephone companies in California are looking for is less

oversight. There are no two ways to slice that. What we're concerned about is that lack of oversight.

When you have a competitor to whom you pay over 35 percent of your revenues (and Amvox indeed pays over 35 percent of its revenues to the telephone company) when you have a competitor who has no need to raise capital, when you have a competitor who has more lawyers than we have employees, and when you have a competitor that has a long record of anti-competitive abuses, we worry. We worry about that competitor using the multitude of advantages that they gained from their monopoly position to dominate an emerging competitive market.

If the telephone company wants to enter competitive markets, if that is what they want to do, then let them do it. They should be allowed to do it. But, let them do it under the same circumstances as everyone does. Let them go out and find money to do it, not use ratepayer money to do it. Let them set up separate subsidiaries so we can at least reduce the potential for cross-subsidization. Give the PUC at least the chance to find it. If they dominate a market, if they end up dominating the a new market, let it be because they provided better service, not because they had more lawyers or more accountants and could out last any other competitors in either the courts or the CPUC.

CHAIRWOMAN MOORE: All right.

MR. PAVLIDES: I have one more item.

CHAIRWOMAN MOORE: One sentence.

MR. PAVLIDES: Pacific Bell for 13 years, they were selling to the public a service that they didn't have, and they knew about it. I have sworn statements with me.

CHAIRWOMAN MOORE: There is a procedure to address that, though. Let's hear from Jim Martin and then to the cable industry.

MR. JIM MARTIN: Madam Chairwoman and Members of the Committee. I'm Jim Martin, regional director of the Western Region of the NAACP [National Association for the Advancement of Colored People]. I am here in these hearings today because the NAACP clearly perceives a very urgent need for our constituency to be heard, represented, and involved in the issues of telecommunications. We are very clear that as the technology evolves and changes the society we live in, there are significant risks and we must contemplate methods to deal with them. Particularly in an industry and generally moves rather slowly when it comes to the kinds of changes needed to keep all the people in their various communities and constituencies current with the changing times.

Discussion has centered around regulation. Regulation of the industry is clearly something that is needed. I, as a former utility employee in the telecommunications environment for approximately 20 years, know that the corporation doesn't necessarily seek to meet the needs of the people and keep the people well informed, unless they need to manage an issue or to get something for it.

We will be involved with this issue. We will seek communications with the industry and this Committee to a much

greater degree. We perceive that, should the telecommunications regulation we have traditionally known, be lifted, we would see a greater jeopardy to the constituency that I represent.

I might add we represent nine western states and Japan in my region. I have approximately 150 branches. We service over 3 million Black citizens and a broad range of low-income and other people of color throughout this region. I have approximately 121 telecommunications utilities in our region, and we are beginning in California since over approximately 65 percent our constituency is in this state. We will be very involved.

CHAIRWOMAN MOORE: Thank you very much for your comments. Let's hear from Sprint.

MR. DENNIS LOPER: We have to submit our testimony in writing for Sprint due to the fact Mr. Pongrancz was not available. [See Attachment M].

CHAIRWOMAN MOORE: Okay. Good enough. The Center for Public Interest Law, are they still around? No? Okay, then we will hear from Nick, and then to Spencer, and then we will give everybody on my side of the table a chance for concluding remarks.

MR. NICK SELBY: Good afternoon, Madam Chairwoman, my name is Nick Selby appearing for the Information Providers Association (IPA). IPA consists of information providers who deliver information and entertainment services via the telephone; relying primarily upon the billing and collection services of the local exchange carriers.

In brief, our concern is that there are already signs that the local exchange carriers intend to use their bottleneck control over

billing and collection services to influence and control the amount of content and information that will be available to the marketplace. Pacific Bell, this week, filed document with the Public Utilities Commission which said that as a private company it was not required to provide any due process before it disconnected an information provider. There will be a need for continued regulation in the future to ensure that this bottleneck monopoly, this control over basic billing and collection services, is not used by Pacific and General to favor their own information services which we know are coming down the road. Thank you.

CHAIRWOMAN MOORE: Thank you. Let hear from the California Cable Television Association. Those are great charts. I am sorry they weren't up earlier.

MR. SPENCER KAITZ: Madam Chair, I will be brief because I know you don't want repetition, but I thought these charts would be helpful to the Committee because they are in detail. [See Attachment N].

CHAIRWOMAN MOORE: The people can't see them.

MR. KAITZ: I have copies that I will be glad to make available to all parties.

CHAIRWOMAN MOORE: Okay, go ahead.

MR. KAITZ: The charts illustrate what is really at stake here,Madam Chair and Members. The rate case is something that we understand. It provides for cross-examination of witnesses and discovery of evidence. What Pacific has proposed has been characterized by one of their executives as "oversight capability." I don't think any of us fully understand what oversight capability

means, but what we think it means (based on most of what we have been able to gather) what we have identified on the chart. If I may characterize it, I think what we have under that proposal is ratemaking and protection of competitors by schmoozing. It has also been called "touchy-feely" regulation.

We all get together at a workshop, in a room, and we talk, and there is a little information filed by Pacific, not very much. They now view much, if not most, of their information as proprietary because they have gone into competitive businesses. Therefore, the basic information that Sylvia and others need to evaluate their cases is not longer available without the enormous expense of discovery; and then often not available either.

From the standpoint of competitors, I would characterize this as the classic 900-pound-gorilla-versus-canary syndrome. What I find interesting is that Pacific, under their proposal,wants to make sure they only have one canary at a time to stomp on. The only remedy that a competitor would have, to deal with subsidy problems, would be to file a complaint. This isolates them from the other parties that used to be in the rate case as a group, and forces them to bear all the costs of going through discovery, perhaps -- or perhaps not -- with support from DRA. For any small businesses, this eliminates any effective review of whether subsidy exists.

This leads me to the basic question that we have about this. Many questions that have been raised: Is this unfair to small business or is it fair to small business? Is there subsidy by Pacific of its voice-mail services, data services? Are they creating a subsidy situation ultimately for going into video transport for cable

television? is the $700 million plus proposal for fiber, $400 in the four years of the proceeding, cost justified? Those are the questions the rate case was designed to find out. The only way you can answer those questions is look at their business and their business records. Now, all of the elements that allowed anyone to do that under any reasonable cost scenario are being stripped away.

Everybody who is concerned about the Pacific and General plans is arguing for doing this carefully. In a worst case scenario, if the PUC really trashed Pacific's proposal, all they would get to do is sit back and make $2.5 billion a year for the next few years, and sulk about how badly they were treated by the Committee and the California PUC. This would be a situation where they could not do anything other than continue to ride in their limousines. But we are asking, why can't the consumer, cross-subsidy, and competitive issues be dealt with carefully? For 50 years, the rate case has offered all of these protections. All of us are willing to look at changes and modifications; speed it up a little bit; or this, that or the other. They are proposing to throw it all out. We think that is dead wrong. We think that sets up a scenario for destroying a very competitive sector of California's telecommunications economy.

CHAIRWOMAN MOORE: The chart raises several questions, and maybe it is a good way to end the hearing. Let me also recognize that Barry Ross from the California Telephone Association is in the audience is going to submit his testimony in writing, in the interest of time. So is James Smith from CalTel. He indicated that he also would submit their testimony in writing. I'm sorry to really have to be so short because I have really been looking

forward to this hearing. The budget dispute just kind of got in the way of our telecommunication hearing.

I don't think anyone would disagree with what Spencer described as rate case protections. My rate case expert for consumers, let me ask you, do you agree pretty much with what they set forth?

MS. SIEGAL: I believe it is right. I really didn't read every word.

CHAIRWOMAN MOORE: You're getting to be just like a lawyer. Do you know how cautious they are?

MS. SIEGAL: After 20 years, I begin to think like them.

CHAIRWOMAN MOORE: She said she didn't read every word, but it seems like it was in order. Let me ask both General, DRA and Pacific: In exchange for the ratecase protections that we have had, what does your program put in their place? There are no public hearings, for the most part, under your proposal, the protections that come from cross-examination, and on and on?

Secondly, I have a question to ask and I want the four that were up here to comment on it; things that were raised by others. This notion of shifting the burden of proof in a complaint procedure, to shift the total burden to the consumer, the ratepayer, or someone who wants to raise some issue or complaint -- I can understand the need for that, because you can have a number of frivolous kinds of things. What about some shared responsibility, where there is some regulatory framework or regulatory flexibility, some kind of shared responsibility in terms of a complaint

procedure. Some method that would differ a little bit from the current process?

MR. JAMISON: Let me address that second question first. I think two issues have been confused here. Pacific, indeed, is looking for an improvement, a change in the way that protests about new products or services are handled. Today, competitors complain that we use the regulatory process, but I submit they can tie up new products and services that Pacific would like to offer today. We are asking for some relief from that.

However, we are not proposing changes in the complaint area whatsoever. All of the complaint procedures should still be available.

CHAIRWOMAN MOORE: But the point is, under the current complaint procedure, if there is not a rate case, then the burden of proof is on whomever is bringing the complaint. What I'm saying is, if you're not going to have rate cases anymore, then there ought to be some step between that allows for shared responsibility. I can understand not wanting a bunch of frivolous cases every time somebody wanted to make a complaint. But with you having all your information and Sylvia Siegal being outnumbered by 50,000 - one attorney and everybody else you have, there ought to be some balance. Giving you certain flexibility is all bad, given the changing environment, but I do think there have to be some safeguards. I think that is what everybody here is saying, recognizing that if there are some changes, there ought to be some balance. Anybody can respond to that question. Sylvia, you grabbed your mike, so why don't you answer?

MS. SIEGAL: I don't see how you can share that kind of responsibility. Legally, I think it would be insufficient. Excuse me for borrowing legal phrase. But the purpose of having a full-blown or even a semi-full-blown proceeding before the PUC is that you have the protection of the procedures. The parties have rights: The right to get information from the company, the right to cross-examine witnesses, and so on. If you have some kind of nebulous sharing on a complaint procedure, you would be wiped out in two minutes. You would have no recourse, and I'm for rights.

CHAIRWOMAN MOORE: What I'm suggesting is some kind of complaint procedure on an issue that would similarily situate one as does a general rate case proceeding. In other words, if you were complaining, you would have the right to get the information. You would have the right to cross-examine. You would have the right to some of the other things that you don't have now.

MS. SIEGAL: If they say "no," then it's tough crunchies, you know. You have no recourse.

CHAIRWOMAN MOORE: I'm saying there ought to be something that can be worked out. Some kind of complaint procedure that would allow that to occur.

MS. SIEGAL: We have to have "full-blown" procedures with protection of rights for all parties. We have, Madam Chair, some really immense issues coming down the pike. In fact, one is here right now, and that is the whole issue of privacy. That's wrapped up into this whole new telecommunications world. Nobody is dealing with it.

CHAIRWOMAN MOORE: Again, if we were going through our normal cases ,that issue would be reviewed in the regular process.

MS. SIEGAL: It's a policy issue, Madam Chair. I respectfully recommend that the Legislature take this up with respect to future services for telcos. Secondly, I respectfully recommend this Committee consider legislation to remove limited liability provisions from telcos' protective devices. They can put a business out of business in two minutes if they leave the Dennis Love's out the telephone book or if they do other things to customers. There is a very protective limitation on liability. It has to be removed. If these guys are going to get into competitive businesses, they have to observe the practices of the business community.

CHAIRWOMAN MOORE: That's not a bad idea. I see them both frowning. All right. Mr. Kaitz?

MR. KAITZ: Madam Chair, for a small business to lodge a complaint, they immediately are up against a group of lawyers and experts funded by the ratepayers and employed by a company that does $8 to $10 billion of business a year. That is simply not a level playing field, when you have subsidy flowing out of the ratepayers' pockets to take on the fight in the first place. The ratecase allowed parties to at least intervene at a point in time in which the company had enough at risk that it took seriously conduct that would be offensive to the PUC deciding that case.

CHAIRWOMAN MOORE: Okay. I hear what you're saying. DRA, did you want to make a comment?

MS. MURRAY: What we have tried to do in the DRA plan, recognizing that you do lose the full-scale investigation of the ratecase, is to get the starting point right. Then, to have in place the kind of index, based on companies' specific inflation and productivity factors, that would, in many respects, simulate the results that ratepayers might to expect of a full-blown ratecase proceeding. Only when all the savings of productivity have been appropriately returned to the ratepayers, do we look at sharing of unexpected revenues due to exceptional management efforts. Let's get the incentives right.

CHAIRWOMAN MOORE: Do you support this notion of a cost study? Basically that is saying that you have to have the numbers right to start with.

MS. MURRAY: You have to have the numbers right to start with whether that entails the type of stand-alone cost study that Ms. Siegal described is not necessarily the case.

CHAIRWOMAN MOORE: How do you get the right numbers without some kind of study?

MS. MURRAY: There is, for example, the simple fact...

CHAIRWOMAN MOORE: The "trust-me" factor?

MS. MURRAY: Pacific Bell is on a regular basis earning considerably more than its authorized return. Our attrition process does not automatically give that back. If we had had a general rate case, we would have reexamined the entire revenue requirement. We hope to come up with some relatively simple way.

CHAIRWOMAN MOORE: Of course, a "revenue requirement" assumes that everything that has gone before is

correct. You still don't have a detailed study that would point out whether these assumptions are correct or not.

MR. JAMISON: Everybody seems to believe we are not going to be submitting cost studies. Mr. Perez from the City of Los Angeles became very upset that there may be rate changes without cost studies. There is a Supplemental Rate Design to follow this proceeding which will require all the changes we have proposed in principle, except the inclusion of the touchtone and expansion of the local calling area, to be subject to cost studies and review before those flexibility bands are set, and before any increases of business rates are linked to those other rate decreases could take effect.

I cannot let Spencer's signs go without a comment. Because he has printed those words on those sign doesn't make them right. We have sat here and repeatedly said we are not proposing rate increases except for those business rates which will go through that proceeding. Those charts are not a fair reflection of our proposal.

CHAIRWOMAN MOORE: Point that out. I didn't see that part. Where is that? Which one was it?

MR. JAMISON: "Significant rate increases by advice letter, effective 'conditionally' unless a protest can show 'irreparable harm.'"

MR. KAITZ: Once you establish the bands, then you can do significant rate increases within those bands by advice letter. What's wrong with that?

MR. JAMISON: That is a mischaracterization of our proposal. The band, itself, is something that would be fully explored by the Commission before it was established.

CHAIRWOMAN MOORE: If we strike "significant" and put "rate increases and rate decreases by advice letter," would that be okay?

MR. JAMISON: I won't sit here and try and correct his misstatements.

CHAIRWOMAN MOORE: Oh, that was good.

MS. SIEGAL: Madam Chair, can I correct the misstatement by PacBell?

CHAIRWOMAN MOORE: Wait a minute, we are not going to keep beating up on PacBell.

MS. SIEGAL: Why not? They're big and rich.

CHAIRWOMAN MOORE: All right, go ahead.

MS. SIEGAL: Let me just make this one point. So, they submit cost studies with all of the new services. Those don't mean a darn thing.

CHAIRWOMAN MOORE: We want independent cost studies.

MS. SIEGAL: They would be as flawed as every other cost study they have submitted. I can assure you that until we get a stand-alone cost study, this is all poppycock.

CHAIRWOMAN MOORE: Let me ask Pacific and General Telephone, if we are talking about getting the numbers right. Do you guys have any problems with an independent cost study?

MR. JAMISON: Our cost studies today undergo great scrutiny by this Commission. People are able to ask for information and make their own studies. In the followup procedure that has to

take place, the Supplemental Rate Design or Phase III, all of those will happen.

CHAIRWOMAN MOORE: So, is the answer "yes" or "no"?

MR. JAMISON: The answer is that the cost studies that we produced will be provided. Other parties can ask for information and create their own estimates.

CHAIRWOMAN MOORE: So, the answer to the question is "no." You are comfortable with what you provide, but if anybody wants to add or change, they can build on what you give them. Is that correct?

MR. JAMISON: They can require information to be provided to them by us.

CHAIRWOMAN MOORE: Never mind, I got your point.

MS. SIEGAL: I respectfully recommend, Madam Chair, that this Committee order the Public Utilities Commission to commission an independent stand-alone cost study. I don't want the Commission staffto do it. They don't have enough staff to do it. I want an independent outside purveyor to do it. An independent purveyor selected by the parties involved.

CHAIRWOMAN MOORE: Okay, you had three shots at the apple. We are going to close it out. I am going to give everybody one last sentence. I will let General, Pacific, DRA, and Sylvia have the final word. Past the mike around and let's go.

MR. KAITZ: You have in the audience right now a group of smaller providers, telephone answering services, who find that Pacific is able to use their thousands of service representatives to market competitive voice-mail businesses. I think the closing issue

here should be a question to Pacific: Given that the telephone answering services didn't have enough money to be involved in the Alternative Regulatory proceeding, and these are small businesses with small margins, now competing with the tens of thousands of people on Pacific's sales forces, how under Pacific Bell's proposal will they protect themselves when the rate case is gone?

CHAIRWOMAN MOORE: Okay.

MR. SELBY: As you know, Madam Chairwoman, Pacific Bell is on the verge of offering a host of new "information age" services. Not just voice-mail. Pending right now before the Commission, on a motion for interim approval, is Pacific's voice store and forward service. This will put Pacific Bell almost into a direct partnership with certain selected information providers, and through its control of the billing and collection mechanism, as well as its control of the local exchange bottleneck, the company will have the ability, in subtle ways that are very difficult for an individual competitor to challenge to control the marketplace. I hope the Legislature will continue to fund the Commission. Give the Commission the resources to ensure that discrimination is not allowed to occur. Thank you.

MR. SCHWEDOCK: Madam Chairwoman, today we have listened to a lot of people argue about a lot of things with respect to cross-subsidy. I would suggest that there is a very, very simple solution to this, and that is simply to have two companies. There are the regulated telephone companies with their monopoly services, and there are the unregulated competitive services. If the telephone

companies want to be in those businesses, let them do it exactly the same way as everyone else does.

It has to make any person in a business that is competing with them feel terribly uncomfortable when the person that he has to buy his basic services from is also his competitor. There is no amount of "trust-me," no amount of oversight procedures that are going to get people past that. If you want to play the game, then play it the same way that everybody else does.

MR. HOWLEY: We don't compete with Pacific Bell. In fact, we are one of its most effective sales...

CHAIRWOMAN MOORE: This is your parting shot. You can't give me a whole history. You have to do one or two sentences.

MR. HOWLEY: A quick sentence, is we don't compete. We sell and manage their services very effectively. And yet, we have the same concerns, in some respects, as the other companies here. I think the reason is obvious: The impact this will have on the industry for the next 20 years. Not only the industry, but how information products develop in that timeframe. We outlined Centex's four points which we thought.

CHAIRWOMAN MOORE: We have those four points and we will go back through those.

MR. HOWLEY: We would like to ask your Committee to closely monitor the results of the hearing. If those are not properly addressed, to take legislative action to correct that.

CHAIRWOMAN MOORE: Let me say this to you: Given the fact we didn't have the kind of hearing that we really hoped to have, with full discussion, we may end up having to do this another time.

Once we sort through the testimony and the information we have, then there may be a need to call you together again, so that we can maybe come up with some recommendations for change.

MR. PAVLIDES: Madam Chairwoman, my belief is that no matter how we change the rules of the game, if we allow the management group that inherited 100 years of monopoly culture to be in charge, nothing will change at all. As I stated before, when the president of the company comes and misstates the law, there is nothing that you can hope for by changing the rules of the game. You just change the players. They have done enough criminal acts so far that it's justified.

MS. MARTINEZ: API has one further comment. From what we've heard from the DRA and witnessed in the proceedings, with the litany of information that's been provided during these proceedings, it's evident that the Commission's resources are inadequate. API recommends that you create an oversight, a watch dog committee. This is not uncommon. They have been established in a number of states that are able to look at these issues and take care of the general ratepayers, of which we are one.

MS. MURRAY: In looking at regulation for the 90's, DRA seeks three things: A regulatory framework that is (1) flexible enough to induce innovation and efficiency on the part of the local exchange carriers; (2) stringent enough to guarantee that those benefits flow through to the ultimate ratepayers; and (3) fair enough to ensure that both the local exchange carriers and their competitors have a reasonable opportunity to compete on equal basis, so that California consumers are the ultimate winners.

CHAIRWOMAN MOORE: I think that ought to be the goal of everyone. That sounds great. Excellent. That's where I am. I'm with Terri. Go ahead.

MR. MCCALLION: I will make this very brief. In closing we feel that our plan is good news both for the ratepayers and the telephone companies.

CHAIRWOMAN MOORE: You think it is flexibile enough, stringent enough, and fair enough?

MR. MCCALLION: Yes. It was carefully designed to be such.

I would like to add a comment relative to many of the parties who spoke near the end of this session. That is, we at GTE California also have some concerns relative to our existing rate design. The last time we had a full-blown rate design decision for GTE California was in 1984. Certainly, conditions have changed to a great extent and we need a new rate design. So, we agree with some of the concerns raised by some of those parties.

As you may be aware, we had a 1988 general rate case, and the rate case has been concluded. The rate design portion was put on hold and rolled into the Supplemental Rate Design portion of this proceeding. So, we are anxious to receive a rate design decision. I just want to point out the rate design portion of the Supplemental Rate Design is more than supplemental for GTE California.

CHAIRWOMAN MOORE: All right. We recognize that. I think that has a number of people concerned. Go ahead, next witness.

MR. JAMISON: I think Terri said it best as far as what a change in regulatory structure should contain. I believe Pacific's proposal does that and, notwithstanding the discussion of the latter half of this proceeding today, Pacific's proposal does exactly those things. It is fair to our customers, to Pacific, and provides safeguards for competitors as we move to a competitive environment that is going to come whether we like it or whether they like it or whether the DRA likes or whether this Committee or this Legislature likes it.

MS. SIEGAL: Last but not least, Sylvia Siegal for the residential customers. While many residential customers look forbenefits that really might help them, I think the Legislature must bear in mind that the whole wrath of proposals currently under discussion are not necessarily beneficial, prudent, or cost effective as far as the larger body of ratepayers is concerned. Further, we would urge this Legislature to continue to exercise oversight over the Commission. Your surveillance has already helped the regulatory proceedings this year and stopped a lot of "speed up", ill-considered notions, and so forth. I won't go into those details. We need you. We need you. And we will be happy to provide whatever information we can.

We look to the future and its benefits. But, I'm not entirely convinced that the only thing that our future citizens will be concerned with is information. Information is not the be-all or end-all of our existence. I think economic issues are a lot more important. Thank you.

CHAIRWOMAN MOORE: Thank you very much. Let me close by thanking everyone who came, and again, apologizing to

those of you who came a long way and perhaps did not get to say as much as you would like. Let me assure you that your comments will be included in their entirety in the recorded publication of this hearing.

Secondly, once we can sort through the great deal of information that you have provided to us, there may be a need to come back. There are some issues that are unresolved. There are safeguards that have been pointed out that perhaps have not been adequately addressed, and there are some legislative suggestions that may need a response. I hope we can work together to come up with a means of addressing the problems. We have had a taskforce in the past. There may be a role that such a taskforce could play again. Most of you who have come here today would certainly be invited to participate in such a task force.

Again, let me thank you. Let me ask one final question: What is the status of Phase III of the OII? Does anybody know?

MR. JAMISON: It hasn't been set yet, as far as I know.

CHAIRWOMAN MOORE: Okay. A lot is riding on that, including the rates and competition and some of the other things have been mulled over. Certainly, we want to be aware. It certainly ought to be widely noticed in public so that people can participate.

With that, this informational hearing is adjourned.

SUBMISSIONS AND CORRESPONDENCE

Opening Comments of Chairwoman Gwen Moore Utilities and Commerce Committee Special Hearing June 6, 1989

Committee Members, Witnesses, and Members of the Public:

In 1910, after years of strife between the utilities and their customers, the people of California, by initiative, created the California Public Utilities Commission (PUC) to create order and to protect their common interests.

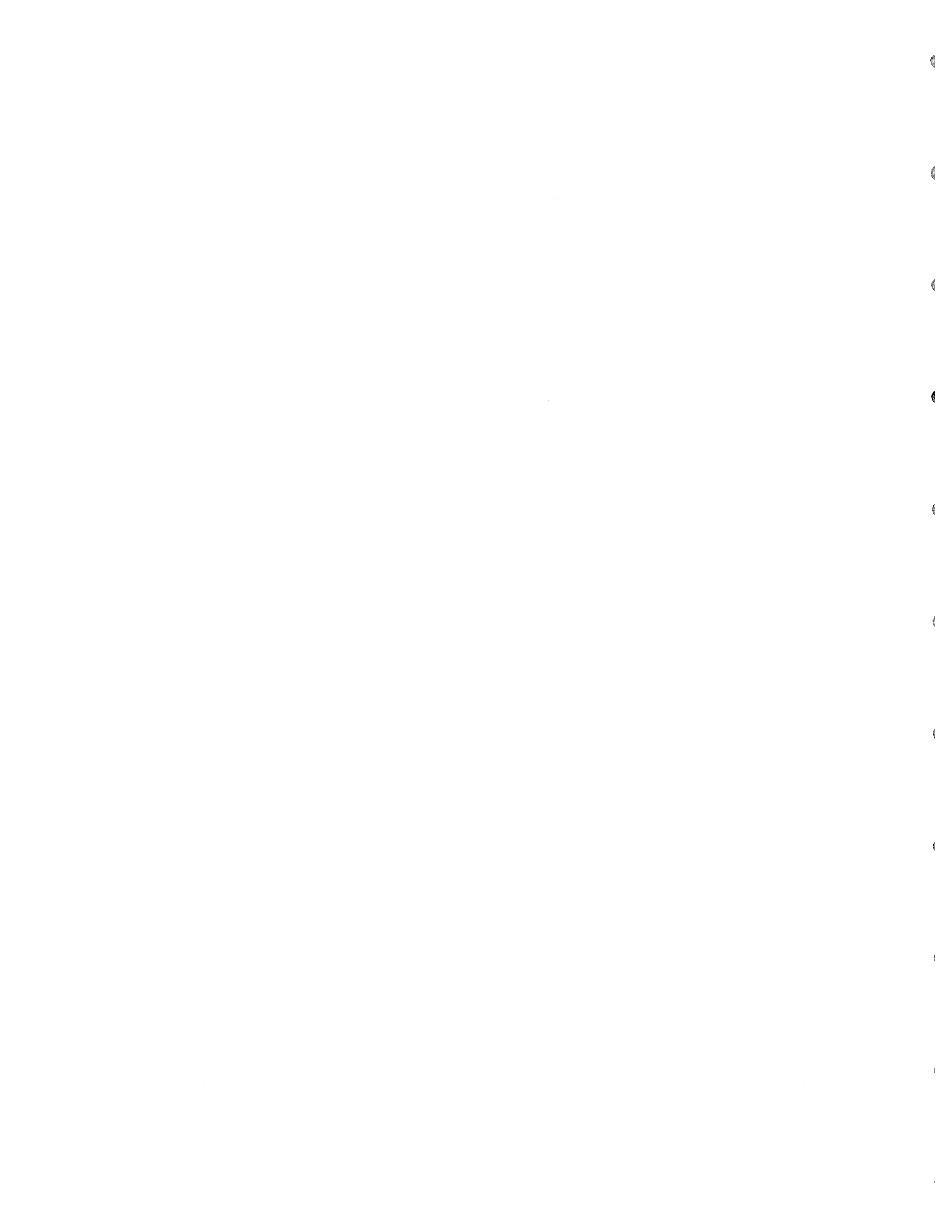
Now the PUC is engaged in one of its most important assignments ever: Determining how to regulate California's telephone companies in the 1990's. In December, the PUC significantly lightened regulation of AT&T, the largest long-distance carrier, as it had done for MCI, US Sprint, and the other long-distance carriers. Now the local telephone companies are petitioning the PUC for their own lightened regulation.

But there is a bigger issue. That issue is how telecommunications services will be provided in California, in the last years of the 20th Century and the first years of the 21st.

Our hearing today is convened to discuss what our state's telecommunications policies should be. Ever-changing federal policies and new technological possibilities require that we reassess our state's policies on a regular basis.

For that reason, I am asking our witnesses, who represent almost every active player in the telecommunications arena, to concentrate their testimony on the Big Picture, the policies that they recommend for the future. Among these is the appropriate role of the PUC. I don't want to reiterate the proceedings now before the PUC, except as they point the way toward the future.

As Californians, we all have a big stake in our state's telecommunications policies. They will determine, more than we can imagine today, how we will live our lives tomorrow. Can we build a social consensus for the 21st Century -- for the "Information Age"? Can we afford not to?



Pacific Bell Prepared Testimony

of Bruce F. Jamison

Submitted to the Assembly Committee

on Utilities and Commerce

June 6, 1989

Pacific Bell appreciates this opportunity to participate in these proceedings as they explore alternatives to traditional telephone regulation. Pacific believes that the modification of today's regulatory procedures is essential to the continued development of California's telecommunications infrastructure.

This committee is well aware of the current proceeding before the California Public Utilities Commission entitled Order Instituting Investigation Into Alternative Regulatory Frameworks for Local Exchange Carriers (or OII 87-11-033). Pacific Bell, along with numerous other parties, participated in the proceeding. Pacific Bell has submitted a complete proposal, recommending revisions to the current regulatory system. To briefly summarize, Pacific proposes to:

- Freeze the price of basic residence service through 1992, at rates already among the lowest in the nation.
- Include Touch-Tone service for free as part of residence basic service.
- Expand local calling areas for residence and business customers from about 8 miles to about 12 miles.

- Modernize the telecommunications network over three years so all Pacific Bell customers can have access to same level and variety of services regardless of where they live and provide a telecommunications infrastructure that will support California's continued economic development.
- Continue regulation by the CPUC, with some streamlining of procedures to allow downward pricing on services presently priced above cost and to allow for more timely introduction of new services. (For example, pricing parameters would require review and approval by the CPUC.)
- Share evenly with customers any earnings above a level set by the CPUC.
- Gradually adjust prices for business services so they are closer to the cost of providing the service, by the amount of reductions ordered by the CPUC for interexchange carriers (IECs). (The CPUC has ordered that the reduction to the IECs should be offset in the remainder of Pacific's business. There will be no revenue increase for Pacific Bell.)

As you can see, Pacific's proposal does not envision deregulation, or even a radical departure from traditional regulation. Rather, Pacific's proposal is a thoughtfully planned evolution of today's approach to regulation to one which offers greater benefits to customers and the company and is fair to competitors.

More specific responses to the Committee's questions follow:

Key Questions of Interest to the Committee

1.Q The traditional goals of regulation include:

a) assuring just and reasonable rates,

b) preserving the ability of the utility enterprise to attract capital on reasonable terms,

c) preventing abuse of monopoly power and undue discrimination among customers, and

d) assuring high quality service and adequate facilities.

Are these goals inappropriate for the 1990s? Should additional goals be pursued in the 1990s?

1.A The goals you have stated are appropriate goals today and for the 1990s and are similar to goals the CPUC has articulated:

1. Universal Service: This goal directly correlates to goals (a) and (d) above.
2. Economic Efficiency: This goal relates to (a) and (b) indirectly, for as economic efficiency is approached, customers will be further assured of just and reasonable rates; capital will continue to be available as investors remain confident about the level of return.

3. Encouragement of Technological Advances: This is related to (d) above, and is a goal that must be pursued more vigorously if California is to remain competitive in the new, worldwide economy.

4. Financial and Rate Stability: This goal has a customer and a utility component, in that the stability of the utility will enhance the stability afforded customers. Thus, both (a) and (b) are addressed.

5. Full utilization of the local network: High quality service and adequate facilities are the outgrowth of a fully-utilized local network, or (d) above.

6. Avoidance of Cross-Subsidies and Anticompetitive Behavior: This goal is embodied in (c).

7. Low Cost Efficient Regulation...an additional goal not stated above which should be pursued due to the increased competition in this industry.

Pacific Bell developed its proposal in support of all of those goals, and we still believe these goals are appropriate to pursue in the 1990s. A brief summary of our proposal is attached.

2.Q Traditional rate-of-return regulation ideally links rates to costs (including the cost of capital). It is the principal method to achieve the twin goals of (a) capital attraction on reasonable terms and (b) just and reasonable rates. Is a new form of telephone regulation recommended -- or can traditional rate-of-return regulation still serve

the public interest? Please restate (briefly) your position, if any, before the Public Utilities Commission (PUC) in OII 87-11-033 ("Alternative Regulatory Framework") and A. 88-08-031 ("Enhanced Services").

2.A As used today, rate-of-return regulation may in fact work to the detriment of both the customer and the Company. Pacific is proposing a modification to correct the deficiencies with rate-of-return regulation to make it more appropriate for today's increasingly competitive environment.

Pacific's plan enhances the ability of the current regulatory process to achieve the goals outlined by the Commission and this Committee in its first question.

The improvements we envision include:

- more reliance on incentives to encourage greater productivity, such as the shared earnings plan.
- the ability of the company to lower prices so it can compete more effectively when current prices are above cost. (For example, the Commission would determine that a price range is reasonable, taking into account the costs of providing the services in question. The costs, as determined by the CPUC, could serve as the price floor in some cases.)
- the simplifying of some regulatory processes so new products can be introduced more quickly.

Pacific is proposing to move toward a regulatory structure more appropriate for the current environment and more capable of accommodating further change. Under the structure proposed by Pacific, the Company will be encouraged to perform at its best because there are better incentives for excellence, as well as greater risks for failure.

Pacific also has proposed in A. 88-08-031 ("Enhanced Services") that enhanced services should be detariffed, but still be part of the regulated business. Not only will this help ensure the continued evolution of a robust public network, but also money earned by these services will help keep the price of basic service low. There should be flexible pricing for such services, but the Commission should retain oversight of the services. This is consistent with what Pacific has proposed in response to OII 87-11-033.

3.Q Are current regulatory procedures adequate to identify and consider, in a coordinated fashion a full range of issues that should be of concern to policymakers? These issues include, among others:

a) Maintaining and enhancing universal service.

b) Improving the efficiency of the public telecommunications network.

c) Competitive access to telephone company facilities.

d) Conditions under which telephone utilities may compete in unregulated markets.

e) Privacy of telephone subscribers' personal information.

f) Consequences of activity in the telecommunications sector for state and local economic development.

3.A The commission currently has many procedures through which it may examine issues. The "Order Institutuing Investigation" (OII) in which we now are involved, obviously is one such procedure. It formally began more than one and one-half years ago, although the issues it examines really took shape and were defined over several years prior to the issuing of the OII. And the process clearly will continue for some time.

The OII process, rule making procedures, audits, and the complaint processes provide other ways to identify potential or actual problems and resolve them.

Pacific believes the current procedures, such as the OII, can and do deal with the full range of issues that are of concern to policymakers.

That is not to say they cannot be improved upon. While some procedures may be "adequate" to consider issues, they often require more resources and time than would be considered reasonable. Pacific believes we should not close the door

to new ideas on how to make the current procedures more efficient.

4.Q Does the existing regulatory environment encourage the presentation of points of view that represent the interests of Californians at large? Should greater participation be encouraged? If so, how?

4.A The Commission's investigation into alternative regulatory frameworks provides perhaps the best insights into this question.

The Commission began examining these issues even before divestiture of the Bell System was completed. In 1983 and 1984 the Commission conducted investigation concerning competition and regulatory structure. In 1986 in response to questions asked by then Commission President, Donald Vial, Pacific first proposed modifying the regulatory process. Commissioner Vial said the proposal "...merits further consideration." Because of the nature of Pacific's proposal, Commissioner Vial said a separate proceeding was the appropriate way to assess the proposal.* Pacific's current proposal, the California Plan for Rate Stability,

* The paper distributed by the Utilities and Commerce Committee entitled '"Don't Hang Up!": The PUC and Telephone Service in the 90's -- Regulation, Deregulation, or Reregulation?' signed by Robert Jacobson is in error in its characterization of this subject. That same paper also contains other errors of fact.

evolved from that earlier proposal is similar to it, but is enhanced from that first proposal.

On August 11, 1987 the Commission formally commenced its investigation into alternatives to cost-of-service regulation by issuing its Notice of En Banc Hearing to publicly announce its intention to hold hearings. The Commission invited 23 participants, representing a wide cross section of utilities, competitors, consumer representatives and academicians to participate by responding to specific questions during the September 24 and 25 hearings.

After reviewing the written comments filed by the parties, and after listening to the discussions and debate during these two days of open hearings, the Commission issued Order Instituting Investigation 87-11-033, on November 25, 1987. In this OII, the Commission set forth a procedural framework for considering changes in the regulatory framework for LECs, and divided the proceeding into three phases: Phase I to examine pricing flexibility for services subject to competition; Phase II to look at alternative approaches to ratemaking for LECs; and Phase III to consider lifting the ban on intraLATA competition for toll calls and related services. (Note: Considerable competition, both authorized and unauthorized, already exists in Pacific's service areas.)

To date, the Commission has completed Phase I and has had 61 days of evidentiary hearings with 43 witnesses testifying on behalf of 20 parties of Phase II of this OII. In addition, 13 public participation hearings were held throughout the State to provide an opportunity for members of the general public to express their views directly to the Commission.

These comprehensive proceedings have developed an extensive record (literally a stack of papers about 10 feet high) upon which the Commission can base its Phase II decision.

The Commission also has the proceeding in progress on enhanced services (A. 88-08-031). And Pacific anticipates there will be further action by the Commission on billing issues and on Open Network Architecture.

It is clear that the Commission has gone to great lengths to encourage Californians with many divergent interests to present their views in its proceedings. In addition, many groups and individuals send letters to the Commission explaining their views. Pacific believes that those who want to participate in Commission proceedings have ample opportunity to do so, and the record shows they do take advantage of those opportunities.

From this discussion one can easily see that the Commission has taken and continues to take comprehensive measures to

encourage presentation of various points of view from Californians with many different interests. Furthermore, many special interest groups also communicated their unique perspectives directly to the Commission in letters, ensuring their voices were heard. Pacific does not believe that such an extensive process needs to be expanded still further.

5.Q What would you recommend to the Legislative and the PUC of the 1990's as an appropriate approach to telecommunications policy?

5.A Pacific already has offered a comprehensive, balanced proposal to the Commission on this question, and it probably is not necessary to review that here. We believe our California Plan for Rate Stability does provide an appropriate approach to regulation through the 1990s. But if after some experience, policymakers believe some further changes should be made, a review process is appropriate. That's why we proposed such a review in 1992. It would be an opportunity to evaluate our initial experience under whatever regulatory framework the Commission adopts, and fix whatever may not be working.

Pacific has proposed holding rates for basic residential service at their present level through 1992. The review process we have proposed at that time would be the logical place to consider any changes in rates that may be needed beyond 1992. It also may be reasonable to link any such changes to some kind of adjustment factor, such as a price index. That would be an evolution of the regulatory process worth considering.

Pacific Bell's
California Plan for Rate Stability (CPRS)

- Enhance services; hold residence basic rates constant.

  Guarantee no increases in basic residential rates through 1992; no extra charge for Touchtone for residence customers; expand local calling areas for both residential and business customers. (In Zone Usage Measurement (ZUM) areas combine Zones 1 and 2; in non-ZUM areas eliminate toll band 2.)

- Give all customers -- rural and metropolitan -- access to a network which meets the needs of the Information Age.

  By 1992, replace older equipment with digital switches and transmission facilities. Perform this replacement program with no increase in rates.

- Gradually move business rates priced below cost toward cost.

  Match the increases toward cost with the annual revenue reductions, already authorized, for long distance access. This results in no net revenue increase for Pacific.

- Continue regulation, but make it more streamlined and responsive to market demands.

  Replace rate case and associated annual attrition filings with incentive-based regulation based upon actual performance that will allow Pacific to operate as efficiently as possible. Establish downward pricing flexibility for all services now priced above cost. Review Plan in 1992.

- Share profits above a benchmark rate of return.
  Divide equally with customers earnings over a proposed benchmark of 12.37%. Pacific commits not to ask for higher rates if earnings fall below the benchmark.

- Continue high-quality service to all customers.

  Provide the same standard of service quality as measured by the criteria set by the CPUC as well as from the customers' perspective.

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

In the Matter of the Application of PACIFIC BELL (U 1001 C), a corporation, for authority to increase intrastate rates and charges applicable to telephone services furnished within the State of California.	Application 85-01-034
And related proceedings.	I. 85-03-078 OII 84 Case 86-11-028

OBJECTIONS OF CENTER FOR PUBLIC INTEREST LAW

TO PROPOSED SETTLEMENT

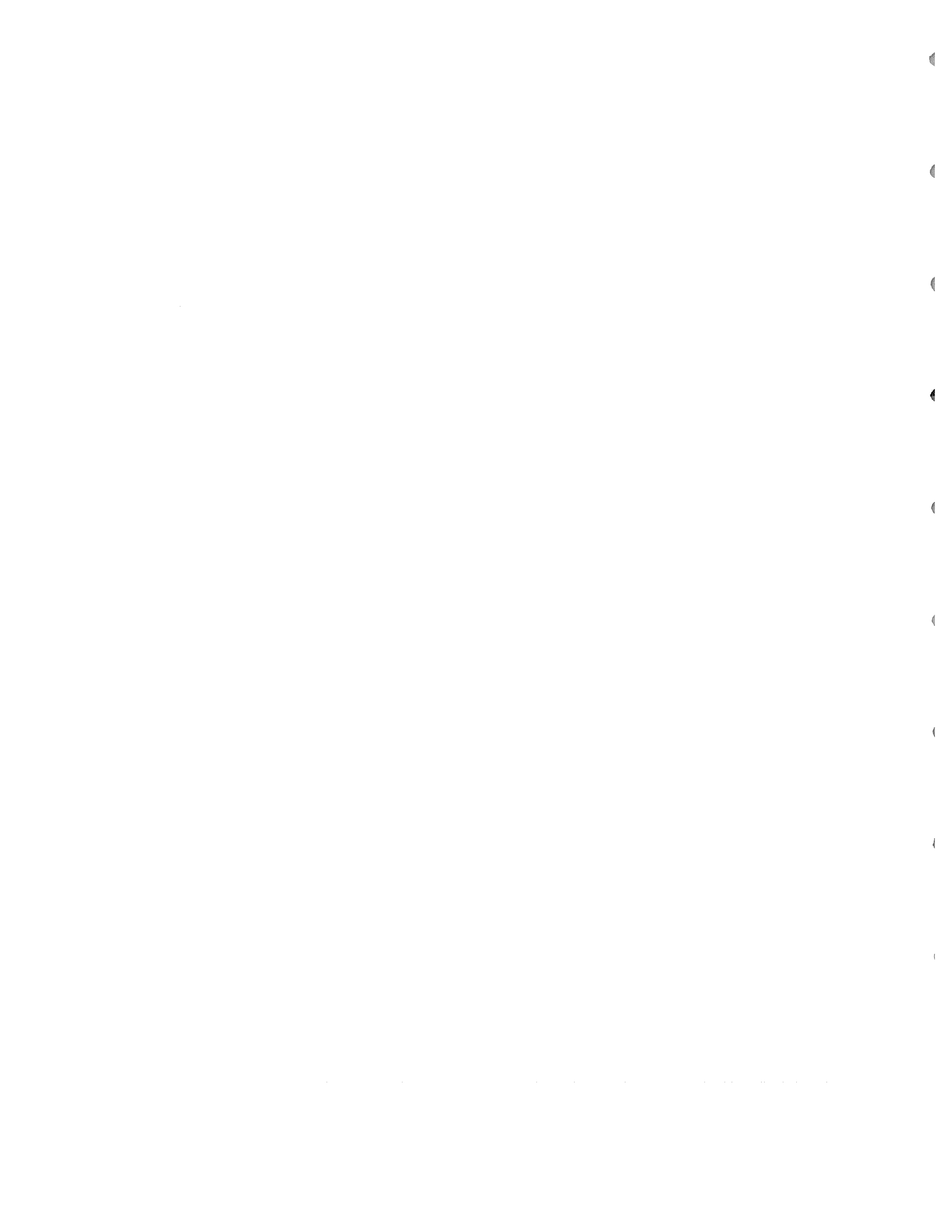
OF PHASE 3 OF APPLICATION 85-01-034

AND REQUEST FOR HEARING

March 16, 1989

James R. Wheaton
Center for Public Interest Law
University of San Diego
Alcala Park
San Diego, CA 92110
(619) 260-4806
(415) 431-7430

Exhibits A through I are not appended to all service copies. Exhibits are available upon request made to the Center for Public Interest Law.



The Center for Public Interest Law (CPIL) is a private nonprofit academic center. The charter of CPIL is the education of students in public interest law, focusing on state regulatory law issues. CPIL publishes the California Regulatory Law Reporter, an academic quarterly journal detailing the actions of the sixty business and trade regulatory agencies in California.

CPIL has participated extensively in Phases 1 and 2 of the instant 85-01-034 proceedings. CPIL's contributions to both phases were adopted by the Commission, including proposed policies for the application of curvilinear drivers in attrition formulae and the development of a defined policy for prudent cost calculation of utility advertising. Intervenor compensation was awarded for these and other CPIL contributions.

The major concern of CPIL expert testimony and cross-examination concerned the lack of a clear conceptual framework guiding prudency cost and "used and useful" rate base standards. Most important has been the failure of the utility to gather adequate information in categories necessary for the regulator to make proper decisions. Information concerning the impact of proposed rate changes and investment decisions on the utilization of current fixed plant committed to monopoly power loop facilities was an example of basic information lacking outside of the outside plant (OSP) matched pair utilitization percentages and central office utilization (COU) measures used by DRA to measure lack of utilization for penalty purposes.

CPIL's continued examination of the rate process increased our concern about the lack of relevant information absolutely necessary to enable the regulator to make proper decisions. As

the proceedings carried over into the Modernization, Utilization and Productivity (MUP) phase--which is the predecessor of the immediate proceeding, CPIL increased its participation and developed an outline proposal of the information appropriate to require in the case of major modernization commitments of a regulated utility, either in the monopoly power sector or in newly deregulated competitive sectors. That information requirement was formalized in a proposal for an "Economic Impact Statement" (EIS). It was not the purpose of the proposal to require a supplemental proceeding as a prerequisite to major modernization, but merely to precede those major commitments (which are difficult if not impossible to unwind once made) with very basic information from which a regulator could accurately judge important consequences central to this Commission's purpose.

During the MUP proceedings, CPIL gathered evidence in major document discovery efforts, produced expert testimony, and cross-examined witnesses. The cross-examination of PacBell experts was a particularly important part of this proceeding, since they admitted that the information to be required in CPIL's EIS proposal is in fact important to a proper evaluation of the appropriateness of investment decisions. CPIL presented substantial evidence that the information in its proposal is capable of presentation; is not included in any required form by the PUC; is not received by the PUC; and that, lacking such information, the Commission operates without knowledge about the most critical consequences of substantial modernization

investments in the complex economic setting of mixed monopoly power/deregulated competition.

Exhibit A herewith presents the Opening Brief of CPIL in that proceeding. That Brief sets forth the legal arguments and summarizes and cites evidence adduced by CPIL. Exhibit B presents CPIL's Reply Brief filed in that proceeding. Both of these exhibits are part of the official record of 85-01-034, as is the evidence cited therein.

On December 22, 1987, the Commission issued Decision 87-12-067 covering the MUP proceeding. The 339-page opinion decided most of the issues before the Commission. However, the extensive record laid by CPIL on the issue of modernization was temporarily deferred by ALJ Lynn Carew. Exhibit C contains the single page of the decision concerning modernization and addressing the proposal of CPIL. Although consideration of the A.D. Little Report and the SRI Report was deferred to the instant Phase 3, the decision promises a "separate modernization decision" within the next several weeks on the issue of modernization, and acknowledges that "...an extensive evidentiary record was developed during Phase 2, aimed at issuing a policy-related decision to assist in framing the issues for the Phase 3 modernization review. Pacific Bell, DRA, and CPIL presented evidence on these Phase 2 modernization issues, and filed opening and reply briefs, containing extensive arguments and analysis" (D.87-12-067 at 288).

As Phase III began, CPIL expressed concern. No decision was rendered by the PUC, as the D.87-12-067 indicates was intended. CPIL was in a quandary. CPIL is a "soft money" public interest

law center required to be self-supporting. PUC intervenor compensation, instead of enhancing market value fees with "multipliers", divides those fees where any portion of the advocacy is not adopted and attributable to the intervenor. CPIL had committed over $200,000 in market value time to two years of proceedings and had no result, notwithstanding a contribution it believed to be meritorious and necessary to the process. If its proposal were to be adopted, it would devote its energy in Phase 3 herein to its refinement. If it were rejected, such efforts would be moot and further exhaust its limited and by now depleted resources--a depletion which may jeopardize its future.

Meanwhile, the PUC embarked upon its related "In the Matter of Alternative Regulatory Frameworks for Local Exchange Carriers" (87-11-033). Many of the questions raised in this initial _en banc_ proceeding and then in its subsequent Phase 2 before the Honorable Administrative Law Judge Charlotte Ford raise the identical need for the information advocated by CPIL in MUP.

CPIL decided to participate in order to buy time while the MUP decision was forthcoming and to broaden and amplify its proposal. Exhibit D attached hereto includes the January 11, 1988 testimony by CPIL's Professor Fellmeth. Exhibits E and F include the Opening and Reply Testimony, respectively, of Professor Fellmeth in that Phase 2 proceeding. Exhibit G includes a reprint of a feature article outlining in another form the CPIL EIS proposal, as published in the _California Regulatory Law Reporter_.

When the instant proceedings covering the identical areas

began, we wrote a letter to the Administrative Law Judges involved: Lynn Carew, George Amaroli, and Charlotte Ford, respectively. That letter is attached as Exhibit H attached hereto. CPIL appeared and stands as a party in this instant proceeding. The Honorable ALJ Amaroli was kind enough to schedule a special hearing on the problem, jointly attended by the Honorable ALJ Ford, on December 16, 1988. (See Exhibit I attached.)

As a result of that hearing, it was orally agreed hearing that the instant proceeding would not foreclose the consequences of the delayed decision by the Honorable ALJ Carew scheduled for PUC adoption, and that CPIL would make its presentation on the subject before the Honorable ALJ Ford in 87-11-033. CPIL has arranged the stipulated introduction of the instant exhibits and additional information in that proceeding to support its proffered EIS proposal regarding minimal information provision requirements as predicates to major modernization investment commitments by PacBell. Although a party, we relied upon that decision and did not present the extensive body of evidence and analysis in the instant proceedings. Nor were we in a position to litigate for a third time the same point.

Now we are presented with a comprehensive proposed "settlement" which violates the instruction of that hearing and which would render moot both the prior and current proceedings of the Commission on this subject. We object to the terms of the proposed settlement, and request a hearing thereon pursuant to Rule 51.5 of the Commission's Rules.

We have reviewed the Little and SRI reports. They fail to

address the issues raised by CPIL's proposal. They generally fail to see the forest for the trees.

The instant proposed settlement scheduled for conference on March 22, 1988 appears to provide the final insult to CPIL before the Commission. PacBell and DRA propose to stipulate to conditions that avoid gathering the basic information absolutely necessary for the Commission to do its job competently. Instead, PacBell agrees to pay $36 million in an annual revenue reduction in each of four years. This amount is <u>not</u> a significant percentage of gross revenues. PacBell agrees to negotiate with SRI (a private concern) in an "interactive, nonadversarial process" (whatever that means) an "evaluation" of appropriate modifications of Pacific's investment decisions in these areas:

"1) Non-guideline driven investment justifications;

2) Engineering guideline justification;

3) Documentation standards and their enforcement;

4) Training/professional development needs; and

5) Peer reviews including feedback process."

Leaving aside the substanceless jargon to which professional consulting firms are addicted, this proposed procedure avoids the gathering <u>or</u> presentation <u>or</u> review of the basic information the regulator must have to evaluate a major investment: (1) What is its impact on the utilization of current fixed plant in the existing monopoly loop upon which ratepayers must rely and which is the most fundamental concern of the regulator? (2) What is the impact in terms of marketplace intrusion from monopoly power sourced financing?

CPIL has presented the nature of these concerns, their history, and a brief outline of the kinds of information which CPIL argues should be required and monitored by the regulator. The cost-benefit analysis modus operandi of the consulting firms is here badly misplaced. Such consulting firms can easily advise private concerns operating in the marketplace how to measure benefits and costs for profit maximization. But the substitution of such schemata by a public agency for its very different duties is inappropriate. The systems here at issue do not measure utilization. They do not measure external costs commonly at issue. They do not concern themselves with anticompetitive impacts. Since these are the abuses which led to divestiture and which drive the need for regulation, their omission from PUC consideration is both baffling and irresponsible.

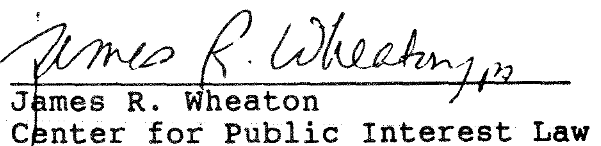
In return for a trivial and easily manipulated-away revenue reduction, and the privatization of modernization review to a conulting firm--which will be thereafter financed by PacBell, the utility obtains a blank check. "There will be no audit or follow-up audits of modernization investment decisions which are implemented by Pacific...." It is unclear to CPIL how a government agency can constitutionally enter into a binding agreement not to regulate so long as the utility follows the instructions of a private concern the utility will thenceforth pay.

Exactly whose idea was this? Who is going to blow the whistle when the utility decides to cross-subsidize from the monopoly sector into a major competitive investment which meets

all cost-benefit criteria--except for the fact that it is a predatory effort violative of the principles behind the Robinson-Patman Act and gratuitously destroys more efficient small business entities competing in that sector? Who is going to measure the higher rates which must be borne because monopoly loop modernization investment expands fixed costs and lowers utilization of existing plant? Presumably, we'll ask PacBell to renegotiate its contract with SRI and lower their commissions.

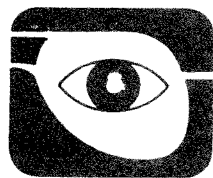
If the PUC wishes to consider seriously this proposed settlement, CPIL asks that it be approved without prejudice to the EIS proposal of CPIL still pending before ALJ Carew and now before the Commission in 87-11-033. A failure to allow for the modification of this settlement to require that information and its evaluation as a predicate to any modernization investment approval would create a procedural problem making the settlement and ancillary PUC proceedings subject to court reversal. Two separate proceedings now affect the subject area of this proposed stipulated agreement. Both are still pending. This agreement would bind the Commission to terminate or limit both not through the mechanism of those proceedings, but through a separate proceeding which did not have available to it the evidence and advocacy before the other tribunals. Such a posture creates a regulator at war with itself, with related proceedings binding other proceedings based on partial information.

Respectfully submitted,



James R. Wheaton
Center for Public Interest Law

FEATURE ARTICLE



Regulation of Telecommunications Utility Modernization Investments: A Proposal to Require An Economic Impact Statement

*Robert C. Fellmeth**

INTRODUCTION: DEREGULATION, COMPETITION, AND THE REGIONAL BELLS

A "natural monopoly" is normally subject to maximum rate regulation.[1] Such a monopoly exists when economies of scale for a single physical plant structure exist across the full range of expected demand for that structure.[2] Such a structure usually involves high initial fixed costs, as with a railroad or power utility. In other words, there is room for only one enterprise to operate efficiently. It is uneconomic to repeat rights of way, tracks, or lines where a single system accommodates all of the anticipated traffic.

Maximum rate regulation is imposed by state public agencies to prevent excessive prices, and also to assure the owners of the monopoly a fair rate of return on their investment.[3] The purpose of regulation is to substitute for the absent marketplace. The ideal market—which would normally allocate resources according to consumer preference through purchasing decisions, and improve competitive performance through the natural selection of the most efficient—accomplishes neither function where a natural monopoly exists. The regulator must somehow set fair prices and prescribe conditions of operation to satisfy consumer preference and stimulate efficiency improvement.

But what happens when the monopoly enterprise wishes to enter into areas where there is competition—where there is clearly room for more than one entrepreneur? What happens when the structure of the industry begins to change so that the fixed cost structure becomes divisible, or perhaps usable by several competing entities? What happens when it can be bypassed entirely to provide the same service without reliance on the fixed cost structure? What happens when some people are still dependent upon the fixed cost natural monopoly, but others can avoid it, abandon it, lower its utilization, and raise the unit costs for those who must continue to rely upon it? What happens when competitors can take from the fixed plant traffic and "skim the cream," thus removing the high-profit traffic from the fixed plant monopoly enterprise?

These are basic regulatory questions. They are not new. They have been faced, albeit sometimes very unsuccessfully, by the federal Interstate Commerce Commission in its regulation of railroad rates as they interplay with water carriage and trucking enterprises also subject to regulation.[4] And in the establishment of both power and telecommunications regulation, state public utility commissions have confronted monopoly/competitive sector interaction in a host of contexts: regulated companies dealing with affiliated (non-regulated) suppliers operating in the competitive sector;[5] and protection of a natural monopoly structure from competition.[6]

But no area presents these questions more starkly than does the continuing technological revolution in telecommunications. Cable television regulation by state and local authorities involves local companies often given effective monopoly franchises, with extremely crude and scandalously deficient arrangements for rate regulation.[7] Here, a new enterprise raises increasing and serious natural monopoly questions in the control of information distribution, not merely as to recently-addressed issues of free speech access,[8] but in the ignored area of rate review.[9]

In our more traditional telephone and data communication systems, we are moving somewhat away from what has been an overwhelming natural monopoly structure. Substitutes for some services heretofore thought to be the province of pre-1984 AT&T and its subsidiaries are technologically feasible apart from the rights of way and lines which formed their high fixed cost "loop". These advances are still largely in gestation, but they do portend possible changes for America's telecommunications industry.

The interaction of competitive business sectors with our telephone monopoly is not new, except historically it has occurred by abuse from the monopoly side into the competitive sector rather than by competitive challenge to the monopoly. AT&T has a long history of incursion into the competitive sector beyond the scope of its monopoly responsibility. It has used its monopoly power to eliminate competition in areas of non-monopoly enterprise in which it was involved.[10] For example, consumer phone equipment may be manufactured by any number of entities, and the activities of then-AT&T regional phone subsidiaries in prohibiting connection to their loops of any equipment except that manufactured by its own subsidiary or affiliated companies have been documented in antitrust litigation over the past two decades. And there are other abuses one might expect, given the verity of Lord Acton's sage dictum that "power corrupts; absolute power corrupts absolutely."

There proved to be a check on the abuses of AT&T: the Antitrust Division of the U.S. Department of Justice.[11] In ordering the divestiture of AT&T and the break-up of the Bell operating systems into separate regional companies, Judge Greene in *United States v. AT&T* dramatically reshaped the industry. The concept was not complex: structurally inhibit monopoly power abuse; allow competition where new technology moots the natural monopoly structure; and confine the monopoly to its minimum territory. The brunt of the monopoly power was left with the spin-off independent regional Bell companies. They control the high fixed cost "loop" of rights of way and lines upon which most of us still rely for our telephone service.[12] The generic name for the pro-

The author is a tenured professor at the University of San Diego School of Law and director of the University's Center for Public Interest Law, and is serving as an expert witness during the ongoing Pacific Bell General Rate Case proceedings before the California Public Utilities Commission.

viders of this local loop (the Regional Bells and other small providers which exist outside the previous AT&T structure) is "local exchange carriers," or—in the jargon of telecommunications—LECs.

Now, with the devolution of these LECs, we are left with a new version of old questions, except the interaction is two-sided. New technology may challenge these local monopolies, injuring the monopoly power structure upon which essential services still depend. And the local Bells are anxious not only to meet any such challenge, but to expand into areas of commerce clearly subject to competition and which do not necessarily require any natural monopoly connection.

Some of the parameters of LEC entry into competitive sectors will be set by Judge Greene as he refines his *U.S. v. AT&T* order, but in the long run they are likely to depend more substantially on regulation by state public utility commissions, which now have what is for many of them a newly complex problem: what to do about the proclivities of these LECs to use their still-existing monopoly power structure for advantage in the competitive sector?

This question is a great deal more difficult than the traditional maximum rate regulation questions, such as the definition and calculation of proper rate base, prudent expenditures, anticipated revenue, and fair rate of return at a sensible debt/equity ratio on invested capital. Now we have additional variables: antitrust concepts and concerns; issues of cross-subsidy; protection of the monopoly fixed plant from underutilization; and others.

Moreover, we have regional Bells and other LECs singing a consistent song: if competitors are going to challenge us, let us challenge them. The LECs insist that a new day is already upon us—that their monopoly power system is being bypassed by new technological challenge; and that COMSAT, microwave relays, and private fiber-optic networks are skimming the cream off their high-profit commercial data and other traffic. They argue that in this era of "deregulation," they should by deregulated as well, and should further be allowed "rate flexibility"—that is, the right to lower rates for specific customers to retain high and efficient traffic levels where those customers are presented with competitive alternatives. They want to invest heavily in modernization to maintain that same traffic or to attract new traffic. That modernization will provide services already or prospectively available from competitive sector sources. The LECs seek latitude to compete.[13]

An examination of these issues is now underway in California as applied to Pacific Bell (PacBell), the regional Bell LEC subsidiary of Pacific Telesis. As part of its initial post-divestiture rate review, the California Public Utilities Commission (PUC), to its credit, has entertained a separate yearlong phase on questions of PacBell's modernization, utilization and productivity (MUP).[14] Growing from this proceeding (which is still ongoing) is a November 25, 1987 order of the Commission to consider *en banc* PacBell's request for "pricing flexibility" for services subject to competition, and certain other related questions.[15]

The Center for Public Interest Law (CPIL) has participated in these hearings and has had the opportunity to conduct regression studies on the cost and traffic features of the PacBell physical plant as it is evolving. CPIL has also had the opportunity to engage in substantial discovery into PacBell operating documents and internal memoranda. CPIL has offered its own hearing testimony and exhibits, and has cross-examined at some length those experts provided by PacBell. These proceedings serve as a useful forum to examine the basic regulatory issues, precedents, and policy alternatives applicable to the regional Bell companies and other LECs.

Based on that examination, and on the information currently available from which regulatory decisions are made, CPIL has proposed the formal adoption of a required Economic Impact Statement (EIS), which must be filed by a regional Bell LEC before committing itself to a major modernization investment program. Completion of the EIS would provide a clear structure, consonant with sound regulatory policy, for the proper evaluation of such ventures. And its principles are applicable not only to modernization expenditures to increase traffic, but also to LEC-proposed "rate flexibility" plans, where rate reductions toward out-of-pocket costs (and without overhead contribution) are proposed for a particular group of customers to meet competition.

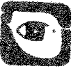
PACBELL'S MODERNIZATION PLANS AND CRITERIA

During 1986, PacBell spent some $2 billion for new construction.[16] Expenditures for both growth and modernization will consume many millions of dollars in additional rate base funds, upon which a rate of return or debt interest payments will be assessed from ratepayers. Over the past decade, much of this "modernization" has involved the replacement of existing switching facilities with more advanced electronic technology.[17] Much of this aspect of PacBell's modernization program has been completed,[18] and PacBell now proposes to enter into a "market need concept," with emphasis on profitability.[19] The electronic switching modernization was justified under a "CUCRIT" formula (discussed *infra*) where direct cost advantages in comparison with existing equipment allegedly justified the investment made.[20]

The utility now proposes, often under the misnomer of "revenue factors," to advance a modernization program with implications far beyond switch upgrading justified by lower maintenance costs. The LECs are now advancing fiber-optic technology.[21] The alteration of basic transmission equipment has implications beyond a simple "the maintenance cost savings pay for this improvement" kind of calculation. More important, the LECS are now proposing major ventures into areas subject to unregulated competition, from alarm services to modular phones to data transmission services.[22] And the LECs are focusing system changes in areas where they believe bypass threatens loss of business.[23] Further, they are entering directly into the offering of products and services available from competitive sector sources.[24]

PacBell (as with regional Bell LECs generally) has confined modernization criteria substantially to the use of its CUCRIT formula. This formula calculates the net present value of alternative technology or equipment strategies based on discounted cash flows.[25] It purports to calculate whether or not a "modernization" investment is more cost-effective than present equipment or alternative proposals. The value of such a calculation is undeniable.

But PacBell is interested in directing its modernization efforts not merely where more efficient equipment can do the same task more cheaply, but in areas where it can offer new services altogether, particularly where competition threatens the loss of existing customers.[26] In PacBell testimony during current PUC rate hearings, witnesses consistently stressed a need to return to market concepts to maintain the satisfaction of long-term existing customers.[27] PacBell's expert witness Sullivan contended that PacBell had specific areas "vulnerable to competition."[28] PacBell witness Bandler testified that "modernization is the



orderly integration of new technology," and that the post-divestiture environment requires "flexibility" and a "profit orientation."[29] PacBell witness Whittiker testified that the utility must achieve economic growth and evolution.[30] And, with particular candor, PacBell witness Copeland testified that the purpose of modernization should be to maximize the pool of money available for distribution by the utility,[31] and in testimony defended this rationale as sufficient, standing alone.[32]

PacBell leaps from its CUCRIT history into broader arenas by citing "revenue factors" which vaguely must be taken into account.[33] They are to be examined by unannounced criteria on a "case by case" basis.[34]

MISSING MODERNIZATION CRITERIA

LECs cannot justify major modernization decisions in the new environment based on a CUCRIT formula standing alone, or supplemented by "revenue factors" based upon the need to stem traffic loss because competitors take traffic from their fixed cost plant or "loop." The new environment faced by the LECs makes the introduction of other relevant considerations essential. These additional factors perhaps understandably are not considered by a utility which has never previously dealt this substantially in the competitive sector, and which continues to operate by examining internal cost efficiencies and external factors affecting growth. Where growth is not a function of mere "forecasting," but may be a dynamic interaction between the LECs' cost advantages and those cost advantages of companies operating in the competitive sector, the criteria relied upon before advancing risk capital must be much different. We now do not have the mere task of forecasting population and use growth or decline. We now have the possibility of substantial changes in utilization levels for fixed plant. We now have a PacBell modernization commitment which will bring a counter-stroke by those in the competitive sector. Based on the state of the record in the MUP phase of the PacBell rate proceeding before the California PUC, these prospects are not familiar concepts to LEC managers.[35]

Apart from the utility, the regulator has additional responsibilities to calculate whether or not the utility should enter into a sector otherwise served by competitive forces, to measure the effect of such entry on the structure it regulates (particularly the monopoly power portion where its stewardship remains), and to measure cross-subsidies both within the utility between competitive and noncompetitive areas, and between the utility and those outside forces contending with it.

Utilization and Economy of Scale Analysis

As an LEC, PacBell remains a high fixed cost enterprise, subject to increasing competition for some of its business, while retaining monopoly power for the brunt of it.[36] As a general matter, higher utilization of its network lowers average costs, promoting affordable rates and universal service, and can also mean avoidance of duplicative investment.

It is theoretically possible for competitors to remove traffic from the fixed plant portion of PacBell ("bypass"). It is also possible that the fixed plant cannot be "stepped down" or reduced in size to accommodate that lower flow at high utilization levels. Where that decline in traffic lowers the utilization of fixed plant, revenue requirements per unit of traffic increase. Unit costs go up if the same plant handles less traffic. This loss is particularly important if it affects high-profit traffic already cross-subsidizing those who have no alternative but PacBell services. Hence, PacBell's theoretical argument that "universal service" is threatened may have merit if those conditions giving rise to the danger exist.[37]

In its Notice of En Banc Hearing to consider modernization criteria, the PUC acknowledged the relevance of utilization analysis, but fell into a conceptual trap in assuming that: "[f]ull network utilization has two components: (1) retaining and expanding the customer base for existing services and (2) adding new services."[38] In fact, full utilization[39] of the local network and accompanying lower average costs are not directly or necessarily dependent on either retaining existing customers, or expanding customers, or adding new services.

To assume that maximizing each of these factors necessarily leads to lower average costs presumes that the local exchange network is everywhere operating below its optimum, and therefore all customers should be retained and more traffic added. There is no data to support this thesis and much to refute it. Particularly as it assumes that growth is always preferred, the theory is on decidedly thin ice, and the regulator should be wary of going very far with it.

The LECs routinely assume that there are essentially infinite economies of scale and that increased efficiencies are always possible through the capture or retention of maximum traffic. For example, they routinely assume that more net access lines (NALs) yield greater overall efficiencies. Thus, PacBell's efficiency measures traditionally rely on figures derived from NALs. However, and as admitted by PacBell's expert economic witness Dr. Lewis J. Perl,[40] it is a well-known axiom of economics that very large enterprises often reach a point of diseconomy of scale. That is, they achieve maximum efficiency at a given size, and further traffic addition requires capital or other cost commitments which raise the unit cost of providing service. Hence, additional traffic can increase average costs for all customers and diminish overall plant efficiency.

It is critical that the regulator not assume that the LECs have infinitely increasing economies of scale. As a simple illustration, if a major sunk-cost facility serving a stable market is already operating at 95% utilization, it may be very unwise to permit expansion of new services in that area, in order to generate 10% more traffic, if that will necessitate major new capital expenditures for core services. These costs would be over and above those directly related to the new services, and would be borne by all ratepayers, yielding a net increase in average costs. This same *caveat* exists in allowing the LECs to lower rates to marginal cost (that is, out-of-pocket costs) to keep traffic or attract new traffic when the result may be required capacity (plant) expansion costing a great deal more than the low rates charged for that traffic. This concern for both rate lowering or modernization commitment to keep or enhance traffic is especially appropriate, since both rate breaks and modernization are generally directed at various kinds of business traffic—and the surge of business traffic from 9:00 a.m. to 5:00 p.m. is what compels the capacity levels of current plant in the first place.[41]

The generally correct statement in the Notice that "higher levels of network utilization lower average costs" goes astray with the apparent corollary that expanding the customer base and adding new services are necessary components. That analysis "assumes only straight line total cost curves, a highly unlikely possibility."[42] Therefore, while it may be true as a general matter that increasing levels of traffic may lead to increased levels of utilization which may lead to lower overall average costs, the regulator should not adopt that syllogism uncritically in every case. When-

ever an LEC refers to utilization levels to justify capital expenditures (or selectively lower rates), either to retain existing customers or to expand the customer base or products, the regulator must examine the underlying thesis with extreme care to be certain the data justify the assumptions.

CPIL has performed a rudimentary study of PacBell's economies of scale, in order to preliminarily test the assumption that "expanding the customer base" and "adding new services" are linked to decreasing average costs.[43]

The genesis for the study is a simple set of facts. Since 1970, PacBell has more than doubled in size. If it is true that economies of scale exist, then the increased size should reveal that average costs are declining as more traffic is handled. The questions are obvious: as the number of NALs double, what happens to normalized average costs per line? Per CCS message unit (a measure of line wage)? Per number nine toll call? When the plant handles twice as many CCS message units, does the average cost of CCS message units, adjusted for inflation, decline? What is the case for toll calls?

CPIL's study has been hotly disputed by PacBell, which would prefer it be discarded. CPIL has never pretended its study is definitive or comprehensive; it could not be, since only PacBell has the data and wherewithal to perform complete economy of scale studies. However, two factors from the CPIL study stand out: (1) a large LEC such as PacBell may already be close to an optimum size such that little if any further decreases in average cost can be anticipated from further growth;[44] and (2) PacBell has steadfastly refused to do even preliminary work to determine its economies of scale in its own plant, either as a whole or as to any of its parts relevant to its modernization plans.[45]

CPIL used data supplied entirely by PacBell, and used PacBell's own "Telephone Plant Index" to normalize costs for inflation. CPIL took each separate PacBell cost factor, as well as total costs, and ran a series of statistical computer regressions. The results are remarkable. There is very little reliable relationship in the individual cost accounts as to the unit costs at varying PacBell operational sizes. No measure of growth compared to costs shows any strong economy of scale, and some may even show diseconomies of scale. In all cases, the curve is very shallow, suggesting that while there may be diseconomies of scale as CCS and NALs have grown, and some economies of scale as toll calls have increased, the difference in unit costs produced by increases in NALs, CCS, and toll calls is very slight, whether higher or lower. Thus, the gross measures relied on by the LECs do not evidence any substantial economy of scale structure.[46] Fluctuations up or down in total traffic simply may not make any statistically significant difference in average costs.

This study and its results should not be the end of this inquiry, but should give the regulator pause before adopting a generalized theory of growth assuming economies of scale and necessarily leading to lower average costs overall. Before the Commission relies on that syllogism for its decisions, it should require the LECs to collect and provide appropriate analyses of their economies of scale.

This argument is not meant to imply that economy of scale and utilization analysis should assume no economies of scale. It is possible that for a given aspect of an LEC's plant (*e.g.*, where fiber-optics are being applied), there is a major economy of scale feature. It is also possible that the relationship between traffic and cost is curvilinear and that, for example, diseconomies of scale for NALs become sharply more pronounced as NALs are added. These questions are not dispositive, but illustrate the most challenging aspect of the study: the LECs have *no* idea of their economies of scale and have conducted few if any studies to determine them.[47]

Turning from the link between growth and average cost to the particular case of competition within the existing customer base, the threat of bypass does not necessarily mean a decrease in utilization or an increase in average costs. The regulator should not assume that fixed costs assigned to a customer who opts to bypass the system will necessarily stand idle following loss of the customer.

First, of course, to the extent that the organization has grown beyond its optimum size, stepping back in a particular part of the plant may result in net savings for all. Even more important, the loss of the existing traffic from bypass may simply not register at all, due to growth.

The astonishing continuing growth in demand for telecommunications services—regardless of population or economic indices—belies any hard connection between bypass and absolutely lower utilization levels. For example, PacBell faces growing demand regardless of competition. The loss of a particular customer does not necessarily diminish overall utilization; rather, it may simply slow the rate of growth. In the revenue requirements phase of the ongoing General Rate Case, for instance, PacBell's witnesses identified various increasing sources of traffic for PacBell's future business.[48] Every one of the indices of traffic and operational size increase available—number of new telephones, CCS units, NALs, and number nine toll message units—indicate steady increase every year, with the exception of one measure during one year.[49] The evidence is conclusive that regardless of some competitive challenge, traffic continues to increase. Thus, bypass by a given customer, or even class of customer, may be swallowed by the continuing growth in other customer classes.

Accordingly, the regulator should avoid the LECs' kneejerk reaction to alleged customer loss. Although the LECs may have an institutional desire to retain every customer, the regulator should not share that goal, and steady traffic increases raise doubts about the validity of a syllogism automatically linking retention to high utilization to lower average costs.

Despite the evident need for data on utilization, PacBell and the other LECs have done nothing to gather the data they need, or to apply it to their competitive investment decisions. Even PacBell's own econometricians acknowledge the need for utilization data. For instance, PacBell's Perl has recently testified that with regard to the marginal cost of additional services, "in order to assess that you have to know whether those costs vary depending on the scale of the output."[50] Furthermore, he agreed that specific utilization projections were necessary regarding specific parts of the plant affected by a modernization decision before the investment could be made.[51]

Another of PacBell's experts testified that valuation of outside plant (OSP) utilization must be based on "incremental cost analysis and not on simplistic analysis...."[52] Similarly, yet another PacBell witness has argued that the measurement of central office utilization (COU) is not adequate.[53] Yet these two indices of utilization (OSP and COU) are the *only* indices available from current PacBell data, are not presented by the utility by aspect of plant affected by an investment decision, and play no role in rate or modernization decisions at PacBell. Nor are they a part of

PacBell's CUCRIT benefit-cost computer model.

The significance of utilization and economy of scale analyses is not new to the California PUC. The Commission has already recognized that there are severe problems with simply assuming that costs are directly correlated with growth. In Decision 86-01-026, the Commission specifically put the LECs on notice that uncritical application of "sizing drivers" (allowing costs to pass through and allow more revenue based on a percentage increase in new traffic or NALs added) is a thing of the past.[54] At the urging of CPIL, the Commission for the first time refused to simply assume any straight line relationship between net access lines and costs, and instead demanded a close analysis. "In future rate proceedings, we expect Pacific Bell, General and Continental to address in their direct showings the correlation between their various sizing drivers and incremental expense changes."[55] In other words, if the PUC calculates that an LEC justifiably needs $800 million in revenue to operate in 1987, the LEC projects 10% more traffic (or 10% more NALs) in 1988, and the next rate proceeding is set for 1990, how is the revenue requirement for 1988 to be figured? LECs will propose, in an abbreviated "attrition" proceeding, that rates be set to yield $880 million—a straight-line sizing driver. But if there *are* economies of scale, the unit costs should decline with additional traffic and costs should be projected at less than $880 million.

The California Commission has rejected the notion that there is a direct correlation between "expanding the customer base" or "increasing traffic" and total costs. Economies of scale must be considered. Regulators should be careful not to inferentially readopt, in the context of allowing modernization investment to protect unit costs, what they have rejected in the context of traditional monopoly ratemaking.

CPIL has presented to the PUC four threshold sub-tests of utilization which should be considered in making a modernization investment decision. These factors are quite beyond the CUCRIT considerations of PacBell.[56] These four tests form the "utilization" element of CPIL's proposed EIS requirement, and should provide the basis for PacBell justification and PUC review of a proposed modernization investment.

First, the PUC must determine that there is in fact a natural monopoly structure appropriate for protection. If all services deemed necessary by society can be provided by the competitive sector, there may be no inevitable natural monopoly structure to warrant concern.[57] Clearly, such a monopoly structure exists today as to most or all LECs.

The second test concerns the impact of the modernization investment on utilization of existing plant. Although the PacBell CUCRIT formula partially measures utilization of the specifically proposed modernized equipment, it does not measure utilization impact on ancillary equipment, or on the plant as a whole—and, as explained *infra* these are critical factors. In order to determine whether or not a system efficiency benefit will accrue from a modernization program, one must know which aspects of the utility plant are fixed and which are variable (*i.e.*, how do the costs respond to changes in traffic), and also the utilization levels for major fixed cost increments.

For PacBell or another utility to consider a modernization investment, it must make a sophisticated economy of scale and utilization analysis.[58] Then it must determine to what extent a proposed modernization project will affect economies of scale and utilization levels resulting thereafter. This analysis must include those aspects of fixed plant connected to it and affected by it.[59]

This analysis is particularly called for as to PacBell, given the fact that the gross unit cost numbers appear to justify, in and of themselves, no modernization campaign to maintain either NAL or CCS levels, and only an extremely focused and frugal modernization effort to maintain toll call levels. Given the fact that toll call levels have doubled during the last eight years, it is doubtful that a substantial argument could be made for modernization investment to stem bypass even here. And, as noted above, all traffic measures have been steadily increasing. However, the data to support such an argument may be available as to a particular part of PacBell's plant, and should be marshalled if applicable.

Following this analysis, PacBell must move to the third consideration relevant to utilization: that of "indivisibilities." To the extent it finds declining utilization or substantial economy of scale structure, to what extent can fixed plant be "stepped back" or reduced and put to alternative use? How big are the pieces of fixed cost increments and over what period of time can they be adjusted to the alterations and traffic flow *in futuro*?[60]

Finally, PacBell must calculate the cost of modernization on a unit basis *vis-a-vis* the savings which will occur from the increased utilization of physical plant. It must measure the cost savings from increased utilization and calculate that against the cost of modernization. These are calculations above and beyond those required by the CUCRIT formula, but they are important to any modernization investment decision which does not rely on straight out-of-pocket cost savings justifications.

Competitive Impact and Cross-Subsidies

PacBell and other regional Bells and LECs are increasingly subject to competition. In the tradition of monopoly enterprises, PacBell seeks to use its market power to extend itself into areas subject to competitive challenge. This extension by a utility requires a measurement of the competitive environment. At the most basic level, the utility must look at its new venture unit costs *vis-a-vis* those of its existing or likely competitors. If the competitors can do it more cheaply, the utility should not try it, even if the competitors' *current* prices are high enough to give the utility a theoretical profit on its new investment venture. Further, the regulator must be sensitive to the cross-subsidies which may be implicit in a new investment—including where certain users pay a larger proportion of total utility fixed plant overhead, or pay for modernization capital costs while those using modernized facilities or services pay only out-of-pocket costs.

Finally, the impact on outside entrepreneurs and the competitive marketplace should be evaluated. These competitive impact concerns form a part of the major discipline of antitrust law. Prior and limited monopoly/competitive sector interaction has given rise to a series of egregious restraints of trade by AT&T, PacBell, and others, which have resulted in extensive litigation and court-ordered divestiture.[61]

As in the area of utilization, however, the LECs have been woefully deficient in recognizing or gathering the most basic economic data needed to assess the competitive impact of their entry into new markets. In evaluating an investment designed to compete with existing facilities available in the market, several steps must be considered—none of which are part of the criteria currently used by the LECs. The regulator must impose upon the LECs the obligation to assess the competitive impact of their

investment decisions.

First, the LEC must measure the current and potential cost structure of its competitors. Any entrepreneur in the marketplace seeking to venture risk capital will begin by surveying the market and will then evaluate the present and potential competitors capable of offering competing cost structures.

In effect, most LECs are still bound by the monopoly mentality. They measure only two factors in making their modernization investment decisions: their own internal cost factors, and external factors only as they affect growth. They utterly ignore the competition. They simply fail to recognize that the environment is not a benign one which is static; on the contrary, competitors will react to the LEC's entry into the market, and customers will react to both the competitors and the LEC. In the simplest terms, the competitors will immediately begin to drop their prices to best the LEC. The LEC must therefore also begin to lower its price to stay competitive, or offer other incentives that raise the LEC's cost to retain the customer.

In either case, the cost and revenue figures calculated in the vacuum are no longer relevant. A vigorous competitive marketplace ensures that this kind of move and countermove will continue, as each side drops its prices toward its long-run marginal costs. Neither side can long continue in the market once the price drops below its marginal cost. However, the LECs simply fail to assess their competitors' cost structures to determine whether they have an inherent cost advantage that will necessarily result in the competitor undercutting the LEC.[62] This most basic information that every shopkeeper needs before he opens his doors—how low can I go and how low can the fellow next door go—is utterly lacking in one of the largest companies in the state.

In addition to gathering basic competitive data, the LECs must be required to calculate cross-subsidies. To the extent cross-subsidies may be involved within the LEC in order to carry the competitive enterprise, they should be revealed. It is possible that this cross-subsidy may take the form of low utilization levels of new modernized plant, to be carried by lower levels of utilization and higher average costs by existing ratepayers. If so, the analysis urged above as to utilization should reveal that cross-subsidy. There may even be subtle cross-subsidies (profitable aspects which are carrying below-marginal-cost ventures).

Finally, the regulator must be concerned with issues which escape the LECs regarding the legal impact of utility intrusion into the competitive sector. LECs are in a position to commit what would otherwise be antitrust violations in the marketplace. These violations may include all or any of the following vagaries of behavior traditional where an entrepreneur possesses substantial market power in one market and intrudes into another: group boycotts (Sherman Act Section 1); tie-ins (Sherman Act Section 1, Clayton Act Section 3); predatory practices (Robinson-Patman Act, Sherman Act Section 2); and/or unfair extension of monopoly power (Sherman Act Section 2).

The problems of deferring to a utility's unbridled discretion as it operates in the competitive sector predate *U.S. v. AT&T*, and occupy a large part of the archives of antitrust abuse. The body of law stretches from the 1922 *Keogh v. Chicago & N.W.R.R.* case[63] to the cable television cases recently under litigation.[64] A review of the findings of facts in these cases, and literally thousands of lower court progeny, should make any regulator cautious about countenancing monopoly entry into the competitive sector without maximum information and at least a modicum of prophylactic safeguard.

In addition to monopoly power abuse, a natural monopolist intruding into the competitive sector raises the same problems as those which exist in the body of regulatory law known as "dealings between affiliated enterprises." Problems commonly arise where a regulated monopolist buys and sells, not to obtain maximum service at optimum cost, but in a setting of ancillary interests and motives. PacBell's dealings from monopoly to competitive challenge sector include the same imprudence and cross-subsidy dangers as do dealings with affiliated enterprises (which may also be directly involved as well). These scenarios traditionally demand cost review and impact assessment.[65] In fact, the most pernicious modernization abuses involving negative utilization and competitive impact implications are likely to be cloaked through affiliated enterprises, making this analysis and proposal relevant to the examination of modernization projects of affiliated enterprises a critical part of rigorous affiliated company review.

As noted above, the problems of monopoly competition interaction are not matters of first impression. In transportation and in communications, analogous precedents exist which support required review of the competitive impact outlined above. A leading case is *FCC v. RCA Communications, Inc.*[66] There, Justice Frankfurter reviewed FCC policy concerning an attempt by Mackay Radio and Telegraph Company to compete in an area of RCA's FCC-granted franchise. The Court reversed the Commission's allowance of competitive interaction, and thoroughly scolded the regulator for simply assuming a benefit from competition as a "national policy" without a thorough, fact-based inquiry into public interest impacts. The Court rejected the notion that competition is automatically to be preferred, or that regular monopoly intrusion into competitive areas is to be presumed.[67] The Court then instructed the Commission to evaluate in detail the interaction between monopoly and competition in setting its policies.[68]

In *American Commercial Lines, Inc. v. Louisville and Nashville Railroad*,[69] Justice Marshall explored in detail the kinds of cost comparisons which should be evaluated by the Commission in determining regulatory policies. The issue there turned on whether the railroad should be allowed to compete against water carriers, which are not a natural monopoly, in the carriage of ore. Related to the issue of the monopolist's desire to invest in modernization of the competitive sector in order to capture business now carried by another, the railroad sought a reduction in rates to allow it to compete. The first area of detailed consideration was the "inherent cost advantage" of the railroad's monopoly structure seeking entry into the business area of the barges. Justice Marshall discussed the ICC's computation of both modes' fully distributed and out-of-pocket costs per ton,[70] and then the history and meaning of the term "inherent advantage."

The entire context of the *American Commercial Lines* decision—and, indeed, the entire body of law in this area—is the fundamental examination of basic out-of-pocket and fully distributed costs of the monopolist and those with whom the monopolist might compete.[71] Yet the behavior of the nation's LECs to date voids this critical line of inquiry which has been mandated by the courts on regulators. Adoption of the suggested EIS would ensure that the considerations repeatedly demanded by the courts remain part of the competitive investment calculation.

Perhaps the most telling language

supporting the proposed EIS can be found in *United States v. Western Electric Co., Inc.*[72] There, the trial court, having reviewed an elaborate evidentiary record of telephone utility abuse, was confronted with requests for "waivers" by regional holding companies for competitive sector entry—otherwise limited by a then-outstanding court order. The court refused to grant any such waivers, and issued scathing remarks about the history of regulatory review of holding company operations in the competitive sector:

> In response to these concerns, the Regional Holding Companies argue primarily that cross subsidization is not a competitive issue but a regulatory cost allocation matter for which regulatory sanctions and penalties already exist. In addition, they contend that, even if they did engage in such anticompetitive conduct, the appropriate remedy would be a new antitrust action, not a refusal to grant a waiver. [footnote omitted] These arguments are entirely without merit.
>
> The cross subsidization of competitive activities with profits earned from a regulated enterprise constitutes precisely the kind of conduct the decree was intended to curb, and for which the decree contains...a very precise remedy. There is therefore no reason or basis for turning elsewhere when such practices are threatened by organizations subject to the provisions of the decree.
>
> That remedy, moreover, is preferable to a regulatory one. Cost misallocations and improper transfer pricing in interaffiliate sales have proved difficult, if not impossible, to detect.* It is for that reason that regulatory oversight has not been in the past,** nor is it likely to be in the future, an adequate check against them; it is for that reason that section VIII(C) was incorporated in the decree; and it is for that reason, too, that the burden was placed on the Operating Companies to demonstrate the absence of an anticompetitive effect. By contrast, in a new antitrust action or in a regulatory proceeding the proponent of a restriction would have the burden of proof. In short, the prevention of cross subsidization and other anticompetitive practices is an appropriate and significant ingredient in any decision under section VIII(C).
>
> *There is no formula for allocating common costs among services, and, even if there were, the fact is that the Regional Holding Companies alone possess all the relevant cost information and have a great deal of discretion in the treatment of such costs.
>
> **The crux of the government's case against AT&T was that regulation had failed to safeguard competition from a powerful firm, engaged in both regulated monopoly and unregulated services, which had the incentive and the ability to use its regulated monopoly to impede competition in potentially competitive markets.[73]

The court concluded that the Holding Companies should carry the burden in showing competitive impact *before* granting any waiver.[74] Once a sunk-cost investment has been made, its unwinding may prove difficult even where "imprudent investment" is later adjudicated. PacBell and other LECs have a propensity to raise arguments about the illegality of "retroactive ratemaking."[75] However, penalties or disallowances as to prospective operations are—in most cases—unlikely to compensate ratepayers fully for the improvident use of ratepayer revenues or ratepayer financed investment monies.

PACBELL'S FAILURE TO CONSIDER CRITICAL CRITERIA: THE RECORD

PacBell has argued throughout its 1985-88 rate review proceedings before the California PUC that the considerations cited above are not included because they are "unnecessary." It is important for the regulator to know the extent of the present void as to this largest LEC, both for its own sake and inferentially for the nation's other less extensively-staffed LECs. In Application 85-01-034, CPIL presented extensive data requests to PacBell concerning utilization and utilization-related factors.[76] For example, CPIL requested "all studies regarding utilization of fixed plant of PacBell."[77] The response filed by PacBell staff witness Pettit is followed by several pages of sample data of the information gathered by PacBell in response to this question. The first two pages presented central office utilization data for 1986 for approximately 100 exchanges; additional pages covered other exchanges for other years. PacBell also presented a similar sample of its OSP data. This response by Pettit to a request for "all studies" regarding PacBell's utilization of fixed plant yields no utilization analysis or study whatever, except for the central office equipment and OSP percentage figures required by the Commission and denigrated by PacBell itself, and even this information is not used in utility investment decisions.

Additional CPIL data requests asked for all studies differentiating costs of fixed plant between customer or customer types; all studies showing the marginal costs of adding additional NALs by customer categories; all studies showing how modernization costs have been or will be allocated among customer categories; and all incremental cost studies, such as exchange costs, dial tone costs, and imbedded cost studies. These various requests were made in order to fully explore possible considerations missing from the existing record which PacBell might employ. PacBell's responses cited existing information in certain workpapers,[78] which also lack the utilization and competition considerations described above.

In order to further document the way in which PacBell makes its modernization decisions, CPIL asked a series of questions in 85-01-034.[79] CPIL asked for documents outlining planned "new products and services" as described in the testimony of PacBell witness Whittiker.[80] Another request asked, as to each new product or service initiated after 1980 or planned for implementation during the 1980s decade, for any documents or studies outlining investment or operating costs, and any demand studies or other documents indicating the actual or anticipated user group as to each.[81]

PacBell responded to these and other CPIL requests by revealing its inhouse process for new product-service approval, including PacBell internal deliberative documents for a substantial number of the post-1980 projects. The internal memoranda produced in 85-01-034 in response to CPIL requests for all such documents are starkly revealing. Unfortunately, these documents were produced by the utility only under a protective order barring their disclosure. Although embarrassment (rather than trade secret protection) is a more likely utility motivation for confidentiality as to some of these documents, we are compelled to respect the protective order. However, the PUC is in possession of this material, presented by CPIL in sealed exhibits.[82]

The conclusions any observer must draw from a review of the current PacBell pre-approval analysis are as follows:

(1) the utility's economic analysis ranges from crude to non-existent;

(2) The utility is focused on its business customers;

(3) The utility calculates its likely return, if that calculation is made at all, based on existing competitor *prices* (not costs);

(4) If an investment will "keep" existing customers, it is justified, according to PacBell;

(5) There is a willingness to invest ratepayer monies solely to improve the image of the utility; and

(6) There is no consideration of the variables proffered here, including plant capacity, economies of scale, utilization (or, indeed, traffic impact accommodation at all), competitor costs, cross-subsidies or anticompetitive impact.

PacBell does not hide its orientation; during recent PacBell General Rate Case hearings, CPIL cross-examined PacBell staff witness Bandler about "a modernization expense which is undertaken solely because, regardless of any other criterion, it could generate a net profit from ...[PacBell's] customers." Bandler responded: "I think that would be proper."[83] Bandler continued with candor: "The prime determinant of a probable modernization project would be the increase in net present value that one would get from the economic analysis one would do with that project. That, in effect, optimizing the profitability or the net present value is in fact the prime criteria we would use for deciding whether to do a modernization project."[84] Note that the net present value calculation in PacBell's CUCRIT formula, as noted above and as admitted by PacBell, does not include any of the plant utilization or competitive impact elements urged by CPIL.

PacBell believes it should use the same criteria as those used by an unregulated business subject to competition. The cross-examination of PacBell's witness Copeland is consistent: "The same methodology or the same tool, the same decisionmaking tool would be appropriate either in the franchise area or in an area which is highly competitive with other existing suppliers and service."[85] Certainly PacBell should use the considerations common in the competitive sector (which it does not), but it must then factor in (for regulatory review) additional elements because of its natural monopoly and the problems of monopoly-competition interaction (which it also does not do).

The failure of PacBell to address the two major areas of inquiry in any modernization decision—and its lack of plans to do so—is particularly regrettable in light of its own expert's testimony at recent rate hearings concerning their impact. PacBell's expert Dr. Perl testified under CPIL cross-examination that economy of scale and utilization numbers, as well as cost data, are important information to have in making modernization decisions.[86]

THE PROPOSED ECONOMIC IMPACT STATEMENT

Regulators cannot simply cut the LECs loose to freely make investment decisions justified by their incantation of "competition." State regulators must recognize that LECs are emphatically *not* just another player in the telecommunications marketplace.

The public agency has a set of regulatory goals more inclusive than and different from the LEC's internal goals. The regulator is caught between several conflicting interests: a desire to encourage new technology, especially where that technology may subject to competition an area of commerce previously subject only to a single entrepreneur; a desire to give the utility a chance to provide the same technological services challengers may proffer; a desire to see those who are dependent upon monopoly services receive those services at a reasonable cost; and a desire to make sure that the sunk cost already committed to a particular monopoly enterprise is efficiently used.[87]

In order to prevent unfair competition or cross-subsidies, an Economic Impact Statement (EIS) should accompany any proposed investment decision designed to address competition[88] in excess of $5 million, or which involves more than $2 million in additional projected annual expense or revenue.[89]

After the decision to proceed, substantial flexibility in implementation, timing, and pricing by the utility may be appropriate. The only crucial restraints that need be imposed on the LEC by the regulator are those with regard to expenses and prices. First, the expenses and costs of the investment decision must accurately be held against the revenues from the competitive product, service, or customer category, to avoid any cross-subsidy. Second, the price charged the customer for the new service, or for the service supplied to retain or attract customers, must never be allowed to fall below the long-run average costs of the project. Within these rather broad constraints, however, there is a diminished need for the regulator to intimately involve itself in the management of the project.

It is crucial, however, that this be a prospective decision. The regulator will be faced with insuperable problems in trying to assess and allocate financial data after the fact. If segregation is desirable from a regulatory viewpoint, it must occur before the investment is made. Moreover, as the cases discussed above make clear, the regulator has an affirmative duty to oversee the competitive impacts before the actions are undertaken. Post hoc decisionmaking will not suffice under a general rubric of fostering competition. For the LEC, the advantage of careful scrutiny before the investment may be balanced by relaxed regulation in the implementation.

CPIL recommends a required EIS which includes three elements. We note that precise data and minimal required information in each category may be subject to further refinement. But the basic elements suggested for initial inclusion in the EIS are currently within the capability of the LECs.

Financial Impact. The first of the three elements is an analysis of the projected revenue stream and return on investment impact. PacBell currently performs this through its CUCRIT computer formula which calculates the net present value of an investment and limited alternatives. Although the Ratepayer Advocate Division of the PUC has many concerns about the proper usage of PacBell's computer formula, a properly devised model and analysis may show direct cost savings from an investment decision under current traffic and equipment conditions so as to justify approval without proceeding further. If such a showing can be made, the two remaining steps of the Economic Impact Statement may be waived.

However, where an LEC makes a large-scale investment decision (certainly involving more than $5 million in total investment or anticipated annual revenues or expenses in excess of $2 million in total), where that decision may affect traffic, and where it involves a competitive interaction with a non-utility service or product, EIS steps Two and Three, respectively, should be undertaken. The Economic Impact Statement should be submitted in advance to the regulator's staff for review, to intervenors and affected competitors for comment (albeit in summary form to respect any relevant trade secrets of the utility).

and finally to the regulator for at least summary consideration.

Utilization. The second element is utilization, as discussed in detail above. In the EIS, this factor measures the impact of the proposed product, service, or investment on utilization levels of both added and existing physical plant. The LEC should be required to provide the following information relevant to utilization levels: (1) the projected utilization of the added plant required for the proposed product, service, or investment over its life; (2) the impact of the product, service, or investment on the increased or decreased utilization of existing fixed plant facilities already in place as a sunk cost; and (3) the calculated total average cost reduction (if, any) attributable to any such increase in utilization. This analysis requires utilization and economy of scale measurement of the LEC plant as a whole, and for the particular portions of the LEC plant which would be operationally affected by a given product, service, or investment modernization decision.

Competitive Impact. The third element—competitive impact—would analyze the relationship between the proposed new product, service, or investment and similar services or alternatives which may be offered by others.[90] This element requires an analysis of the following: (1) whether the proposed product, service, or investment must be or is inextricably connected to the monopoly power loop of the LEC, and if so, how and to what extent (*i.e.*, is it something only the LEC can offer or is it amenable to competitive offering); (2) the extent to which outside nonmonopoly competitors are capable of providing that product or service; (3) the comparative cost characteristics of providing that product, service, or investment from the LEC resources as opposed to the competitive sector; (4) the cost advantages of LEC assumption of that new product or service against outside alternatives; (5) the current incidence (or announced plans) of entrepreneurs in the competitive sector to provide the proposed product or service; (6) the restrictions or guidelines on the purchase or use of the items or services *vis-a-vis* their marketing by competitors; and (7) the extent to which a cross-subsidy may occur from monopoly power loop sectors within the LEC structure to carry the operations proposed. As to this last subject of analysis, a cross-subsidy analysis would include the extent to which the new product or service will be carried on a marginal cost basis without contribution to the LEC's existing overhead.

CONCLUSION

The proposals put forth here are based on the need for full and accurate information from the LECs as they increasingly unlimber their competitive muscles.

The stunning lack of basic information about the LECs' economies of scale and utilization levels affected by competitive investment should give LEC regulators pause before unleashing them. Further, the unwillingness or inability of the LECs to behave as true entrepreneurs in assessing their competitive positions suggests they are less ready for the competitive forces than their professions of eagerness would indicate. The regulator necessarily has a set of goals which are far broader and more complex than are the LECs' internal concerns. The anticompetitive potential of the LECs' involvement in nonmonopoly interactions requires, under well-established precedent, careful, thorough, and prospective oversight by the regulator. Flexibility may be a desirable regulatory mode, but it cannot fulfill the regulator's other public goals unless that flexibility is preceded by an assurance that cost or efficiency advantages exist, and that anticompetitive impacts have been minimized.

On October 2, 1986, PacBell issued a press release announcing Memoranda of Understanding with two companies to jointly develop an advanced telecommunications network system. The press release and ensuing news articles announced that it was a move which "could lay the foundation for hundreds of new customer services."[91]

The reporters covering the story noted that "PacBell officials would not discuss the financial aspects of the memo, the cost of...[PacBell's investment], and would give only limited examples of services the planned software would provide."[92]

The signing of memoranda of understanding with two firms, legally committing PacBell to a long-term relationship for the provision of new products and services as a part of a long-range modernization program, was not revealed to the California PUC prior to its formal public announcement, or prior to its entry in final legally binding form. PacBell's failure to inform the regulator about imminent plans in this area was particularly unfortunate, given the fact that the announcement occurred after almost one year of proceedings on the very subject relevant to those commitments: the modernization policies of PacBell—which hearings were in progress while the discussions were held and decisions were made.

The bad faith of the utility is accentuated by the fact that it had before it, for a full four months prior to this announcement, a data request from CPIL for information which would have compelled the disclosure of these plans and respective commitments.[93] Its responses omitted their mention.

Pacific Telesis, the parent of PacBell, continues to engage in substantial public relations advertising which it may erroneously believe PacBell ratepayers will finance. But whoever pays for it, PacBell's imprimatur is placed on the ads running in the mass media throughout California seeking to associate the management of these related companies with the courage and skill which brought the world major human advancements deserving of admiration through the millenia. One ad purports to equate the *modus operandi* of Pacific Telesis management with the skill involved in early weather satellite prognosis, which, it is announced in stentorian tones, has saved thousands of lives in the tracking of hurricanes. Another ad associates the logo and name of PacBell's parent with the miracle of the Golden Gate Bridge, featuring stoic workmen stringing massive cable in the sky. The most recent advertisement attempts to associate management philosophy with the foresightedness which created the Suez Canal. In each case, the definition of "telesis" is paraded forth: "intelligent planning."

It is not intelligent planning to enter into binding legal commitments without developing the most elementary criteria for prudent modernization investment. It is not intelligent planning to ignore the ways in which the basic economic structure of your own capital plant may be affected by those decisions. It is not intelligent planning to fail to calculate traffic impacts and utilization levels as they may affect average costs for the system as a whole. It is not intelligent planning not to investigate, and at least estimate from available information, the cost structure of competitors. And it is not intelligent planning to be unaware of the cross-subsidy impacts on existing services and customers of planned investments totaling billions of dollars.

If the regulators of PacBell and other LECs wish to assure "intelligent planning," they will have to provide it—or require it—themselves. They can do so most assuredly by obtaining the information, in advance, relevant to their public

responsibilities as regulators: information about monopoly sunk plant utilization and cost impacts, and information about competitive impact. An Economic Impact Statement is a formalized procedure which will ensure routine consideration of basic factors now missing from these momentous long-term decisions.

FOOTNOTES

1. A "natural monopoly" is typically described by economists as occurring where "the long-run unit cost function declines continuously out to a scale of output which saturates potential market demand." F. Scherer, **Industrial Market Structure and Economic Performance** at 520 (1970).

2. Note that maximum rate regulation of businesses "affected with the public interest" has historically passed constitutional muster based upon a judgment that the business is basic to other enterprises (*e.g.*, common carriage), mixed with concerns over monopoly. See *Munn v. Illinois*, 94 U.S. 113 (1877).

3. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

4. *See, e.g.*, *ICC v. New York, New Haven & Hartford Railroad*, 372 U.S. 744 (1963); *see also American Commercial Lines, Inc. v. Louisville & Nashville Railroad*, 392 U.S. 571 (1968). For a critique of ICC policies which irrationally protect inefficient modes of transport from competition, see Fellmeth, **Interstate Commerce Omission** (Grossman, 1970).

5. Regarding affiliated enterprise transaction, see *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133 (1930); *In Re Pacific Telephone & Telegraph Co.*, 53 P.U.R.3d 513 (Cal. P.U.C. 1964).

6. Regarding protection of monopoly structure from competition, see *Idaho Power & Light Co. v. Blomquist*, 26 Idaho 222, 141 P. 1083 (1914); *see also FCC v. RCA Communications, Inc.*, 346 U.S. 86 (1953); *Hawaiian Telephone Co. v. FCC*, 498 F.2d 771 (D.C. Cir. 1974).

7. Far from being regulated at the federal level, cable rate regulation is delegated to local jurisdictions; in California, as in most other states, there is no rate regulation authority at the state level. Fragmented local government agencies—with their own proprietary interests in the collection of "franchise fees"—generally do not engage in fair-rate-of-return maximum rate regulation, notwithstanding the practical natural monopoly structure of most cable systems.

8. See *City of Los Angeles v. Preferred Communications*, __U.S.__, 106 S.Ct. 2034 (1986).

9. Although federal antitrust law would appear to preclude the "blank check" grant of monopoly cable franchises by a state to local governments, see *Community Communications Co., Inc. v. City of Boulder*, 453 U.S. 921 (1982), the Ninth Circuit has ruled that a state legislature may, if it so intends, allow a local agency to grant such monopoly franchises without required competitive bidding or clear rate regulation standards. *Tom Hudson & Associates v. City of Chula Vista*, 746 F.2d 1370 (9th Cir. 1984); *see also Preferred Communications, supra* note 8.

10. See *U.S. v. Western Electric Co., Inc.*, 592 F. Supp. 846 (D.D.C. 1984); see also *U.S. v. AT&T*, 524 F. Supp. 1336 (D.D.C. 1981).

11. *Id.*

12. Note that on December 3, 1987, U. S. District Judge Greene somewhat narrowed the areas of business open to the regional Bell companies created by his 1984 AT&T divestiture order. However, the scope of new investment opportunity for the regional monopolies is unclear, as is the tenure of his revised order. Further, Judge Greene has noted that his enforcement of his own orders depends upon U.S. Department of Justice protests and reportage, which he openly suggested has not been assiduous.

13. In California, Pacific Bell (PacBell) has proposed a program of unilaterally-determined "modernization investments," advocating no outside preclearance; "rate flexibility" within bands so as to enable it to meet competition and maintain traffic; and the freezing of residential rates for three years. See PacBell's proposal to California Public Utilities Commission (PUC), En Banc Hearing held September 24, 1987, preliminary to OII 87-11-033.

14. See PUC Application 85-01-034.

15. PUC Application 87-11-033.

16. PUC Application 85-01-34, Exhibit 530 at 5. All further references to "Exhibits" and "Transcripts" refer to documents filed in the PUC's ongoing PacBell rate review proceeding, which consists of an initial phase (now completed) concerning capital accounts and revenue requirements before Administrative Law Judge Ira Alderson; and a second phase covering modernization, utilization and productivity (MUP) before Administrative Law Judge Lynn Carew, which awaits final Commission decision as of this writing.

17. Exhibits 559, 565, and 580.

18. *See, e.g.*, Exhibit 559 at 522.

19. Exhibit 603 at 9, 11.

20. Exhibit 572.

21. See Exhibit 603 at 19; *see also* Exhibit 565 at 4 and Exhibit 530 at 6.

22. *See, e.g.*, Exhibits 2 and 3 of CPIL's Exhibit 679.

23. Exhibit 603 at 9.

24. See Exhibit 603 at 9-15; *see also* Exhibit 559 and Exhibits 2 and 3 of CPIL's Exhibit 679.

25. *See, e.g.*, Exhibit 572.

26. *See especially* Exhibit 3 of Exhibit 679 ("Competitive Impacts—A Report on Bypass by PacBell").

27. *See, e.g.*, Exhibit 603 at 9.

28. *Id.* at 11.

29. Exhibit 559 at 22.

30. Exhibit 561 at 10.

31. Exhibit 572 at 5.

32. Transcript at 12122-23.

33. *See, e.g.*, Exhibit 561 at 23-24, 58.

34. Exhibits 603, 686.

35. *See, e.g.*, Transcript at 17202-04.

36. Exhibit 541 at 4.

37. Exhibit 541 at 5-12.

38. PUC's Notice of En Banc Hearing Re Alternatives to Cost-of-Service Regulation, at 6 (notice dated August 11, 1987).

39. Actually, "full" utilization is by no means the goal. Optimum utilization at some factor less than 100% utilization is in fact the economic goal, to allow for, *inter alia*, churn, maintenance, and repair. Accordingly, optimum utilization of fixed plant will be referred to hereafter.

40. Exhibit 686 at 14.

41. See Testimony of R. C. Fellmeth, filed January 11, 1988, in OII 87-11-033 (detailing time-of-day traffic levels and analyzing rate level policy issues).

42. Exhibit 686 at 14.

43. See Exhibit 541 at 25-31, and Exhibit B thereto.

44. Exhibit 541 at 26-31, and Exhibits B, C, and D thereto.

45. See PacBell's briefs in PUC Application 85-01-034; Transcript at 17428-46. PacBell acknowledges in its argument and expert testimony that it has performed no study more extensive or detailed than the CPIL regression analysis it criticizes.

46. See Exhibit 541 at 26-31, and Exhibits B, C, and D thereto.

47. See *supra* note 45; see discussion *infra*.

48. *See, e.g.*, Exhibit 114.

49. See Exhibit 74 at 16-18; Exhibit 42 at 5-10; Exhibit 76 at 12-14; Transcript at 921-22.

50. Transcript at 17461-62.

51. *Id.* at 17464.

52. Exhibit 565 at 4. The same witness testified that "OSP utilization is not an appropriate indicator of outside plant capital deployment efficiency." *Id.* He contends that "fiber-optics" cannot be measured by traditional utilization measurements at all. *Id.* at 14.

53. Exhibit 580 at 12.

54. Decision 86-01-026 at 110-12. It is worth noting that PacBell had routinely used sizing drivers for many of its costs that applied direct ratios derived from net access lines. In effect, these simple multipliers presuppose that as access lines increase, so will costs. That is, there is no economy of scale. This, of course, directly contradicts the assertions used to justify new investments to retain and add customers: that the retention and expansion will result in decreased average costs. As is so often the case, the argument useful in one context is turned on its head in another context.

55. *Id.* at 112.

56. Exhibit 541 at 12-15.

57. See *Market Street Railway v. Railroad Comm'n*, 324 U.S. 548 (1944).

58. Transcript at 17216-22.

59. Exhibit 541 at 30.

60. *Id.* at 16.

61. See *supra* notes 10-12.

62. See Exhibit 2 of Exhibit 679; Transcript at 17202-04. Note that PacBell's position through its witnesses throughout Application 85-01-034 has been that its formula measuring PacBell revenue based on current competitor *prices* (not costs) is sufficient; see discussion *infra*.

63. 260 U.S. 156 (1922); *see also U.S. Navigation Co. v. Cunard Steamship Co.*, 284 U.S. 474 (1932); *U.S. v. Borden Co.*, 308 U.S. 188 (1939); *Federal Maritime Board v. Isbrandtsen Co.*, 356 U.S. 481 (1958); *PanAmerican World Airways, Inc. v. U.S.*, 371 U.S. 296 (1963); *Ricci v. Chicago Mercantile Exchange*, 409 U.S. 289 (1963); *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963); *Carnation Co. v. Pacific Westbound Conference*, 383 U.S. 213 (1966); *FMC v. Seatrain Line Inc.*, 411 U.S. 726 (1973); *Hughes Tool Co. v. TWA*, 409 U.S. 363 (1973); *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973); *Gordon v. New York Stock Exchange*, 422 U.S. 366 (1975); *S.S.W. v. Air Transport Ass'n*, 191 F.2d 658 (D.C. Cir. 1951), *cert. denied*, 343 U.S. 955 (1952). For an FCC communications case, see *U.S. v. Radio Corp. of America*, 358 U.S. 334 (1959).

64. *See, e.g., Preferred Communications, supra* note 8.

65. See *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133 (1930); see also *In Re Pacific Telephone and Telegraph Co.*, 53 P.U.R.3d 513 (Cal. P.U.C. 1964).

66. 346 U.S. 86 (1953).

67. *Id.* at 93-95.

68. *Id.* at 95-97.

69. 392 U.S. 572 (1968).

70. *Id.* at 577.

71. See also *ICC Cost Evidence Proceeding*, Docket No. 34013 (sub. No. 1) (May 1, 1973). For a similar analysis of the factors relevant in another area of monopoly/competition interaction (cable television), see Boies and Verkuil, *Note on the Regulation of Cable Television*, **Public Control of Business 88-97** (Little Brown & Company 1977); for another interesting discussion, see Hjelmfelt, *Retail Competition in the Electric Utility Industry*, 60 **Denver L.J.** 1 (1982).

72. 592 F. Supp. 846 (D.D.C. 1984).

73. *Id.* at 854-55 and nn. 19-20.

74. *Id.* at 873; *see also id.* at 865-73 for detailed justification of confinement of regional holding companies to decree-permitted local telephone service provision. For a similar analysis regarding the Operating Company's past and likely abuse, *see U.S. v. AT&T*, 524 F. Supp. 1336, 1373 (D.D.C. 1981).

75. *See, e.g.*, Application of PacBell for Rehearing of Decision No. 87-10-075, filed November 30, 1987 in PUC Application 85-01-034.

76. See Exhibit 1 of Exhibit 679.

77. See Data Request 3 USD #1.

78. See PacBell 1986 NOI Generic Overview of Methodology at 10004-10006; IC:1 to IC:3, September 1984, Vol. 3, Exhibit 80 at 43-90; *see especially* Volumes 3 and 10 of the Scholl workpapers.

79. See Exhibit 2 of Exhibit 679; Data Request 3 USD #14.

80. Data Request 3 USD #15.

81. *Id.*

82. See sealed Exhibits attached to Exhibit 679.

83. Transcript at 12122.

84. Transcript at 12123.

85. Transcript at 12633.

86. Transcript at 17432-64.

87. Exhibit 541 at 10-11.

88. Of course, many investments are made not only to meet competition, but also to achieve cost savings in existing plant. Where a new investment does not intersect with the competitive sector, but is likely to affect traffic volumes, the utilization element of the proposed EIS should be required. Where there is competitive sector entry or interaction, the full EIS should be required—in advance.

89. These threshold figures were selected after reviewing PacBell's new product-service projects from 1984 to the present (contained in sealed exhibits in Exhibit 679). *De minimis* or marginally-impacting projects appear to cluster below these levels. These size parameters may be adjusted to a lower level for a smaller LEC. The regulator must also take care to scrutinize under-threshold initial proposals which may "get in the door," only to expand past these limits after implementation.

90. If the competition is for existing customers or service, the analysis would shift from new products or service to making investments designed to retain existing customers.

91. The Memoranda of Understanding were signed with Integrated Technology, Inc. (ITI) of Plano, Texas, and Tandem Computers of Cupertino, California. The Memoranda of Understanding provide for both PacBell and Tandem to buy a 24.5% interest in ITI, with each company given a member on ITI's board.

92. See CPIL's Motion to Compel Further Responses from PacBell to Document Request, Exhibit C, filed November 3, 1986 in PUC Application 85-01-034.

93. At least eight of CPIL's twenty-five data requests submitted to PacBell on May 30, 1986, would require disclosure of these Memoranda of Understanding.

BACKGROUND

GTE PROPOSES NEW REGULATORY PROCESS

GTE California is proposing to the California Public Utilities Commission (PUC) a landmark regulatory reform which would give customers, as well as shareholders, a vested interest in their phone company's success.

The GTE reform would speed responsiveness to customer needs, decrease regulatory costs, and boost company efficiency and productivity. Plus, customers automatically would share in GTE's profits when an established earnings target is exceeded.

GTE's plan rewards customers with a modern, feature-rich network, while protecting vital telephone services.

Background

Because of the complexity of the current regulatory system, issues requiring regulatory action often take years to resolve.

In addition, technological advances and new federal court and regulatory orders have increased competition in the telecommunications industry.

In this environment of rapid change, the telephone company needs efficient regulatory responsiveness and pricing flexibility to maintain high-quality service to customers.

For these reasons, the PUC began hearings in November 1988 to gather proposals and information on how to create an "alternative" regulatory program. The plan that the PUC ultimately chooses must fulfill the following goals:

+ protect affordable basic telephone services for all Californians;
+ promote economic efficiency;
+ encourage new technology;
+ promote financial and rate stability;
+ promote full use of the local telephone networks;
+ avoid anti-competitive behavior and cross subsidies; and,
+ promote low-cost, efficient regulation.

GTE California's Proposal

GTE California has proposed a comprehensive plan that would meet these PUC goals. Plus, customers would automatically benefit financially from improved company efficiency and productivity.

The GTE proposal divides regulated services into two categories (detailed below) to guarantee reasonable and predictable rates for basic communications services, and at the same time, provide greater marketing flexibility for optional services.

This would protect vital services and give customers more product and service choices at competitive prices.

The GTE long-range plan would reduce operating costs and regulatory complexity while delivering technologically advanced services. It also would ensure continued PUC regulation of all GTE network services and review of customer complaints.

Protecting Vital Services (Category I)

GTE's plan would subject basic communications services (Category I), such as local calling from residences, businesses and coin phones, to a revenue cap with PUC oversight.

Because basic telephone services are vital, GTE believes the revenue cap would guarantee that its prices remain reasonable.

The revenue cap has the added benefit of encouraging the company to run efficiently because the company can only increase earnings by reducing operating costs, not by raising rates.

The cap would be adjusted annually to reflect changes in inflation and productivity.

Basic telephone services have traditionally been priced below their cost, while being subsidized by more profitable areas of telephone business, such as long-distance and large-business customer services.

The degree of subsidy which exists today cannot be sustained in the increasingly competitive telecommunications market. To bring rates closer to costs, Category I service rates would be adjusted annually based on PUC-approved programs to reallocate costs among services.

This process is called "rebalancing." It would ensure reasonable and predictable rates for vital services.

Flexibly Priced Services (Category II)

In 1988, the PUC authorized local telephone companies to flexibly price a limited number of discretionary or competitive services.

GTE's plan would place this group of services, along with several other existing and new services in Category II. Some of the Category II services are: centrex features, call waiting and call forwarding.

Pricing flexibility enables the company to respond quickly to the marketplace. Under GTE's plan, price increases would be limited to 10 percent annually, but GTE could reduce prices at any time, so long as the prices do not fall below cost.

If the company increases its overall earnings through pricing flexibility, basic service customers would benefit through GTE sharing earnings.

Sharing Earnings With Customers

Under GTE's plan, the telephone company would channel a portion of its earnings directly to customers. When the company's annual earnings exceed the target set by the PUC, half of the additional earnings would be paid to basic service customers through a credit on their monthly bills.

Shareholders would receive the other half as an incentive to run the company more efficiently. The sharing of earnings would be based on profits from all regulated services.

GTE's Proposal is Good News

GTE's proposal is good news for the customers. When GTE's increased efficiency and new technology leads to higher earnings, customers gain a share of those earnings.

Meanwhile, customers are protected by revenue caps on basic services and price increase limits. The telephone company bears the risk for new services, but ratepayers share the rewards.

In the long run, customers win with modern, high quality telecommunications service, increased choices of products and services and reasonable prices.

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ATTACHMENT D

WRITTEN RESPONSES OF THE DIVISION OF RATEPAYER ADVOCATES, CALIFORNIA PUBLIC UTILITIES COMMISSION TO THE ASSEMBLY COMMITTEE ON UTILITIES AND COMMERCE "KEY QUESTIONS OF INTEREST TO THE COMMITTEE" JUNE 6, 1989

QUESTION 1: The traditional goals of utility regulation include: (a) assuring just and reasonable rates, (b) preserving the ability of the utility enterprise to attract capital on reasonable terms, (c) preventing abuse of monopoly power and undue discrimination among customers, and (d) assuring high-quality service and adequate facilities. Are these goals inappropriate for the 1990s? Should additional goals be pursued in the 1990s?

ANSWER 1: These traditional goals of utility regulation indeed are still appropriate for the 1990s. The emergence of competition in some markets does not mask the fact that the vast majority of LEC services continue to be provided by a monopoly firm. DRA agrees that regulation must continue to promote the traditional goals in the monopoly marketplace. The emerging competitive marketplace for some services calls for additional goals, including (a) ensuring a fair competitive environment for all firms in the marketplace, (b) protecting captive ratepayers from the risks of the competitive marketplace, and (c) encouraging the development of valuable new services in the competitive marketplace.

QUESTION 2: Traditional rate-of-return regulation ideally links rates to costs (including the cost of capital). It is the principal method to achieve the twin goals of (a) capital attraction on reasonable terms and (b) just and reasonable rates. Is a new form of telephone regulation recommended -- or can traditional rate-of-return regulation still serve the public interest? Please restate (briefly) your position (if any) before the Public Utilities Commission (PUC) in OII 87-11-033 ("Alternative Regulatory Framework") and A.88-08-031 ("Enhanced Services").

ANSWER 2: Traditional rate-of-return regulation has served us well over the past several decades. Universal, high-quality service has been achieved, and the telecommunications system in California is among the finest in the world. However, the world has changed in the last several years. Decisions by Judge Greene (the breakup of AT&T, lifting of some line-of-business restrictions), the FCC (competition for CPE, payphones and inside wire; ONA) and the CPUC (high-speed data services competition; pricing flexibility for competitive centrex services) have fundamentally changed the LEC from a pure monopoly to a mixed competitive/monopoly firm.

DRA believes a modification of the existing regulatory framework is necessary in order to meet the traditional and emerging goals of regulation (discussed above). To this end, DRA has proposed the following plan, which would continue to align rates with (declining) costs and allow the LEC a fair opportunity to earn a reasonable return:

- Move competitive services into a separate profit center

- Index monopoly rates to automatically capture all expected cost decreases for ratepayers without regulatory lag

- Decrease LEC rates upfront to reflect a fair return

- Allow limited pricing flexibility to respond to competitive markets

- Share any excess profits with the LEC as an incentive, and use the balance to lower rates for captive customers

- Step up monitoring of financial information and service quality

- Allow enhanced services to be developed in the separate profit center at no risk to captive ratepayers

QUESTION 3: Are current regulatory procedures adequate to identify and consider, in a coordinated fashion, the full range of issues that should be of concern to policymakers? These issues include, among others:

(a) Maintaining and enhancing universal service.
(b) Improving the efficiency of the public telecommunications network
(c) Competitive access to telephone company facilities
(d) Conditions under which telephone utilities may compete in unregulated markets
(e) Privacy of telephone subscribers' personal information
(f) Consequences of activity in the telecommunications sector for state and local economic development.

ANSWER 3: Current regulatory procedures are adequate to handle these matters. So long as both the Commission and the Legislature support full deployment of all the investigatory tools traditionally at DRA's disposal (including access to all pertinent utility data), DRA believes that it will be able to address the important issues identified in the question and advocate for the interests of ratepayers in every appropriate proceeding.

QUESTION 4: Does the existing regulatory environment encourage the presentation of points of view that represent the interests of Californians at large? Should greater participation be encouraged? If so, how?

ANSWER 4: DRA favors the widest possible representation of interests before the CPUC. The existing regulatory environment allows for the presentation of many points of view, as evidenced

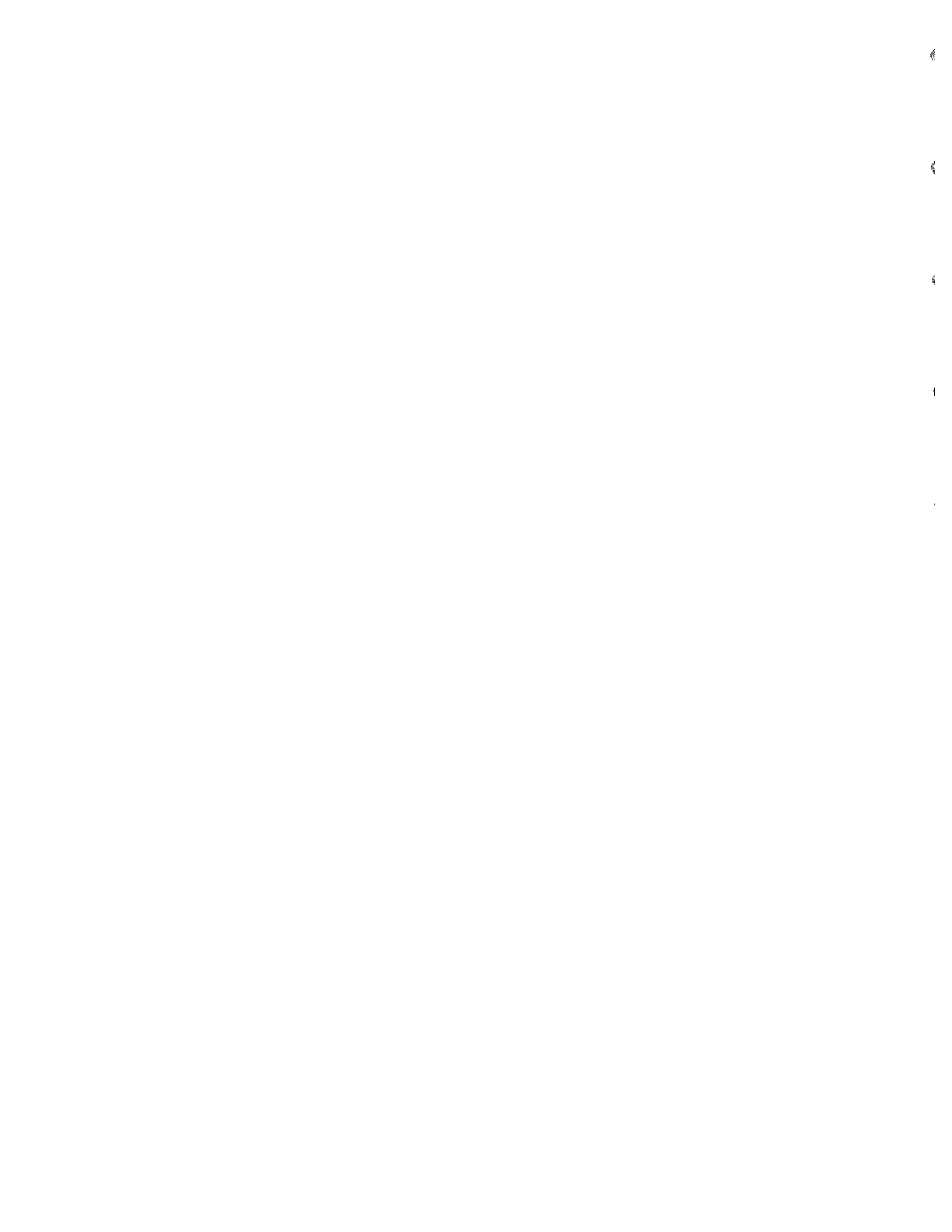
by over a dozen active parties and several dozen interested parties in the Alternative Regulatory Framework Investigation (I.87-11-033). Undoubtedly, however, the extensive discovery and hearing process that characterize any major proceeding can discourage some parties from participating in CPUC proceedings. Our intervenor funding program is an important step in encouraging representation of varying viewpoints, as is the availability of the CPUC's Public Advisor office. DRA has no recommendations to offer at this time regarding other measures to encourage public participation.

DRA does note that those parties with the greatest resources -- predominantly utilities -- have the ability to present their case more effectively than most other parties due to their large in-house legal and regulatory staffs, access to decision-makers, and control of vital information. As the advocate for the ratepaying public, DRA must continue to have complete access to all utility records and information, as well as adequate staffing to analyze data fully and to determine the consequences of moving into this new era.

QUESTION 5: What would you recommend to the Legislature and the PUC of the 1990s as an appropriate approach to telecommunications policy?

ANSWER 5: Telecommunications policy must focus on effective regulatory oversight as protection for captive ratepayers. In some respects, the emerging mixed competitive/monopoly firm requires more oversight of financial records, costs, pricing policies, and competitive interactions than ever before. The opportunities for cross-subsidy and unfair competitive actions grow by the day. DRA's proposal for modifying the CPUC's approach to telecommunications regulation should not be construed as an endorsement of a "trust-me" form of regulation which

allows the LEC to act as it wishes in this rapidly changing environment. Some changes are appropriate to the current regulatory system, but the focus on regulatory oversight must not be sacrificed under the guise of a "simpler" form of regulation.



Statement of Robert B. Stechert
On Behalf of AT&T Communications of California, Inc.
Before the Assembly Committee on Utilities and Commerce

June 5, 1989

The traditional goals of utility regulation of: (a) assuring just and reasonable rates, (b) preserving the ability of the utility enterprise to attract capital on reasonable terms, (c) preventing abuse of monopoly power and undue discrimination among customers, and (d) assuring high quality service and adequate facilities continue to be appropriate goals in the 1990s. However, technological advances and the increase in competition to meet customers' needs have changed the telecommunications environment, necessitating significant changes in the manner in which these goals are achieved. The California Commission is working to adapt regulation to these changes in technology and the economics of the industry.

Looking forward to the 1990s, an additional goal of regulatory reform should be to complete the removal of regulatory constraints on AT&T that do not apply to other interexchange carriers and permit the competitive market for interexchange services to work without unnecessary regulatory intervention. An unencumbered competitive interexchange market will more effectively facilitate the development of a

telecommunications infrastructure that best meets the needs of all Californians.

There are compelling reasons to seek alternatives to rate-of-return regulation. It is widely recognized that rate-of-return regulation was instituted to ensure that ratepayers pay reasonable rates and receive adequate supply of monopoly services offered by a regulated utility, while providing utilities with an opportunity to recover their costs of operation, including a fair rate-of-return. Although rate-of-return regulation has always been difficult to implement, it has been justified as a substitute for marketplace competition. Conversely, where competition is present, as in the interexchange telecommunications markets, rate-of-return regulation or any alternative regulatory framework is not necessary to ensure just and reasonable rates and should be eliminated.

Rate-of-return regulation is also difficult to implement because it requires complicated procedures -- including detailed cost studies and extensive hearing processes -- and is necessarily a resource-intensive activity for all parties involved. Moreover, rate-of-return regulation is inherently inefficient because at best it fails to reward regulated businesses for providing services more productively or

efficiently and in the worst instance it encourages inefficiencies in the provision of these services. Presently, regulators must devote substantial resources and time to an ongoing and complicated process which seeks to determine through regulatory proceedings the optimum levels of investment and expense to be devoted to the efficient provision of service. Because this regulatory process is rarely if ever perfect, rate-of-return regulation is unlikely to ensure the lowest possible rates.

There are also legitimate reasons to seek alternatives to rate-of-return regulation for local exchange carriers. The local exchange carriers face competition in some areas, and need flexibility to meet that changed competitive environment. Furthermore, properly designed alternative regulatory arrangements could produce both lower prices for consumers and higher earnings for local exchange carriers in their provision of non-competitive services. However, as an interexchange carrier, AT&T has concerns which must be addressed under any alternative regulatory framework that might be adopted for the local exchange carriers.

First, AT&T needs assurance that it will be able to obtain reasonably priced facilities needed to originate and terminate long distance services for its customers. These facilities,

which are obtained almost exclusively from the local exchange carriers, connect AT&T's offices with its customers' homes and offices throughout the State. Only the local exchange carriers have these ubiquitous and essential facilities, and the prices of these facilities significantly influence the rates for services provided by AT&T and other interexchange carriers in California. For these reasons, any alternative to rate-of-return regulation must provide mechanisms to assure that local exchange carriers cannot reap monopoly profits through excessive rates for the provision of these essential facilities to interexchange carriers. In 1985 the California Commission adopted a seven year transition plan to bring the prices for these facilities more in line with their economic cost. That program must be continued, and the prices interexchange carriers pay for all access facilities should continue to be driven towards cost.

Second, under any alternative regulatory framework, there must be assurances that local exchange carriers cannot use their control over those essential facilities to obtain any unfair advantages in their provision of competitive services. Because the local exchange carriers continue to provide essential facilities under tariff to their competitors it is imperative that the prices they charge their competitors are similarly reflected in the rates they charge their customers

for their services. In this way any potential for leveraging of essential facilities to their competitive advantage will be minimized.

Finally, approval of intraLATA competition in California is essential under any alternative regulatory framework. Currently, the local exchange companies enjoy a nearly exclusive franchise in the provision of intraLATA service. Interexchange carriers have services that their customers want and need that have intraLATA capability. And the interexchange carriers' customers in California should be allowed to realize the full benefits of the available services as they are in other states that permit intraLATA competition.

In the local exchange carriers Alternative Regulatory Framework proceeding pending before the CPUC (OII 87-11-033) AT&T suggested that an incentive-based price cap plan for Pacific Bell and GTE California could be adopted. Such an arrangement would allow all customers to reap the benefits of the companies' efficiency gains through sharing of increased earnings or through a so-called "consumer dividend" arrangement. AT&T proposed that the CPUC separate Pacific's and GTE-C's services into market baskets of services subject to individual price indices for each market basket; establish effective cost allocation mechanisms and other competitive

safeguards to ensure against cross-subsidization of competitive services; develop realistic productivity adjustment factors; and monitor results with periodic reviews of the plan. However, AT&T also suggested that such a price-cap plan should become effective only after the completion of a combined Phase III and Supplemental Rate Design proceeding that would resolve the issue of intraLATA competition and establish the appropriate revenue requirement and cost-based rate design which will constitute the starting point for price caps and pricing flexibility.

Regarding the Enhanced Services proceeding (A.88-08-031), AT&T strongly believes that the development and deployment of enhanced services will be beneficial to consumers, businesses, and the California economy. Although AT&T has not actively participated in the Enhanced Services proceeding, AT&T has advocated to the FCC that competitive safeguards, such as unbundling and cost-based pricing of the monopoly elements required by competitors, be adopted with respect to these services. More specifically, the monopoly building block components for enhanced services, which are available only from local exchange carriers, must be made available to all customers through exchange and access service tariffs. Further, the building blocks must be made available on equal terms and conditions and at equal rates to competitors and the

local exchange carriers which also elect to become enhanced service providers. The prices for those components must be reasonable to ensure that the local exchange carriers do not reap monopoly profits and enhanced services are made available to the public at reasonable rates.

The current regulatory process is adequate for identifying issues of concern though it does not always lend itself to expeditious consideration and resolution of such issues. Considering the rapid pace of technological change and the development of new competitive markets, one of the most significant challenges for regulators today is how to rapidly and appropriately respond to emerging issues.

The existing regulatory process has proved to be adequate to address the issue of maintenance and enhancement of universal service. Universal service is now guaranteed by programs adopted by the CPUC. Similarly the present regulatory process appears adequate to address the issue of the privacy of telephone subscriber's personal information.

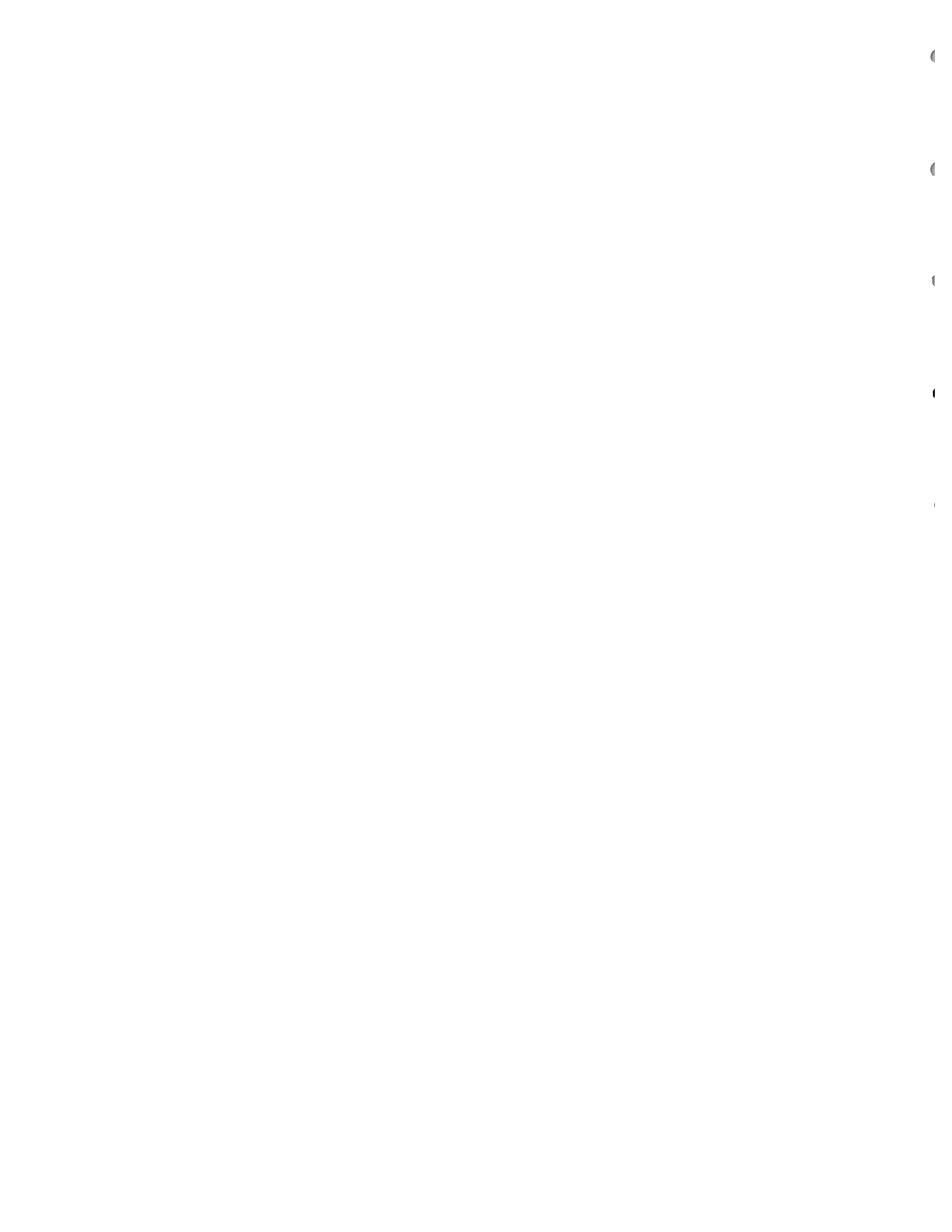
The CPUC is presently considering the issues of telecommunications infrastructure improvements, competitive access to telephone company facilities, local exchange carrier competition in unregulated markets, and impacts of

telecommunications sector activities on state and local economic development in the alternative Regulatory Frameworks and Enhanced Services proceedings. A wide range of interested parties representing the local exchange carriers, interexchange carriers, consumer groups, individuals, large business users, and enhanced service providers are making their views known to the CPUC through the regulatory process. Most of these interested parties, including AT&T, yearn for a prompt resolution of the issues, but it is clear that the CPUC is considering the issues in a measured and coordinated fashion. Once this proceeding is concluded it should produce more streamlined regulatory processes that will better meet the needs of todays telecommunications marketplace.

As reflected in the listing of parties participating in the Alternative Regulatory Frameworks and Enhanced Services proceedings, the existing regulatory environment ensures that anyone can provide input to the regulatory process. Californians have numerous vehicles of participation in the regulatory process, including: complaints or letters to the Commission, Open Forums held by the CPUC Commissioners, public witness hearings, working with the Commission's own Public Advocates Office, participation in consumer groups such as TURN or The Consumer Federation of America, and customer advisory counsels of the utilities. The means of participation depend

upon the time and energy any individual is willing to dedicate to the issue, but the process enables even those who work during the day or who are confined to their homes to contribute to the process.

In sum, the Commission has taken a forward-looking approach to telecommunications policy in California. It has methodically moved forward to address needed change in the way the telecommunications industry is regulated both for local exchange and interexchange or long distance companies. It should continue on this path to increased flexible regulation in the competitive areas of the telecommunications industry and let market forces provide the benefits of this competition to California.



ATTACHMENT F

STATEMENT OF ATTORNEY STEPHEN P. BOWEN ON BEHALF OF MCI TELECOMMUNICATIONS CORPORATION

California State Assembly
Committee on Utilities and Commerce

June 5, 1989

MADAME CHAIRWOMAN AND MEMBERS OF THE COMMITTEE, MY NAME IS STEVE BOWEN. I AM A SENIOR ATTORNEY WITH MCI'S REGULATORY AND PUBLIC POLICY DEPARTMENT IN WASHINGTON, D.C., SPECIALIZING IN CASES INVOLVING REGULATION OF LOCAL PHONE COMPANIES BEFORE STATE UTILITY COMMISSIONS HERE IN CALIFORNIA AND AROUND THE COUNTRY. I REPRESENTED MCI IN PHASE 2 OF THE CPUC'S HEARINGS ON ALTERNATIVE REGULATORY FRAMEWORKS FOR LOCAL EXCHANGE COMPANIES. I AM HERE TODAY TO ADDRESS THE QUESTIONS POSED IN CHAIRWOMAN MOORE'S LETTER OF MAY 25, 1989, AND TO GIVE YOU MCI'S VIEWS ON THE PROPER MANNER OF REGULATION FOR LOCAL TELEPHONE COMPANIES.

ASSEMBLYWOMAN MOORE, IN HER MAY 25 LETTER, DESCRIBED FOUR OF THE TRADITIONAL GOALS OF UTILITY REGULATION, AND ASKED WHETHER THOSE WERE STILL APPROPRIATE FOR THE 1990S. THE GOALS

IDENTIFIED IN THAT LETTER INCLUDED: ASSURING JUST AND REASONABLE RATES, PRESERVING THE UTILITY'S ABILITY TO ATTRACT CAPITAL AT REASONABLE RATES, PREVENTING MONOPOLY ABUSE AND UNDUE DISCRIMINATION, AND ASSURING HIGH QUALITY SERVICE AND ADEQUATE FACILITIES. MCI BELIEVES THAT THOSE "TRADITIONAL" GOALS ARE APPROPRIATE, AND WILL CONTINUE TO BE SO IN THE '90S. BUT, AS MCI TOLD THE CPUC IN ITS TESTIMONY IN PHASE 2, THE COMMISSION WILL HAVE TO DEVOTE MORE OF ITS ATTENTION AND RESOURCES TO ONE OF ITS STATED GOALS -- PREVENTION OF MONOPOLY ABUSE AND AVOIDANCE OF ANTICOMPETITIVE CONDUCT BY MONOPOLY LECS -- THAN IT HAS IN THE PAST, WHILE, AT THE SAME TIME, IT ASSURES THAT THE OTHER GOALS ARE MET.

THE UNDERLYING PREMISE OF THE CPUC'S INQUIRY IN PHASE 2 IS THAT LEC SERVICES ARE NOW, OR SOON WILL BE, SUBJECT TO COMPETITIVE PRESSURES, AND THAT, AS A RESULT, THE LECS HAVE TO BE GIVEN GREATER FLEXIBILITY TO ADJUST PRICES FOR THOSE SERVICES TO

ADJUST TO THE COMPETITIVE MARKETPLACE. MCI HAS NO QUARREL WITH THAT NOTION, AND HAS TOLD THE COMMISSION SO. INDEED, MCI HAS ALWAYS STOOD FOR THE PROPOSITION THAT EFFECTIVELY COMPETITIVE MARKETS ARE PREFERABLE TO REGULATION. BUT THERE IS AN IMPORTANT COROLLARY TO THAT PRINCIPLE, WHICH MCI FEARS MAY GET LOST IN THE SHUFFLE IN PHASE 2. WHILE COMPETITIVE MARKETS, IF THEY TRULY EXIST, SHOULD BE GIVEN THE CHANCE TO WORK, REGULATORY AGENCIES CANNOT FORGET THAT ONE OF THEIR PURPOSES FOR EXISTENCE IS THE PREVENTION OF MONOPOLY ABUSES. SO, MCI WOULD SUGGEST THAT THE FIRST INQUIRY WHICH MUST BE MADE, BEFORE DETERMINING WHETHER ANY MONOPOLY'S RATES SHOULD BE SUBJECT TO GREATER FLEXIBILITY, IS WHETHER COMPETITION IN FACT EXISTS. NEXT, ONE NEEDS TO DETERMINE HOW EFFECTIVE THAT COMPETITION IS OR CAN BE. IT IS NOT ENOUGH TO CONCLUDE THAT THERE IS A COMPETITOR OR A POTENTIAL COMPETITOR FOR SOME OR ALL OF A LEC'S SERVICES. ONE NEEDS TO DETERMINE WHETHER THOSE COMPETITORS CAN EFFECTIVELY OPERATE SO AS TO CONSTRAIN THE UTILITY'S MARKET POWER. A RELATED INQUIRY

IS WHETHER THE REGULATORY STRUCTURE IN PLACE WILL ALLOW COMPETITION TO DEVELOP. STATED OTHERWISE, ARE THERE ANY ASPECTS OF THE REGULATORY SCHEME WHICH WOULD ALLOW THE INCUMBENT MONOPOLY PROVIDER TO GIVE ITSELF AN ARTIFICIAL ADVANTAGE OVER OTHER POTENTIAL COMPETITORS? IF THERE ARE, THOSE MUST BE REMOVED. MCI SUBMITTED A PLAN TO THE CPUC WHICH ADDRESSES THOSE KEY QUESTIONS. UNFORTUNATELY, THE PLANS SUBMITTED BY THE TWO LARGEST LECS IN CALIFORNIA -- PACIFIC BELL AND GTE OF CALIFORNIA -- DO NOT. FURTHERMORE, THE ORDER IN WHICH THE CPUC IS TAKING UP THESE IMPORTANT QUESTIONS CAUSES MCI A GREAT DEAL OF CONCERN.

LET ME FIRST ADDRESS THE QUESTION OF THE ORDER OF THE CPUC'S INVESTIGATION. THE BASIC PROBLEM MCI HAS WITH THE PROCEDURAL APPROACH FOLLOWED SO FAR IS THAT THE COMMISSION IS PUTTING THE CART BEFORE THE HORSE. MCI RAISED THESE CONCERNS IN A MOTION FILED WITH THE COMMISSION LAST SUMMER. THAT MOTION WAS DENIED IN SEPTEMBER. SPECIFICALLY, THE COMMISSION IS CONSIDERING

GRANTING PRICING FLEXIBILITY TO THE LECS IN PHASE 2 OF ITS INVESTIGATION, BUT IS DEFERRING THE QUESTION OF LIFTING THE BAN ON COMPETITION TO PHASE 3. IT NOT APPEARS THAT PHASE 3 HEARINGS MAY NOT CONCLUDE BEFORE THE MIDDLE OF 1990, AND THAT A COMMISSION DECISION IN PHASE 3 WILL NOT ISSUE UNTIL LATE 1990. IF THE LECS ACTUALLY GET WHAT THEY ARE ASKING FOR IN PHASE 2, WHILE MCI, AT&T AND OTHERS ARE STILL LEGALLY SHUT OUT OF THE INTRALATA MARKET, THE LECS WILL USE THEIR "PRICING FLEXIBILITY" TO LOCK UP THE MARKET FOR POTENTIALLY COMPETITIVE SERVICES. THAT IS OBVIOUSLY NOT GOOD FROM MCI'S PERSPECTIVE. EFFECTIVE COMPETITIVE MAY NEVER DEVELOP UNDER SUCH CONDITIONS. FROM THE CONSUMER'S PERSPECTIVE, THE LECS WILL GAIN SUBSTANTIAL FREEDOM TO CHANGE PRICES FOR MANY OF THEIR SERVICES WITHOUT INQUIRY INTO THEIR EARNINGS BY THE CPUC AND WITHOUT THE CONSTRAINT ON THEIR MONOPOLY POWER WHICH COULD BE PROVIDED BY COMPETITORS.

STATED SIMPLY, THE COMMISSION SHOULD FINISH PHASE 3 BEFORE

UNLEASHING THE LECS ANY MORE THAN IT ALREADY HAS. ONCE THAT IS DONE, BUT NOT BEFORE, THE COMMISSION CAN CONSIDER IMPLEMENTING THE VARIOUS PLANS SUBMITTED TO IT FOR "ALTERNATIVE REGULATORY FRAMEWORKS." THE FUNDAMENTAL PRINCIPLE OF MCI'S PLAN FOR REGULATION OF MONOPOLY LOCAL EXCHANGE COMPANIES IS THAT THE COMMISSION SHOULD DETERMINE WHICH OF THE LECS' SERVICES ARE SUBJECT TO COMPETITION AND WHICH ARE NOT, AND WHICH COMPONENTS, OR "BUILDING BLOCKS," OF THEIR NETWORKS ARE USED TO PROVIDE THOSE SERVICES. FOR EXAMPLE, IT IS PROBABLY TRUE THAT THE LECS' PRIVATE LINE OR TOLL SERVICE COULD BE SUBJECT TO COMPETITION, ASSUMING THAT THE CURRENT LEGAL BAN ON COMPETITION WERE LIFTED. HOWEVER, IT IS EQUALLY TRUE THAT SOME ASPECTS OF AN END TO END PRIVATE LINE OR TOLL SERVICE, SPECIFICALLY, THE "LOCAL LOOP" AND CARRIER ACCESS PORTIONS OF THE SERVICE, CAN BE PROVIDED ONLY BY THE LOCAL EXCHANGE COMPANY. SO THAT IF A CUSTOMER CHOSE MCI, RATHER THAN PAC BELL, AS ITS PRIVATE LINE OR TOLL CARRIER, MCI WOULD HAVE TO SECURE A PORTION OF THE SERVICE FROM PACIFIC. IN

THIS EXAMPLE, THE LOCAL LOOP AND ACCESS PORTION OF THE SERVICE IS A MONOPOLY BOTTLENECK "BUILDING BLOCK." IF PACIFIC OR ANY OTHER LEC IS PERMITTED TO CHARGE MCI MORE FOR THAT LOOP THAN IT WOULD "PAY" ITSELF, THEN PACIFIC HAS AN UNFAIR ADVANTAGE IN COMPETING.

THE CORNERSTONE OF MCI'S PLAN IS THAT THOSE MONOPOLY BOTTLENECK "BUILDING BLOCKS" SHOULD FIRST BE IDENTIFIED. NEXT, THE LECS SHOULD BE REQUIRED TO PROVIDE THOSE COMPONENTS TO EVERYONE, INCLUDING THEMSELVES, AT THE <u>SAME</u> PRICE AND WITH THE <u>SAME</u> TERMS AND CONDITIONS. ONCE THAT IS DONE -- AND ONLY AFTER THAT IS DONE -- SHOULD THE COMMISSION CONSIDER PRICING FLEXIBILITY OR LESSENED REGULATION FOR THE LECS. THIS IS NOT MCI'S PLAN ALONE. INDEED, MANY OF THE PARTIES IN PHASE 2 SUPPORT THIS CONCEPT, INCLUDING THE COMMISSION'S OWN DIVISION OF RATEPAYER ADVOCATES, BAY AREA TELEPORT, AT&T, AND OTHERS. THE LECS STAND VIRTUALLY ALONE IN OPPOSING THE NOTION OF "UNBUNDLING" MONOPOLY

SERVICES AS A CONDITION FOR PRICING FLEXIBILITY.

ONE OF THE PLANS NOW BEFORE THE COMMISSION -- PACIFIC BELL'S "CALIFORNIA PLAN FOR RATE STABILITY" -- HAS RECEIVED MORE PUBLICITY THAN ANY OTHER. I'D LIKE TO SPEND A FEW MINUTES DISCUSSING THE PROBLEMS THAT MCI SEES WITH CPRS. AS I SAID EARLIER, MCI OPPOSES ANY MOVE TO GRANT MORE PRICING FLEXIBILITY TO LECS AT THIS POINT. BUT THERE ARE ALSO SOME PARTICULAR PROBLEMS INHERENT IN CPRS. FIRST, PACIFIC SAYS THAT CPRS WILL REDUCE SUBSIDIES. IN FACT, IT DOES NOT. THE SUPPLIERS OF THE LARGEST SUBSIDIES ARE PACIFIC'S INTEREXCHANGE CARRIER CUSTOMERS. CPRS CONTAINS NO PROPOSAL TO REDUCE CARRIER ACCESS CHARGES, AND DOES NOTHING TO REDUCE THE SUBSIDIES NOW BEING PAID BY IXCS. FURTHERMORE, CPRS ACTUALLY <u>INCREASES</u> THE SUBSIDY NOW FLOWING TO ONE CLASS OF CUSTOMERS -- RESIDENTIAL RATEPAYERS. WHILE MCI SUPPORTS THE MAINTENANCE OF AFFORDABLE LOCAL EXCHANGE RATES, AND DOES NOT SUGGEST THAT RESIDENTIAL PRICES BE

INCREASED, IT DOES QUESTION THE WISDOM AND NECESSITY OF EFFECTIVELY LOWERING PRICES WHICH ARE ALREADY SUBSTANTIALLY BELOW COST, AS CPRS DOES. CPRS ALSO CONTAINS A "SHARING" MECHANISM, IN WHICH PACIFIC WOULD SPLIT EXCESS EARNINGS 50/50 WITH ITS RATEPAYERS. BUT PACIFIC SPECIFICALLY EXCLUDES ONE SET OF RATEPAYERS FROM THESE SHARINGS -- ITS INTEREXCHANGE CARRIER CUSTOMERS. THIS IS BLATANTLY UNFAIR, SINCE ACCESS CUSTOMERS NOW PROVIDE THE LARGEST SUBSIDY. IT'S ALSO ANTI-COMPETITIVE, SINCE PACIFIC WOULD CONTINUE TO COLLECT EXCESSIVE CARRIER ACCESS CHARGES, WHILE REDUCING THE PRICES FOR THE SERVICES FOR WHICH INTEREXCHANGE CARRIERS MIGHT SOME DAY COMPETE. FINALLY, CPRS WOULD EXCUSE PACIFIC FROM ANY COMPREHENSIVE REVIEWS OF ITS EARNINGS BETWEEN NOW AND 1992. THERE IS NO REASON TO BELIEVE THAT PACIFIC'S COSTS WILL NOT CONTINUE TO DECLINE OVER THE NEXT SEVERAL YEARS, AS THEY HAVE DONE OVER THE RECENT PAST. REMOVAL OF THE RATE CASE AND ATTRITION MECHANISMS WOULD DEPRIVE ALL OF PACIFIC'S RATEPAYERS OF THE FULL BENEFITS OF THOSE FUTURE

COST REDUCTIONS.

TO RECAP MCI'S VIEWS:

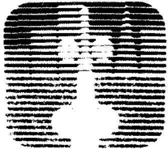
-- THE COMMISSION SHOULD NOT IMPLEMENT ANY PRICING FLEXIBILITY FOR LECS UNTIL IT LIFTS THE CURRENT BAN ON COMPETITION.

-- UNBUNDLING OF THE MONOPOLY BOTTLENECK "BUILDING BLOCKS" OF LEC SERVICES, AND REQUIRING THAT ALL CUSTOMERS, INCLUDING LECS, PAY THE SAME CHARGE FOR THOSE "BUILDING BLOCKS" SHOULD HAPPEN BEFORE ANY FURTHER PRICING FLEXIBILITY IS PERMITTED FOR LECS.

-- PACIFIC BELL'S CPRS SHOULD BE REJECTED.

I WOULD BE HAPPY TO ANSWER ANY QUESTIONS YOU MIGHT HAVE.

ATTACHMENT G



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TESTIMONY OF JOHN AYERS
PRESIDENT, BAY AREA TELEPORT

Special Hearing on Telecommunications Regulation
California Assembly
Utilities and Commerce Committee

Sacramento, June 6, 1989

EXECUTIVE SUMMARY

1. Bay Area Teleport (BAT) is a private provider of high-speed digital network services to business and government. BAT's privately-funded network operates in 11 counties in Northern California. BAT began operations in 1986 and is headquartered in Alameda.

2. Business and governmental users' needs are increasingly sophisticated. Numerous entrepreneurial firms providing metropolitan-area services are becoming operational throughout the United States, and private capital is being made available to support these efforts. This capital flow will be discouraged if the CPUC or Legislature promotes policies which give undue advantage to monopoly providers.

3. BAT is substantially involved in the Commission's OII 87-11-033 -- the "alternative regulatory frameworks" case. BAT supports the CPUC's desire to harness the benefits of new technology and competition to improve the state's business climate.

4. BAT believes the current process of rate-of-return regulation should be adapted to meet emerging needs. However, too much "flexibility" too soon may result in cross-subsidies, anti-competitive behavior, and consumer disruption.

5. BAT has offered four detailed proposals to the Commission regarding supplemental rate design, use of cost allocation manuals, the unbundling of bottleneck services, and price caps/rate bands. BAT believes these safeguards are essential for protecting consumer welfare and the opportunity for competition.

6. **Legislative recommendations.** Modify the structure of Commission processes: provide effective review of CPUC decisions through passage of AB 338 (Floyd); disclosure of ex parte contacts through passage of SB 1125 (Rosenthal); and new legislation requiring the Commission to identify substantial evidence as the bases of findings of facts in its decisions.

Chairwoman Moore and Members of the Committee, I am John Ayers, President of Bay Area Teleport (BAT). BAT is a private provider of high-speed digital network services to business and government. Our network connects eleven counties in Northern California, including the cities of San Francisco, Oakland, San Jose, Sacramento, Santa Rosa and surrounding communities. BAT is headquartered in Alameda.

Because BAT has, since it began operations in 1986, taken an activist role in the shaping of public policy -- both at the California Public Utilities Commission and in the Legislature -- I appreciated your Committee's invitation to come to Sacramento and comment on emerging issues facing policy makers in the area of telecommunications regulation.

My purpose today is neither to criticize the Commission nor any other telephone company. Many of the processes that are in place -- and the shortcomings and benefits of those processes -- are the result of decades of historical precedent. But the Legislature can take affirmative steps to recognize some of these structural shortcomings. The Legislature must continue providing the leadership for telecommunications policy for the 1990s and beyond.

What I offer is the perspective of one entrepreneurial company attempting to compete in a highly charged marketplace. BAT is but one of several metropolitan-area providers now operating throughout the U.S. This trend suggests not only a marketplace willing to buy new telecommunications technologies and offerings, but a sufficient amount of private capital currently being directed into the development of private networks to augment and benefit from a high-quality public switched network. This investment of private capital flow should be encouraged by policy makers -- it will be discouraged if the risks of investment are deemed unacceptable due to policies which give undue advantage to monopoly providers.

I am happy to report that the companies providing competitive local services are quickly becoming organized: I am a member of the board of directors of the Association for Local Telecommunications Services (ALTS) -- a national organization

comprised of numerous metropolitan-area service providers whose networks are entirely privately financed. ALTS intends to have a continuing presence at forums like this one, where the perspective of entrepreneurial telecommunications companies is welcome and indicative of increasing activity in the marketplace to meet the needs of sophisticated business and governmental users. The views I offer here are BAT's, however.

As suggested in the Committee's "Guide for Witnesses," sent to us last Friday, I would like to respond to your specific questions:

Current Proceedings before the Commission in which you or your organization may be involved.

BAT is actively involved in Phase II of the Commission's OII 87-11-033 pertaining to alternative regulatory frameworks for local exchange carriers.

BAT has also made an appearance in the Commission's workshop on customer-specific contracts, which is an outgrowth of Phase I of OII 87-11-033.

Positions which you may have taken in these proceedings / Comments you may have regarding the purpose or structure of these proceedings.

BAT has expressed its support for the Commission's desire to harness the benefits of new technology and competition to improve California's economic and business climate. One manner in which the Commission believes this can be accomplished is through relaxation of regulatory oversight in the process of setting rates for basic telephone services. Pacific Bell, General Telephone, and the Division of Ratepayer Advocates (DRA) have filed proposals spelling out how they would prefer this regulatory relaxation to be implemented.

BAT believes that the current process of rate-of-return regulation should be adapted to meet these emerging technological and business needs, but without sacrificing the well-being of

users of public and private telephone networks.

We are specifically concerned that too much "flexibility," granted too soon, may result in cross-subsidies and other anticompetitive behavior. The remedies to such problems after the fact can have tremendously disruptive effects on consumers at all levels. BAT does not challenge the sincerity of the local exchange companies or of the Commission in their stated goals of future preparedness. We do, however, believe that certain safeguards must be built into a revised regulatory framework.

Specifically, we have proposed:

1. That the Commission complete supplemental rate design before implementation of the Phase II decision. We believe that rate restructuring is fundamental to allow local exchange carriers the wherewithal to respond to inevitable competition, and that it is a prerequisite to rate "flexibility." If rates are based on properly allocated costs, and if the Commission has a high degree of confidence in the rate structure, there is no reason why some form of limited flexibility might not be granted. Preparation for and response to competitive forces could then be addressed by the local exchange carriers, with costs and corresponding rates fully understood by all parties.

In light of recent written inquiries to President Wilk by at least a dozen legislators (including Assembly Members Nolan, Wright, and Hill of this Committee), each of which expresses concern about the issues of cross-subsidy and ratepayer burden, we believe our proposal regarding supplemental rate design is especially timely, and that this legislative interest is right on target.

2. That the Commission require local exchange carriers to use a cost allocation manual. The basic purpose of a cost allocation manual is to separate costs between regulated and non-regulated activities. The Commission, we believe, has the expertise to oversee the development and use of such a manual, even though the business of cost allocation can be time consuming and contentious.

The effort is, in our view, well worth it. A product-specific cost allocation manual makes it possible for all parties to review how a local carrier assigns costs and arrives at rates for the services it offers, and makes it possible to detect anticompetitive activities such as predatory pricing.

3. That the Commission require local exchange carriers to "unbundle" their "bottleneck" services. The loop between the local exchange carrier's central office and the caller's premises is a "bottleneck" through which virtually all calls must pass. Because of their strategic position, local exchange carriers must be carefully regulated to ensure that their bottleneck services are offered on equal terms and conditions for all users of the local exchange network.

How would "unbundling" work? Consider the example of local toll service. It consists of four "bundled" elements: transport of the call from the user's premises to a telephone company central office; switching at the central office; transport between central offices; and billing. "Unbundling" would require each of these elements to be separately tariffed. All users of these services, including the local exchange carrier, would be required to pay -- or "impute" -- the tariffed price for each element. This will ensure basic competitive equality for all companies in the marketplace.

In Phase I of I. 87-11-033, the parties agreed upon, and the Commission approved, this "unbundling" approach in the pricing of bottleneck access services for high-speed digital private line carriers. Application to other exchange services would represent tangible recognition by the Commission that it desires a truly level playing field as it seeks appropriate regulation for the 1990s and beyond.

4. Finally, BAT has recommended that, in the event of adopting rate flexibility, the Commission also employ service-by-service price caps and rate bands to minimize wild swings in pricing. BAT realizes the distinct possibility that the Commission may adopt significant elements of the proposals put forth by Pacific Bell, General Telephone, and DRA. In such an

event, we have recommended modification of those proposals to govern rate changes which may have an anti-competitive effect. We recommend service-by-service price caps to govern rate increases, and rate bands to limit downward pricing flexibility. We believe the first of these proposals will guard against shifting costs from competitive services to monopoly services, while the latter will serve as an effective watchdog against under-pricing services so as to drive potential competition away.

Policy recommendations to the Committee regarding telecommunications policy and regulatory processes.

Having monitored legislative developments in the telecommunications arena for several years, BAT has observed no shortage of activity as the Legislature attempts to respond to changes in the federal regulatory policy and in the marketplace. I am happy to note a gradual change in the orientation of most of the legislation we have been seeing lately: a movement away from legislating specific outcomes and toward the processes by which policy is made.

BAT believes that the Legislature must focus its attention on the structure of Commission processes. I say "structure" quite deliberately: our purpose is not to criticize the behavior of any individual, company, or interest. It is quite legitimate for practitioners and policy makers to utilize all available legal channels to represent their interests and views as best they can. But BAT believes that the process of Commission decision making in the area of telecommunications policy for the 1990s and beyond must structurally altered to meet the types of challenges articulated by this Committee and by other concerned parties.

We propose three specific efforts:

1. Provide More Effective Judicial Review of Commission Decisions. Under current law, appeal of Commission decisions must be taken directly to the Supreme Court. The high court lacks the resources to take on these challenges; moreover, the process of a Supreme Court review is overly time- and resource-consuming to all but a few companies. As a result, the opportunity to challenge

Commission decisions has become stifled. One remedy is immediately at hand: **AB 338 (Floyd)**, which would allow for case review by the Court of Appeals. While Assembly Member Floyd's bill does not allow appellants to take cases directly to the Appeals Court (which we believe to be the ideal process), it does at least allow the Supreme Court to transfer cases for review by the Court of Appeals.

2. Eliminate Ex Parte Contacts. In the long run, BAT believes that it is in the best interest of all affected parties for Commission policy to be made in the full light of day and, as a result, the established tradition of informal lobbying of commissioners and other key decision makers, outside the hearing process, must come to an end. This is one reason for our support of **SB 1125 (Rosenthal)**. This bill would require the Commission to adopt rules and orders governing ex parte communications. These rules would require copies of written ex parte presentations and memoranda describing in-person contacts, as is now required at the Federal Communications Commission. BAT believes this legislation is long overdue, and that no other step the Legislature could take has so great a potential for reforming the manner in which Public Utilities Commission business is transacted.

3. Provide for Evidentiary Integrity. We have proposed that AB 338 be amended to include language requiring the Supreme Court, or the Court of Appeal, to determine whether or not the Commission has identified substantial evidence in the record of its proceeding as the basis of each finding of fact in its decision. The potential is still great for the Commission to rely upon insubstantial statements as the basis for its findings, allowing unsupported "evidence" to be used for supposed "findings of fact." Often, this evidence is presented through ex parte contacts. The net effect could render the record of many proceedings little more than "evidence bins," receptacles for the Commission to rummage through to justify decisions already made.

We believe the Legislature should act immediately to insulate Commission decisions from non-record or informal influences by requiring that each finding of fact be based upon substantial evidence in the record. This will greatly reduce the risk of careless or arbitrary decision making, and should do much to restore confidence in Commission decisions.

Conclusion

The safeguards proposed by BAT are in the "alternative regulatory frameworks" OII are essential for safeguarding competition and consumer welfare. BAT also urges the Legislature to enact SB 1125 and AB 338 (with the amendments discussed above). The Legislature should continue its monitoring to ensure that the Public Utilities Commission enacts the proposed safeguards before making any decision modifying the regulation of local exchange carriers.

COMMENTS BEFORE THE CALIFORNIA ASSEMBLY COMMITTEE ON PUBLIC UTILITIES AND COMMERCE

I AM JOHN P. MCDONALD, VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL FOR THE REUBEN H. DONNELLEY CORPORATION, A DUN & BRADSTREET COMPANY.

FROM THE MATERIALS I HAVE RECEIVED, IT IS MY UNDERSTANDING THAT THE FOCUS OF THIS HEARING IS ON THE ADEQUACY OF TELECOMMUNICATIONS REGULATION WITH A PARTICULAR CONCERN FOR THE PROCEEDINGS CURRENTLY UNDERWAY BEFORE THE CALIFORNIA PUBLIC UTILITIES COMMISSION.

WE ARE PARTICIPANTS IN BOTH THE ALTERNATIVE REGULATORY FRAMEWORKS AND THE ENHANCED SERVICES PROCEEDINGS. WE ALSO HAVE FORMAL AND INFORMAL COMPLAINTS PENDING BEFORE THE PUBLIC UTILITIES COMMISSION AND HAVE OPPOSED PACIFIC BELL'S MARKET TEST FILING BEFORE THE FEDERAL COMMUNICATIONS COMMISSION.

IN EACH OF THESE PROCEEDINGS WE HAVE EXPRESSED THE SAME CONCERN. THE HOLDER OF THE LOCAL EXCHANGE MONOPOLY FRANCHISE HAS BOTH THE ABILITY AND THE ECONOMIC INCENTIVE TO LEVERAGE ITS MONOPOLY POWER INTO ADJACENT COMPETITIVE MARKETS. ABSENT LEGISLATIVE ENACTMENT AUTHORIZING ENLARGEMENT OF THE TELEPHONE COMPANY MONOPOLY FRANCHISE INTO COMPETITIVE MARKETS, SUCH EXPANSION OF MONOPOLY POWER SHOULD BE AGGRESSIVELY DENIED.

THE DIVESTITURE OF AT&T ADDRESSED THE MONOPOLY POWER THAT AT&T POSSESSED IN MANUFACTURING AND LONG DISTANCE TELECOMMUNICATIONS. IT DID NOT ERADICATE THE LOCAL EXCHANGE MONOPOLY. WHILE COMPETITION MAY HAVE EMERGED IN MANUFACTURING AND IN LONG DISTANCE SERVICES, NO SUCH COMPETITION HAS EMERGED WITH RESPECT TO LOCAL EXCHANGE SERVICES. THE RATIONALE FOR RELAXATION OF REGULATORY CONTROLS AND OVERSIGHT THAT APPLIES TO LONG DISTANCE SERVICES AND MANUFACTURING FINDS NO SUPPORT WITH RESPECT TO LOCAL EXCHANGE SERVICES. IN FACT, THE EFFORTS OF THE LOCAL EXCHANGE TELEPHONE COMPANIES TO ENTER INTO COMPETITIVE MARKETS PROVIDES SUPPORT FOR THE SUGGESTION THAT THERE SHOULD BE INCREASED REGULATORY SCRUTINY, NOT LESS.

IN THE ALTERNATIVE REGULATORY FRAMEWORKS PROCEEDING, PACIFIC BELL HAS ASSERTED THAT IN ORDER TO MAKE THE INVESTMENTS NEEDED TO PROVIDE CALIFORNIA WITH A WORLD CLASS TELECOMMUNICATIONS SYSTEM AND IN ORDER TO BE MORE COMPETITIVE IN THE MARKETPLACE, IT MUST BE FREED OF REGULATORY CONTROLS. IT HAS ARGUED THAT THE REGULATORY PROCESS IS TOO SLOW AND CUMBERSOME FOR PACIFIC BELL TO BE COMPETITIVE OR TO PROVIDE THE TECHNOLOGICAL ADVANCES THAT WOULD BE BENEFICIAL TO CALIFORNIA.

UPON EXAMINATION, THE ASSERTIONS OF PACIFIC BELL FAIL. IF PACIFIC BELL WERE SUFFERING FINANCIAL HARDSHIP AND THE PUBLIC UTILITIES COMMISSION DELAYED IN PROVIDING RELIEF, THEN ONE COULD UNDERSTAND PACIFIC BELL'S COMPLAINTS. HOWEVER, THIS IS NOT THE CASE. PACIFIC BELL IS CURRENTLY

ENJOYING RECORD EARNINGS -- EVEN THOUGH THE PUBLIC UTILITIES COMMISSION REDUCED PACIFIC BELL'S RATES IN EACH OF THE LAST THREE YEARS. ADDITIONALLY, IT APPEARS THAT PACIFIC IS STILL EARNING IN EXCESS OF ITS ALLOWED RETURN AND THAT FURTHER RATE REDUCTIONS ARE WARRANTED. IT IS DIFFICULT TO UNDERSTAND HOW PACIFIC BELL IS DISADVANTAGED BY THE REGULATORS BEING SLOW IN REDUCING PACIFIC'S RATES OR HOW EARNINGS IN EXCESS OF THEIR ALLOWED RETURN INHIBIT PACIFIC BELL'S ABILITY TO MAKE INVESTMENTS NECESSARY FOR THE TELEPHONE SYSTEM.

ANOTHER ASPECT OF PACIFIC BELL'S PROPOSAL IS THAT IT WILL RAISE RATES FOR A SIGNIFICANT PORTION OF ITS CUSTOMERS. IT HAS BEEN SUGGESTED BY ONE WITNESS IN THE ALTERNATIVE REGULATORY FRAMEWORKS PROCEEDING, THAT RAISING RATES IS NOT THE CLASSIC ECONOMIC RESPONSE TO COMPETITIVE ENTRY.

APART FROM THESE INCONGRUITIES, PACIFIC BELL'S CONDUCT IN THE MARKETPLACE PROVIDES A STRONG CASE FOR ENHANCED REGULATORY CONTROLS. PACIFIC HAS ARGUED THAT IT SHOULD BE PERMITTED TO ENTER INTO THE PROVISION OF ELECTRONIC INFORMATION SERVICES. OPPONENTS OF THEIR ENTRY ARE CONCERNED THAT PACIFIC BELL'S ABILITY TO BOTH DISCRIMINATE AGAINST OTHER INFORMATION PROVIDERS AND TO CROSS-SUBSIDIZE ITS COMPETITIVE EFFORTS WILL STIFLE THE EMERGING INFORMATION SERVICES INDUSTRY.

THESE CONCERNS ARE NOT IMAGINARY. IN ITS ENHANCED SERVICES FILING, PACIFIC BELL HAS INCORPORATED BILLING AND COLLECTION FEATURES THAT FAVOR PACIFIC BELL'S ENHANCED SERVICES PROVIDER AND DISCRIMINATE AGAINST OTHER ENHANCED SERVICE PROVIDERS. PACIFIC BELL'S ASSERTION THAT IT WILL

PROVIDE LOW COST ENHANCED SERVICES IS BASED ON THE FACT THAT THE RATEPAYERS WILL BEAR OR HAVE BORNE A SUBSTANTIAL PORTION OF THE COST OF THEIR PROPOSED SERVICE.

THE DANGERS OF HAVING THE HOLDER OF THE MONOPOLY SERVICE PROVIDER AS A COMPETITIVE ENTRANT OR EVEN POTENTIAL ENTRANT ARE DEMONSTRATED BY THE FAILURE OF CALIFORNIA TO HAVE THE ELECTRONIC INFORMATION SERVICES THAT ALREADY EXIST IN OTHER PARTS OF THE COUNTRY. ELECTRONIC YELLOW PAGES AND DIRECTORIES PROVIDED ON COMPACT DISCS ARE OFFERED TO THE PUBLIC IN OTHER STATES BUT CANNOT BE VIABLY OFFERED HERE IN CALIFORNIA. THE REASON IS FOR THIS IS THE REFUSAL OF PACIFIC BELL TO MAKE LISTING INFORMATION AVAILABLE FOR USE IN CONNECTION WITH AN ELECTRONIC PRODUCT. FROM ITS FILINGS IN WASHINGTON, D.C. IT IS CLEAR THAT PACIFIC BELL INTENDS TO OFFER INFORMATION SERVICES. UNTIL PACIFIC CAN OFFER THEM IT IS GOING TO MAKE SURE THAT NO ONE ELSE CAN OFFER THEM. THIS ANTICOMPETITIVE BEHAVIOR CAN BE EXPECTED WHENEVER A MONOPOLY IS GIVEN THE OPPORTUNITY TO EXERCISE ITS POWER IN COMPETITIVE MARKETS.

OUR RECOMMENDATION IS THAT THE LEGISLATURE OPPOSE ANY EFFORT THAT WILL REDUCE REGULATORY CONTROLS AND OVERSIGHT. FURTHER, GIVEN THE EFFORTS OF THE TELEPHONE COMPANIES TO ENTANGLE THEIR MONOPOLY FRANCHISES IN COMPETITIVE MARKETS, IT MAY BE PRUDENT FOR THE LEGISLATURE TO EXAMINE WHETHER THE DEFINITION OF THE ALLOWED AND PROHIBITED ACTIVITIES OF THE TELEPHONE CORPORATIONS IN CALIFORNIA IS ADEQUATE TO PROTECT THE INTERESTS OF THE RATEPAYERS AND THE COMPETITIVE INDUSTRIES OF THE STATE.

ATTACHMENT I

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE
STATE OF CALIFORNIA

In the Matter of Alternative Regulatory Frameworks for Local Exchange Carriers.	))))	I 87-11-033

BRIEF OF API ALARM SYSTEMS

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INTRODUCTION AND PRELIMINARY STATEMENT

This brief is filed on behalf of API Alarm Systems (API) which has participated extensively in this proceeding as an interested party. API provides burglar and fire alarm services in portions of Southern California and is a large customer of both Pacific Bell (Pacific) and GTE California (GTEC); it will be substantially affected by any decision the Commission may reach in this proceeding as to alternative regulatory frameworks to which those two telephone companies will be subject. Because API has examined carefully the alternative regulatory framework proposals of Pacific, GTEC and the Division of Ratepayer Advocates (DRA), this brief will discuss API's views as to each.

Additionally, API has identified several issues, such as these companies' tariff liability limitations and complaint and advice letter procedures, which may be impacted by the Commission's adoption of any particular alternative framework proposal; they are discussed separately in this brief. As a preliminary observation, API would note its support for any changes in the regulatory process which are necessary and in

the public interest to keep pace with technological and competitive changes in the telecommunications marketplace. This brief discusses shortcomings and potential problems that API has identified in some of the proposals discussed in this brief; API does not, as a general principle, oppose the adoption of any other regulatory changes deemed necessary and in the public interest by the Commission.

As a threshold matter, API does submit that only one alternative framework plan be adopted and applied to the intrastate operations of both Pacific and GTEC. This conclusion arises because these companies are the two largest telecommunications utilities in the state and because these companies have proposed plans which are, in some respect, widely divergent from each other. For large customers like API, who buy substantial quantities of service from both companies, including jointly provided services, the adoption of two widely differing proposals could have profound impacts. For instance, GTEC's proposal would classify low speed, analog private line services (used extensively by API) as a "Category 2" service which would be subject to both upward and downward flexible pricing; Pacific Bell, on the other hand, would not subject these services to flexible pricing.

Any attempt to accurately predict the costs of such services in a two plan environment would be especially difficult for companies like API -- and this difficulty would only be compounded for services which are jointly provided between Pacific and GTEC. Differences in the treatment of basic network connections ("Basic Service Elements") as proposed by these two companies would similarly generate substantial customer confusion and hamper accurate forecasts of telecommunications costs and quantities that should be ordered to provide enhanced services to the public. Although each company's plan has problems, including some of the areas mentioned and discussed in greater detail, infra, the imposition of one plan for these two companies will at least avoid the creation of additional administrative difficulties for companies like API.

This brief will first discuss problems presented by GTEC's plan; it will then discuss Pacific's and DRA's proposals. Finally, this brief will discuss issues which API believes are common to both proposals, and concluding recommendations of API. References to the transcript of the proceedings in this case will be made by indicating the appropriate Volume ("V"), followed by the letters "TR" and the appropriate pagination. Reference to exhibits

introduced into evidence in this proceeding will be made by the abbreviation "Ex." followed by the appropriate number. Reference to the interested parties in the proceeding will be made in the manner in which they appeared.

I. GTEC's Plan

GTEC's witnesses, McCallion and Williams, submitted testimony describing the broad parameters of GTEC's plan for an alternative regulatory framework, and the changes in the Commission's tariff process which are necessary to implement that framework. Broadly speaking, and as set forth in Mr. McCallion's direct testimony, (Ex. A-56), GTEC's plan is predicated upon the division of its presently regulated service into two categories. Services subject to price constraints and rate "rebalancing" will be placed into Category 1 and would be subject to price changes based upon an index proposed by GTEC. Services allegedly subject to competition and/or considered to be discretionary would be placed in Category 2, and would be subject to upward and downward flexible pricing, including annual price increases of up to 10%. (Ex. A-56, p. 6). Earnings above a pre-determined benchmark rate of return would be shared with Category 1 ratepayers. (Ex. A-56, p. 17). The benchmark rate of

return would be reviewed every two years (Id.) and the current rate case process would be eliminated. Charges for flexibly priced Category 2 services would be subject to changes, on ten days notice, based upon Advice Letter filings (Id. pp. 12-14).

GTEC employee Williams outlined GTEC's plan to rebalance 'Category 1' rates on an annual basis (Ex. A-73, p. 6) and described GTEC's plan to offer "information age" services (Id. at p. 15). API has examined GTEC's plan and cross-examined its witnesses in this proceeding. API has significant concerns that the plan as a whole is not cost effective, and that the plan would be particularly unfair for certain "Category 2" users like API who would be subjected to revenue maximizing, rather than cost based, pricing. These concerns are addressed in order.

GTEC Has Not Demonstrated
That Its Plan Is Cost Effective

The evidence in the record indicates that GTEC's plan assumes an increase in the overall rate of return from 11.13% to 12.42% to be used as a benchmark return. GTEC has quantified the revenue requirement value associated with a change in the rate of return as approximately $515, 000 per basis point. (See, V. 35, TR 4040; Ex. A-92). Thus, the upward move requested

for GTEC's overall rate of return alone would represent approximately $65 million in increased revenue requirement. Accordingly, given the magnitude of the requested revenue requirement change and the effect that it would have on rates in the traditional rate-setting process, the Commission should justifiably question what ratepayer benefits attend the 129 basis point increase requested for GTEC's rate of return.

The record does not support a conclusion that GTEC's proposal passes such a cost/benefit test, however. For instance, the evidence produced by GTEC as to its financial performance under the plan was anecdotal, at best. GTEC's witness Williams included the results of a model detailing expected rates under its plan (Ex. A-73, p. 12), which was the only proferred evidence as to GTEC's performance under the plan. (V. 22, TR 2395). The record discloses, however, that the results of GTEC's "model" are not capable of demonstrating customer benefits under the plan. Specifically, on cross-examination Mr. Williams admitted that the model assumed expense reductions unsupported by any factual basis. Mr. Williams had "no facts to confirm that these expense reductions are accurate" (V. 34, TR 3964). Indeed, Mr. Williams testified that he did not know whether the cost savings

he had assumed in his model could be achieved without an incentive plan (V. 34, TR 3962).

While GTEC's failure to substantiate the "benefits" better in the cost/benefit equation presented by its plan is reason for concern, API submits that the plan's departure from cost-based pricing for GTEC's monopoly services are serious defects indeed. In this regard, GTEC's witness McCallion admitted that, other than GTEC's proposed index, nothing would prevent basic rates from increasing beyond costs under its plan (V. 19, TR 1930-31); and as will be discussed in greater detail, infra, GTEC's proposal to engage in upward flexible pricing of up to 10% annually, for certain monopoly services such as low speed private line, certainly represents a departure from cost-based pricing for services not subject to competition in GTEC's territory.

API discusses the portions of GTEC's proposal having more immediate impact upon it below (the treatment of Category 2 services); nonetheless, the underpinnings to support GTEC's request for an

increased rate of return under the plan appear unsound in the first instance. As Mr. Williams testified, the expected savings to be produced under the plan are not based upon fact, but upon Mr. Williams'"best shot" (V. 34, TR 3964). Indeed, GTEC could point to no specific methodologies or practices that it would change under incentive regulation. API's concerns about GTEC's failure to better quantify the "benefits" of the cost/benefit equation presented by GTEC's plan, is only heightened by the numerous defects contained in GTEC's proposed implementation of Category 2 services, as discussed below.

GTEC's Improper Treatment Of Category 2 Services

As previously mentioned, GTEC's plan seeks considerable pricing flexibility for so-called Category 2 services. Of particular concern to API is GTEC's proposal to include analog private line services as a Category 2 service, although API is also concerned that as the network evolves into a more information oriented context, GTEC's plan will financially punish companies like API who purchase future, network access services from GTEC.

A threshold observation about GTEC's proposal to include services within Category 2, based upon their

characterization as 'competitive or discretionary', is the arbitrary and discriminatory manner in which GTEC has applied these definitions. For example, even though GTEC proposed to include analog, low speed private line services within this category, GTEC's witness, McCallion, stated that he did not conduct studies to determine whether alarm grade private line services were subject to competition, nor did he know if his company had conducted such studies (V. 27, TR 2977). Similarly, he had not conducted studies to determine if those same services were considered to be discretionary by alarm companies or their patrons. Id. Indeed, even Pacific's witness, Dr. Hausman, indicated that the way services are categorized under GTEC's plan may be problematical. (V. 14, TR 1290).

Given this decidedly casual approach to ensuring that GTEC's service classifications are consistent with its own standards, (API doubts the validity of GTEC's "discretionary" criterion),*/ it is

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*/ For instance, in the case of alarm grade private line services, API's witness, W.K. Edwards testified that alarm grade private service is neither competitive nor "discretionary" within GTEC's territory. He demonstrated that such services are not available from vendors other than GTEC within GTEC's territory and that high grade alarm service, only available through private line service, would not be considered "discretionary" by customers either required by law or practical circumstances, to purchase this high grade alarm protection. (See, Ex. A-96, pp. 7-8).

not surprising that GTEC proposes no review mechanism for its plan to ensure that its service classifications continue to meet its own established criteria. (V. 35, TR 4053). GTEC's apparent intention to engage in the discriminatory classification of Category 1/Category 2 services at the outset, however, is apparent. In this regard, Mr. McCallion testified that Centrex (a service provided by GTEC which is competitive) loops would be classified as a Category 1 service, while the related features would be categorized at Category 2. He testified, however, that private line loops would be classified as Category 2 (V. 27, TR 2988). Even GTEC's witness, Williams, disagreed with this proposed treatment as inconsistent with his own philosophy of categorizing these services. (V. 34, TR 3992). Thus, GTEC's own testimony demonstrated that its Category 2 classification scheme is not only arbitrary, but is slated for an application that is discriminatory.

The financial impacts of GTEC's proposed treatment of Category 2 customers are equally disturbing. Generally, customers subject to GTEC's Category 2 pricing would be subjected to annual rate increases of up to 10% (compounded) without regard to cost, without any substantive review by this Commission and simply based upon marketing and revenue maximizing

considerations by GTEC's management. API submits that such carte blanche pricing should be rejected by this Commission. Valuable insight into GTEC's corporate pricing policy for these Category 2 services was provided by its witness, Mr. McCallion. When he was asked if an overall revenue or price cap would be appropriate for Category 2 services, he rejected that suggestion because "it would limit management's discretion to maximize revenues". (V. 27, TR 2994). Although Mr. McCallion's explanation of how the 10% amount was selected by GTEC as the appropriate annual rate inflator was equally candid, it was decidedly less scientific: "Ten percent seemed to be a reasonable number for that. It is not based upon a detailed study, but rather it is based upon basically just a need to put a number with the ceiling." (V. 22, TR 2381).

API submits that the Commission should be rightfully disturbed about putting such a tool in the hands of GTEC against this background. Telecommunications intensive companies like API are extremely sensitive to price changes in the network services upon which they rely. API's ongoing presence before this Commission in rate cases and other cases related to both Pacific and GTEC is evidence of that

fact. That dependence promises to become more critical as GTEC's monopoly network evolves to support more sophisticated network information age services and as GTEC moves into the competitive provision of those services itself, (see, e.g., V. 26, TR 2956). Given the fact that GTEC's 10% annual increases could compound indefinitely into the future under its plan (V. 27, TR 2995, 2499), its ability to impose such large rate increases over a relatively short period of time could easily manipulate the demand for certain network services within markets in which GTEC also acts as an unregulated competitor. GTEC's indication that it may increase private line rates based upon "strategic pricing" considerations (V. 35, TR 4049-50) underscores that concern. Indeed, as if to erase any doubt as to the unfettered discretion that GTEC intends to arrogate to itself for Category 2 service pricing, Mr. Williams characterized the Commission's review of Category 2 advice letter filings as "clerical" (V. 27, TR 3094); he did, however, indicate that GTEC might furnish cost support for 'politically' sensitive private line increases (V. 35, TR 4049). API wonders if the Commission and the regulated process would be better off by regulation based upon political contests.

As previously mentioned, an additional area of concern to API centers upon GTEC's plan to offer enhanced services during the life of its plan (V. 26, TR 2956), and the manner in which network access will be offered to other enhanced service providers. The record demonstrates that, as Mr. McCallion testified, a prime objective of GTEC's network deployment under its plan will be its ability to offer enhanced services (V. 27, TR 2968); he also testified that its offering of alarm services is "a possibility" (V. 27, TR 2970). He further indicated that GTEC plans to account for enhanced services "above the line" (V. 27, TR 2971-72) and that information age network access (Basic Service Elements) would be offered by GTEC as a Category 2 service (V. 23, TR 2518).

API witness, Mr. O'Brien, pointed out the necessity of deploying ONA-type services within GTEC's territory, and API indeed supports the evolution of GTEC's network to support more "information age" or enhanced service offerings. (Ex. A-97, pp. 10-11).

Unfortunately, GTEC's proposal to include enhanced services as "above the line" items for ratemaking purposes, and its proposal to include ONA-type services such as Basic Service Elements in its Category 2 services, threatens to scuttle whatever pro-

competitive benefits GTEC's plan might otherwise offer in this regard. As the Commission is aware, under conventional ratemaking methodology costs not borne by one service are likely to be borne by another. Pacific's witness, Mr. George Schmitt, essentially agreed with this proposition when presented with the hypothetical example of Pacific's entry into the burglar and fire alarm business in a manner which lost money. (V. 7, TR 316).

Since API believes that losses in GTEC's non-regulated, enhanced service operations are inevitable -- at least in the short-term -- GTEC's proposal to include these operations as above the line items will unfairly burden GTEC's regulated ratepayers with losses in competitive markets. API submits that a more appropriate way to deal with these services in the competitive information age environment would consist of ensuring correct cost allocation between GTEC's competitive and monopoly services, and allowing GTEC stockholders to enjoy the profits or bear the losses, as the case may be.

GTEC's proposal to price ONA type services such as Basic Service Elements (BSEs) as a Category 2 service -- subject to almost no meaningful oversight by the Commission -- is bad for the same reason. As Mr.

O'Brien pointed out, for instance, ONA services required to be offered by Pacific Bell constitute a series of unbundled basic network connections which may be purchased by Pacific's enhanced service provider competitors. (Ex. A-97, pp. 8-10). If GTEC were thus allowed to price these monopoly network connections essentially at its whim (API has previously discussed the wide discretion that GTEC's plan creates for GTEC in this area), competition could easily be manipulated by GTEC for enhanced service markets in which it is a competitor. Thus, while API supports GTEC's deployment of ONA-type services within its service territory and is willing to pay a cost-based price for those services, API does not support GTEC's proposed regulatory treatment of those services.

As a final note on GTEC's plan, API is constrained to point out that this Commission has recently found that GTEC has been unable to correctly bill API for private line services; in its Decision, the Commission noted many problems with GTEC's billing for these services and with its application and interpretation of its tariffs. See, Decision 88-12-036 mailed December 12, 1988, pp. 64-75 (API Alarms Systems v. General Telephone Company of California). Given GTEC's proposal to flexibly price a large number of

services, including new services which have not yet even been introduced, API believes that GTEC's advice letter filings will occur with greater frequency in a new environment -- a development which will undoubtedly further complicate GTEC's billing system. API doubts that GTEC's billing system will be able to cope with these added pressures, given its inability to correctly bill for private line services now. API thus recommends that if the Commission approves any flexible pricing for GTEC, it require demonstrable proof that GTEC has eliminated the problems in its billing system.

II. Pacific Bell's California Plan For Rate Stability (CPRS)

Pacific's CPRS proposal was generally summarized by its witness George F. Schmitt. The CPRS plan presented by Mr. Schmitt would freeze residential rates at their current levels through 1992, would eliminate Touchtone charges for residential customers and expand local calling areas; it would raise analog private line rates and rates for other business services between the plan's inception and 1992; it would establish the sharing of earnings between ratepayers and the company for earnings above a predetermined benchmark; it would introduce pricing flexibility for certain services; and it would replace

the current rate case and attrition process with regulatory monitoring. Finally, CPRS would allegedly result in a more information services oriented network based upon investments Pacific says that it will make under CPRS. (See, e.g., Ex. A-1, pp. 11-21, and Attachment A).

API submits that CPRS suffers from the same drawbacks as does GTEC's proposal on the question of whether the proposal passes muster under a cost/benefit analysis. And although Pacific's CPRS does not contain the same potential for the upward flexible pricing of monopoly (e.g., low speed private line) customers, it nonetheless proposes unjustified rate increases for business customers and is unacceptably vague and/or overreaching in its proposal to flexibly price and account for enhanced services and network access for those services. Pacific's failure to justify its plan from a cost/benefit prospective, and the shortcomings of its plan vis a vis business and so-called information-age services, will be discussed in order.

The Absence Of Evidence To Justify The Plan From A Cost/Benefit Analysis

Since Pacific's plan is pinioned upon the elimination of the rate case and attrition process, coupled with an increase in its overall rate of return

for benchmark measurement purposes, API submits that the Company's plan should have demonstrable benefits to the ratepayers which justify the related costs of implementing the plan. Those benefits are missing in this record, and the Commission should not buy into Pacific's plan without first seeing those benefits.

For instance, a key element of Pacific's proposal hinges upon a request to raise its rate of return for the CPRS environment, above which earnings will be shared between the company and its ratepayers. This return is approximately 150 percentage points higher for equity capital than Pacific's currently authorized return, which roughly equates to a $150 million increase in revenue requirements (V. 63, TR 7979-80). (Its overall increase in the requested return overall is approximately 103 basis points higher than its existing return. (<u>Compare</u> V. 10, TR 715-718 and V. 64, TR 8051). And although Pacific's equity cost witness Dr. Vander Weide testified that the incremental equity cost of CPRS was 50 basis points (V. 62, TR 7779-81) (as opposed to the difference between Pacific's currently authorized rate of return and the return level requested in this proceeding) it is nonetheless clear that CPRS will impose a premium cost in the rate of return context.

The Commission should thus ask, what are the benefits for this cost, given the fact that Pacific's proposed freeze on basic rates is occurring during the period in which its costs are declining rapidly. (*See, e.g.*, Dr. Harris' responses to cross-examination questions on this subject. V. 8, TR 391-92, 411). A logical answer to this question -- and one would expect Pacific to have provided, would be that added incentives in productivity improvements under CPRS would produce savings for the ratepayers that would outstrip those to be realized under the *status quo*. The record does not support such an inference on Pacific's behalf, however.

For instance, upon being cross examined, Pacific's witness Schmitt could not think of any cost savings programs that would be instituted under incentive rate making, that would not otherwise be instituted (V. 10, TR 614). Nor was proof supplied anywhere by Pacific that ratepayers subject to sharing would benefit more, in terms of rates, under the plan. When Mr. Schmitt was questioned as to whether the plan should be tracked from a business as usual perspective so that such a cost/benefit analysis could be performed in 1992 or 1993, he replied: "I can't think of any reason why you would want to." (V. 10, TR 682-83).

Indeed, Pacific's failure of proof in this regard permeated its showing. It failed to examine its cost of capital or capital requirements during the CPRS environment (V. 64, TR 8049), it failed to produce on the record any studies as to the economics of CPRS and its effect on the cash flows of the company (V. 64, TR 8053-55) and it failed to consider the capital cost effects of modifications that the Commission might make to the plan, such as those proposed by DRA and/or GTEC (V. 62, TR 7781-83). (Also see Mr. Schmitt's testimony that no studies were made to predict the financial performance of the company under the plan; V. 7, TR 251-252, 618). Against this background, API submits that Pacific has failed to demonstrate that CPRS passes muster under a cost/benefit analysis.

CPRS Proposes Unfair Treatment For Business Services And Open Network Architecture-Related Services

API believes that CPRS presents a particularly one-sided proposition for business service users, which include API, by singling them out for large, unjustified rate increases. For example, the record clearly demonstrates that Pacific has targeted a number of business services for rate increases that, during the life of the plan, would range from over 100% to well over 1,000%. Pacific's witness, Dr. Harris,

was presented with Pacific's quantification of proposed business service increases during the life of the plan (Ex. A-6) and was asked to calculate the range of increases as a percentage. Exhibit A-6 and Dr. Harris' answers show that Pacific's plans are to increase business service connections by an amount exceeding 100%; to increase PBX trunks by over 100%; to increase answering line service by approximately 400%; to increase TAS service by over 1,000%; to increase 3002-C bridged alarm service rates by between 600% to 700%; and to increase 3002-C private line circuit mileage by approximately 1500% (Ex. A-6; V. 9, TR 520, 548-553; 556-7). It is noteworthy that Pacific's own witness, Dr. Harris, characterized these increases as "bordering on rate shock." (V. 9, TR 557-8, V. 25, TR 2798).

Thus, for these business customers, Pacific's plan might be more aptly characterized as the "California Plan for Rate Shock." Aside from the turmoil that such large rate increases will undoubtedly cause for network dependent companies such as API, CPRS's apparent dependence on these rate increases is particularly significant in light of the protracted litigation that will be spawned in the supplemental rate design phase (SRD) of this case as a result. The spectre of such a protracted rate design proceeding was

noted by API's witness, Mr. Edwards, who explained API's view that 3002-C private line service is already priced at its cost, given substantial increases recently authorized by the Commission for Pacific in Application 85-01-034. (Ex. A-96, p. 5) Mr. Edwards further noted that these proposed increases proposed by Pacific will likely mire the commission in protracted rate design hearings in this case, given the absence of a finding for service costs in Pacific's most recent rate design decision. (Id.) API believes that these large increases are particularly unfair, when the rest of Pacific's CPRS proposal pointedly avoids looking at costs. Indeed, if the success of CPRS is predicated upon these increases, then its plan seems destined for failure -- Pacific's existing cost studies will simply not support these increases -- at least for the private line category.

Pacific's Proposed Treatment For The Regulatory Treatment Of Enhanced Services And Related Access Should Be Rejected

The record in this proceeding is replete with references to the fact that the key objective of CPRS is to make information age services more widely available to Pacific Bell customers. The elimination of charges for Touchtone service offered by Pacific, together with planned network upgrades, are certainly

steps in that direction. The record also reflects Pacific's intention to offer enhanced services on a detariffed basis (V. 7, TR 314) and to provide unbundled, Open Network Architecture (ONA) services consistent with its plan filed with the Federal Communications Commission for that purpose. (V. 7, TR 317-318; Ex. A-97, pp. 6-7). API submits that two elements of Pacific's proposal in this area should be rejected by the Commission: Detariffed, competitively provided enhanced services offered by Pacific should not be placed "above the line" for rate making purposes, and Pacific should not be allowed to engage in the flexible pricing of ONA services.

As API witness Mr. O'Brien testified, the central purpose of ONA is to provide a "level playing field" between Bell Operating Companies' enhanced services operations (such as Pacific's) and the Bell Operating Companies' competitors, who also also offer these unregulated services. (Ex. A-97, pp. 8-9). As Mr. O'Brien further testified, since ONA services are regulated basic network functions, allowing pricing flexibility by Pacific for these services would allow it to unfairly influence competition in markets in which it competes. (Id., at 9). The FCC has described these ONA services as requiring unbundled "basic

service building blocks" offered under tariffs, called "Basic Service Elements" (BSEs) See, Report and Order, 104 FCC 2d 958 at ¶214 (1986) ("The Computer III Order"). API submits that since these basic building blocks will be used to provide access to Pacific's competitors, they should remain within the conventional regulatory framework in order to prevent anticompetitive manipulation by Pacific. Pacific's failure to even know at this point which BSEs it wants to flexibly price (V. 7, TR 319), coupled with the FCC's recent finding that Pacific Bell's ONA plan is deficient both in terms of the BSE pricing, and the terms under which they will be offered, confirms this result. See, "Filing And Review of Open Network Architecture Plans," Memorandum Opinion and Order, released December 22, 1988, CC Docket 88-2, Phase 1, at ¶496. As API witness Mr. O'Brien testified, Pacific's ONA plan should be finalized at the federal level before this Commission even considers changing the regulatory environment for these services (V. 39, TR 4615-16).

Pacific's proposal to include enhanced services, offered on a detariffed basis, pose similar problems. In this regard, Mr. Schmitt confirmed Pacific's intent to provide enhanced service on a

detariffed basis, with above the line accounting for rate making purposes (V. 7, TR 314); he also admitted, however, that such treatment would require regulated ratepayers to cover any losses for those competitive products. (V. 7, TR 315-316). Indeed, perhaps based upon such concerns, Pacific's witness, Dr. Hausman, agreed that enhanced services should be subject to below the line accounting treatment (V. 14, TR 1292). As API has previously noted, it believes that "information-age" service competition will proliferate in Pacific Bell's service area, if Pacific's network access is offered to others on a "level playing field." API believes that such level competition is dependent upon treating Pacific's enhanced service offerings as truly deregulated services, and according them below the line accounting treatment. Mr. Schmitt's testimony that Pacific can "live with" below the line treatment (V. 7, TR 248), coupled with the fact that above the line accounting treatment is apparently the result of Pacific Telesis policy (V. 7, TR 250), further supports not including Pacific's enhanced services operations within its regulated operations.

DRA's Regulatory Change Proposal

As outlined in Ex. A-85, and as specifically described in Mr. Ahern's testimony (Ex. A-85, Chapter 1), DRA's proposed regulatory framework would split monopoly and competitive lines of business, and would institute a form of indexing (or price caps) which would proceed from rates based upon 1991 and 1992 test years for Pacific Bell and GTEC, respectively. (Id. at 1-12, 13). For operations that are deemed to be monopoly in nature, a benchmark rate of return will be established, above which returns would be shared with ratepayers. Quality of service would be monitored under DRA's proposal, and DRA's plan would be in effect for a five-year period. (Id. at 1-13,14; 15-16). Finally, for new and competitive services, DRA would establish a separate organization which would offer those services on a detariffed basis; these services would be subject to sharing for returns realized above a predetermined benchmark, while the stockholders would bear the risk of any losses. (Ex.A-85, Chapter 3-4-6).

API has examined DRA's plan from the "macro" effects of applying the plan to Pacific Bell and GTEC, and API has also examined DRA's plan from API's unique interest in private line and ONA related services which

it now purchases, and will purchase in the future from these companies. API's concerns and recommendations in these two areas will be discussed in order.

First, API questions the factual predicate for implementing DRA's proposed regulatory framework which would replace traditional, cost of service regulation, with a form of "price cap" regulation (Ex. A-85, p. 3-9). API has seen no evidence in the record that traditional cost of service regulation has been such a failure that it should be scrapped and replaced with DRA's proposal, nor indeed does the evidence suggest that DRA's proposal would succeed. For instance, this brief has earlier discussed the failure of both Pacific and GTEC to supply proof that incentive regulation would produce greater savings (or more efficiencies) as proposed by those companies than would the current regulatory framework. Similarly, DRA's witness Khoury testified that the present system of regulation contains incentives to achieve efficiencies, and that productivities have been realized over time in this environment. (V. 54, TR 6661).

In addition to the absence of a factual basis upon which to conclude that traditional regulation applied to Pacific and GTEC has been a failure, API is

equally concerned about the downside risk in DRA's plan. For instance, API believes that DRA's recommendation to review its proposed alternative framework's operation after a five-year period may be too long. (Ex. A-85, p. 3-21). Since January 1, 1984, (the date of the Bell system divestiture) significant changes have occurred in the telecommunications industry ranging from the method by which jurisdictional cost allocations are performed, the way that local exchange carriers are compensated for the interstate access use of their facilities, to the way that interstate carriers are regulated for their common carrier services. While API does not believe that these changes have undercut the basis for existing cost of service regulation for GTEC and Pacific in California, they nonetheless underscore the need to retain enough flexibility for this Commission to address similar industry changes in the ensuing five-year period. API thus submits that the five-year period recommended by DRA for the initial operation of its proposed plan creates too much downside risk.

API also is concerned about DRA's proposal to establish a 500 basis points floor below the benchmark return as a threshold for measuring the continued propriety of DRA's plan. (*Id.* at 3-22). If the

benchmark were set too low, this floor might impair the ability to finance plant additions and/or to attract capital on reasonable terms -- all of which would have a ratepayer impact. Indeed, API appreciates DRA's candor in describing its aprehension about its proposal in this regard and its indication that it would have preferred an experiment first. (Ex. A-85, at 1-15-16).

Against this background, API does not believe that a sufficient record exists to justify the wholesale change in current regulation that DRA's proposal presents -- particularly when the stakes are so high. And while API does not doubt that DRA's beliefs are sincerely held, DRA's own doubts as to its proposal point to the fact that some experience should be gained with this type of proposed regulation before it should be applied to Pacific and GTEC. API recommends that the FCC's price cap proceeding be monitored closely by this Commission for that purpose. The FCC has recently concluded that price cap regulation is appropriate for AT&T and is proposing the mandatory application of such regulation to major (e.g., Bell Operating Company) local exchange carriers. Report and Order And Second Further Notice of Proposed Rulemaking, FCC 89-91, released April 17, 1989, CC Docket 87-313. This Commission may want to

judge the success of the FCC's endeavor first before implementing DRA's proposed regulatory scheme here.

As previously indicated, API is also concerned about DRA's proposed treatment of new and competitive services. DRA's proposal for this category of services, essentially consists of establishing a separate entity for the provision of the services, coupled with the detariffing of the services and the implementation of a sharing system for related profits. (See, e.g., Ex. A-85, at 34-5). DRA's proposal would also seek to establish accounting guidelines to prevent the improper transfer of costs between regulated and nonregulated operations. (Id., at 76-7). As an initial matter, API supports the detariffing of enhanced services including the complete deregulation of the service offerings to end users. On the other hand, API believes that care should be taken to ensure that "new" services which are basic network functions (e.g., ONA services) remain subject to regulatory oversight. DRA's proposal appears to embrace that principle by recognizing that Basic Service Elements constitute such an exception within the "new service" category. (Id., at 3-4, 3-19). Indeed, DRA witness Ahern agreed that it would be possible for a new service to also be a monopoly

service. (V. 36, TR 4286-87). API's comments here are merely to add emphasis to DRA's recommendations on this point; care should be taken to ensure that basic services are not inadvertently deregulated as "new" as advances occur in the basic network.

API is constrained to point out that for the sake of consistency, it disagrees with DRA's proposal to establish a sharing mechanism for profits associated with detariffed services. API is particularly concerned about the proposal with regard to enhanced services, since API believes that all enhanced services should go below the line for ratemaking purposes. DRA's proposal would apparently place losses for those services below the line, but share related profits with ratepayers. If the DRA is concerned that it will be unable to detect cross-subsidy between regulated and competitive operations within GTEC and Pacific, it should address that concern through accounting and cost allocation procedures. API believes, however, that DRA's proposal is a bad substitute for such accounting protections, and one which could unnecessarily blur the dividing line between regulated and competitive services.

The Commission Should Examine Advice Letter/Complaint Procedures And Tariff Liability Issues That Will Be Implemented By Alternative Regulatory Frameworks

During the hearings in this proceeding, API has been concerned that the adoption of any alternative regulatory framework proposed herein be examined for its impact upon the advice letter and complaint procedures under the Commission's Rules, and that the Commission examine tariff liability issues as well. These topics will be discussed in order.

It is evident that GTEC's and Pacific's alternative regulatory framework plans would place a substantial burden on the advice letter and complaint process. For instance, Pacific would use the advice letter process to request the flexible pricing of certain services (V. 7, TR 257) and GTEC would use the advice letter process to both change prices, on an annual basis, for its Category 1 services and to change prices, on ten days' notice, for its Category 2 services. (See, Ex. A-56, pp.12-14). GTEC's witness, Mr. Williams, additionally testified that the complaint/advice letter process would be an appropriate avenue by which to solve problems in an alternative regulatory framework environment. (V. 34, TR 4018-19). API submits that the present framework for advice

letters and complaints may not carry the load sought to placed upon it in the new environment proposed by either GTEC or Pacific.

For instance, Administrative Law Judge Ford specifically designated as a policy matter, whether changes should be sought in the Public Utilities Code regarding the mechanics of bringing a complaint in the new environment. (V. 66, TR 8307-08). Section 1702 of the Public Utilities Code requires, in this regard, that the reasonableness of any rate may not be challenged by a complaint unless it is signed by the mayor or other officials of a city or county or by not less than 25 actual or prospective customers. If the Commission adopts a framework which relies more heavily upon the complaint procedure as a substitute for regulation, API would support such a change in the Code. API believes, however, that the degree to which the advice letter and complaint process needs to be changed to accommodate any new regulatory framework will become more apparent after the Commission's adoption of a decision in this proceeding. GTE has noted the propriety of changing the advice letter and complaint process in a new environment (See, Ex. A-73, p. 12; V. 27, TR 3025), as have other parties such as DRA (V. 56, TR 7022) and API (V. 39, TR 4614). API

accordingly recommends that in the event that regulatory changes are implemented which make use of the advice letter or complaint process, workshops be convened to ensure the consistency of these mechanisms with any new regulatory framework.

In the briefing conference held in this proceeding, Administrative Law Judge Ford designated as a policy issue whether the Commission should modify current tariff liability limitations for which regulation is relaxed (V. 66, TR 8306). API believes that the issue is more broad. API would state the issue as what safeguards should apply for competitive activities engaged by Pacific and GTEC under their proposals, from a jurisdictional perspective. This issue arises because as (and if) regulation is lessened or eliminated for these companies' operations in certain competitive markets, the degree to which this Commission exerts its regulatory oversight will affect the stockholders, ratepayers and competitors of these companies.

Witnesses for both companies and DRA testified that the appropriate forums for challenging competitive pricing issues should lie in the courts, and not in this Commission. For instance, Pacific's witnesses, Drs. Hausman and Harris, testified that

antitrust laws and the courts should be the forums to handle claims of anticompetitive activity under Pacific's proposed framework (V. 13, TR 1042; V. 25, 2806). Dr. Hausman further testified that in the context of enhanced service offerings, the elimination of tariff liability limitations would be consistent with the concept of a level playing field. (V. 14, TR 1298). GTEC's and DRA's witnesses also agreed. For instance, GTEC's witness McCallion testified that the court system was the appropriate legal avenue available to competitors to prevent below cost pricing (Ex. A-56, pp. 18-19; V. 27, TR 2986). Likewise, DRA's witness Ahern testified that predatory pricing claims should be heard in the courts (V. 36, TR 4295-6).

API believes that this Commission should make clear the extent to which customers who, like API, may look to this Commission's processes for anticompetitive claims against Pacific or GTEC in a new environment. Potential competitors of these companies in enhanced service markets stand in the same shoes. The lack of a clear decision on this issue will either leave customers and/or competitors without an appropriate remedy -- either at the Commission or in the courts -- or may result in disputes as to the appropriate ratemaking treatment of antitrust judgments.. _See_,

Southern Motor Carriers' Rate Conference v. U.S., 105 S.Ct. 1721 (1985) (antitrust liability for regulated operations will exist in the absence of a clear state policy to displace competition and state supervision of anticompetitive conduct; 105 S.Ct. at 1727).

API certainly has no objection to handling claims of unfair pricing or anticompetitive conduct in the courts, consistent with the testimony of GTEC, Pacific and DRA. In order to both avoid leaving competitors and customers without an appropriate remedy, and to avoid unintended results either before this Commission or in the courts, this Commission should be clear in any decision granting competitive freedom for GTEC and Pacific as to the scope of regulation and extent of competition which is thereby authorized.

Conclusion

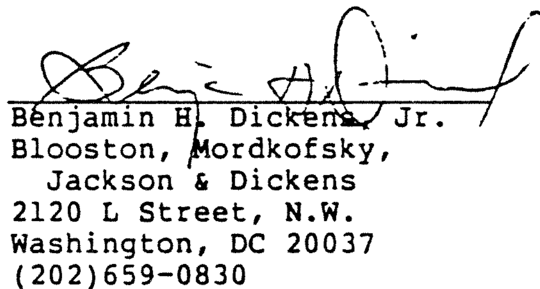
API submits that neither Pacific nor GTEC have justified the overall framework proposed by these companies, from a cost/benefit perspective. An examination of the record discloses that both companies have failed to demonstrate that ratepayers would be better off under either of their plans as they would implement them. Additionally, GTEC's proposed

treatment of Category 2 services would be manifestly unfair to companies, such as API, that buy services from GTEC and for which no other alternatives exist. Pacific's plans for these customers involves less discretionary pricing, but API does not believe that Pacific can justify its proposed cost increases for business services in supplemental rate design. Thus, to the extent that Pacific's plan is dependent upon the substantial increases outlined in this brief, it must fail.

API believes that Pacific's flexible pricing treatment of ONA services also should be rejected. Although competition in the enhanced service marketplace should proliferate, the flexible pricing of network access for these services by an entity which is also a competitor, provides the incentive and ability to engage in discriminatory behavior; it should be rejected. At the very least, API recommends that Pacific Bell's ONA plan become final at the FCC, and that discrete ONA services that will be offered by Pacific be identified, before flexible pricing is even considered for these services. API believes that DRA's price cap plan does not demonstrate problems with current regulation sufficient to justify its elimination. API recommends that experience with the

FCC's price cap plan be garnered first, before such a substantial change in the regulatory process is considered here.

Finally, API believes that DRA's proposed treatment of enhanced services involving below the line treatment of losses, but not profits, should be changed consistent with API's proposed treatment of all enhanced service operations below the line.



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Before the
PUBLIC UTILITIES COMMISSION
of the
STATE OF CALIFORNIA

In the Matter of	)	
Alternative Regulatory	)	I 87-11-033
Frameworks for Local	)	
Exchange Carriers	)	

CLOSING BRIEF OF API ALARM SYSTEMS

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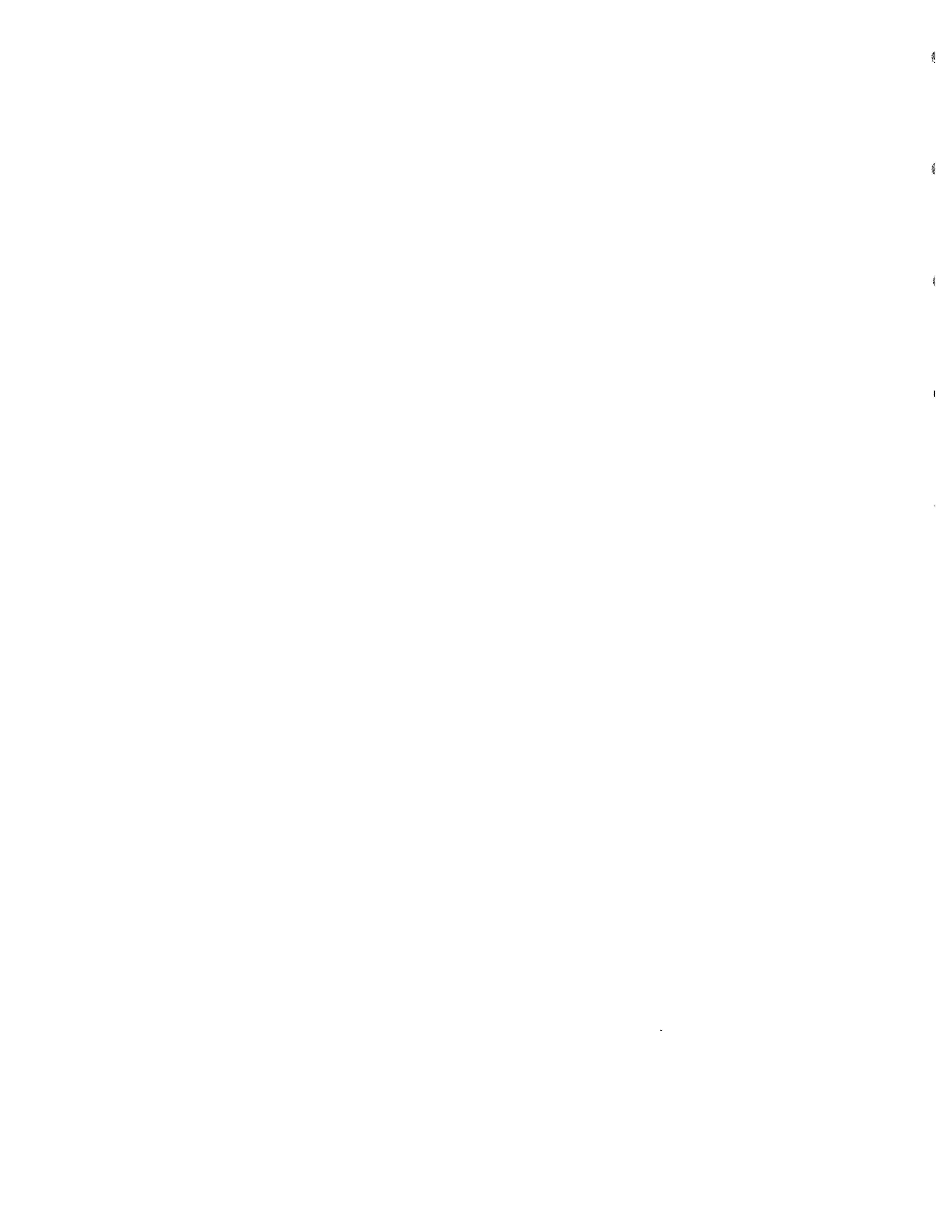

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SUMMARY OF RECOMMENDATIONS

API is an interested party who filed an opening brief (Brief of API Alarm Systems) in this proceeding and who has otherwise participated extensively as an interested party. API's opening brief discussed the Company's position on the alternative framework plans advanced by Pacific Bell (Pacific), GTE California (GTEC) and the Division of Ratepayer Advocates (DRA). Its basic views have not been altered by those parties' Opening Briefs. This Closing Brief is accordingly limited to two issues which nonetheless require brief discussion in light of the opening round of briefs.

First, API submits that Pacific's Opening Brief incorrectly urges the Commission to adopt a hybrid form of regulation which would clothe Pacific with traditional liability protection, normally reserved for regulated operations, for operations that will not be regulated under CPRS (i.e., enhanced service offerings). While Pacific will be free to negotiate such limitations of liability with its customers in a deregulated environment, API submits that its use through a tariff or other regulatory mechanism is improper.

Second, API submits that given the heavy reliance that both GTEC's and Pacific's alternative frameworks plans place upon rate design, the Commission should consider holding the implementation of its Phase II decision in abeyance (at least as far as it relates to rate design factors) until Supplemental Rate Design is completed in this proceeding.[1]

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[1] References to the transcript of the proceedings in this case will be made by identifying the party and witness sponsoring the cited testimony, and by indicating the appropriate Volume ("V"), followed by the letters "TR" and the appropriate pagination. References to exhibits introduced into evidence in this proceeding will be made by the abbreviation "Ex." followed by the appropriate number. References to the interested parties in the proceeding will be made in the manner in which they appeared.

I.

Pacific's Argument To Retain Existing Tariff Liability Limitations Is Improper For Enhanced Services Offered Under CPRS

A. Current Tariff Liability Limitations

Pacific Bell and GTEC currently enjoy limited liability for errors and omissions in the services and facilities that they provide. Pacific's liability limitations are delineated in CAL. P.U.C. No. A2.2.1.14 (Rule 14), as noted in its Opening Brief (Attachment, p. 4). Rule 14 states that damages arising out of mistakes, omissions, interruptions, delays, errors or defects in any of its services of facilities shall not exceed an amount equal to the pro rata charges to the customer for the period during which the services or facilities are affected (Rule 14, §A.3). If an error or omission affecting one service causes a diminution in the value of another service, Pacific's liability would include such diminution, but would not exceed the total amount of charges to the customer for all services or facilities during the period the customer experienced service problems Id.

This general limit on liability has two exceptions. First, if the error or omission causing the problem is attributable to gross negligence, then

Pacific may be held liable for damages totaling up to $10,000. Second, no limit is placed on its liability if the error or omission causing the problem is attributable to willful misconduct, fraudulent conduct, or violation of law (Rule 14, §A.1).

B. Tariff Liability Limitations Apply To The Current Regulatory Environment Which Closely Regulates The Operations Of Pacific And GTEC

Pacific's Opening Brief contains an extensive discussion of the legal and regulatory development of the limitation of liability doctrine to which it is currently subject. An examination of the Commission and Court precedent cited in its brief, however, discloses that while these rules may have valid application to the existing regulatory environment, they are out of place in an environment where enhanced services will be offered on a detariffed, deregulated basis by both Pacific and GTEC.

For instance, Pacific cites In re Investigation Regarding Limitation of Liability for Telephone Corporations, 71 Cal. P.U.C. 229 (1970) for the proposition that five principal reasons underlie the doctrine of limited liability. (See, Pacific's Opening Brief, Attachment at 6). Each of those reasons cited contemplate the traditional form of rate

regulation. An example is provided in item "(1)" which states that limited liability allows the provision of service at a cost to the public that might be higher without the limitation. Id. Such logic obviously contemplates the traditional regulatory scheme since court judgments are sometimes held to be properly includable as an above the line expense which are in turn spread to the ratepayers as a whole. See, e.g., Memorandum Opinion and Order, FCC 89-136, released May 19, 1989 ("Notice of Proposed Rulemaking to Amend Part 31 Uniform System Of Accounts for Class A and Class B Telephone Carriers to Account For Judgements and Other Costs Associated With Antitrust Lawsuits") Cole v. Pacific Tel. & Tel. Co., 112 Cal. App. 2d 416, 249 P. 2d 686 (1952), also cited by Pacific, (Id. at 7), confirms that the existing liability limitation rule contemplates a scheme of close regulation:

> The theory underlying these decisions is that a public utility, being strictly regulated in all operations with considerable curtailment of its rights and privileges, shall likewise be regulated and limited as to its liabilities. In consideration of its being peculiarly the subject of state control, its liability is and should be defined and limited. [Correll v. Ohio Bell Tel. Co.) There is nothing harsh or inequitable in upholding such a limitation of liability when it is thus considered that the rates as fixed by the Commission are established with the rule of limitation in mind. (emphasis added)

Thus, the court found liability limitation equitable for companies like Pacific and GTEC which are strictly regulated in all of their operations and which have their rates fixed by the Commission. See also Davidan v. Pacific Tel. & Tel. Co., 16 Cal. App. 3d 750, 94 Cal. Rpts. 337 (1971); Waters v. Pacific Telephone Co., 12 Cal. 3d 1, 114 Cal. Rptr. 753, 523 P.2d 1161 (1974); Pacific Bell v. Colich, 198 Cal. App. 3d 1225, 244 Cal. Rptr. 714 (1988).

C. Adoption Of The GTEC Or Pacific Proposal Should Incorporate Modified Tariff Liability Limitations For Their Detariffed, Enhanced Service Offerings

Under CPRS the Commission's traditional regulatory oversight roles would be diminished, contrary to Pacific's baseless claim that CPRS would merely "streamline" existing regulation sufficient to retain limited liability precepts. (Pacific's Opening Brief, Attachment at 8). While the Commission may indeed retain some control over certain of Pacific's service offerings, Pacific admits that its enhanced service operations will be offered on a detariffed basis, Opening Brief, at 98, n.*, -- a conclusion that is inescapable given the FCC's preemptive deregulation of these services. See generally, Report and Order, 104 FCC 2d 958 (1986) ("Computer III"). Thus, the

traditional policy rationale for applying limited liability must be reexamined for this set of services.

Under the balancing test established in Cole, supra, increased relaxation of regulation should also be accompanied by less strict liability limitations. Following the rationale implicit in that case, if an area is completely deregulated, then public policy does not demand liability limitation.

This same conclusion was voiced by Pacific's, GTEC's and DRA's witnesses on the record here. As pointed out in API's initial brief in this phase, both companies' witnesses testified that anticompetitive activity claims arising under their proposed frameworks should be heard in the courts, and in this same vein Pacific's witness, Dr. Hausman, testified that tariff liability limitations should be eliminated for Pacific's enhanced service offerings. See, e.g., Brief of API Alarm Systems, pp. 34-36.

API submits that Pacific simply cannot have it both ways -- if its enhanced service operations are deregulated, as they surely will be under existing law -- then it must play by the same rules as do its competitors. A contrary result is more likely to

introduce a playing field tilted in favor of Pacific's enhanced service operations, with a consequent impact on competition.

These same concerns permeate Pacific's (and GTEC's) plans to price network access for these services on a flexible basis, (see, e.g., Brief of API Alarm Systems at 13-15; 23-25), while at the same time they intend to compete in these markets. Id. If the Commission extends limited liability to cover anticompetitive activity for regulated operations which are designed to influence unregulated markets, it may unintentionally invite such activity by Pacific and GTEC. API's initial brief outlined the need for a clear delineation of the ambit of the Commission's regulatory authority in this area (id. at 35-36) and API reincorporates those remarks here. The gist of API's position, however, is that Pacific's and GTEC's proposed alternative frameworks should not result in a playing field for these companies' enhanced service competitors that is not level, or that would leave those competitors without a meaningful remedy for claims of unfair or anticompetitive activity.

II.

The Implementation Of Any Alternative Framework For Pacific And GTEC Should Await A Decision In The Supplemental Rate Design Phase Of This Proceeding

In the Opening Brief of Bay Area Teleport, ("BAT"), it argued generally that Pacific's CPRS proposal is largely a matter of rate design, and that the Commission should not implement any decision reached in Phase II (either for GTEC or Pacific) until the Supplemental Rate Design ("SRD"), scheduled for this proceeding, is completed. (BAT Brief at 6-12). Although API did not raise this point in its opening brief, it agrees both simply because it makes sense, and because SRD now appears to be even more dependent upon Phase II than before. The relevance of these observations to each company's proposal will be discussed in order.

First, as BAT noted, Pacific's CPRS proposal is largely rate design driven given its proposal to freeze residential rates, eliminate TouchTone charges and to raise certain business rates, including analog private line rates. Id. at 6. As API's initial brief pointed out, Pacific's proposal is sadly lacking in the most basic cost details as to allow a fundamental evaluation of its plan. (Brief of API Alarm Systems,

at 17-20). In Pacific's Opening Brief, it nonetheless proceeds upon the basis that certain services are below costs (e.g., private line), which the Commission should now agree to raise "in principle," as a component of CPRS, Id. at 33-34.[2/] While API does not believe that Pacific's private line services are priced below their relevant costs (it has examined the subject in several Pacific rate proceedings), it does not quarrel with the proposition that rates should generally cover their related costs. Pacific's CPRS plan appears much more dependent upon its rate design factors, however, than its plea for an approval of price increases "in principle" would suggest. For instance, what if the Commission were to approve freezing basic residential rates, giving away TouchTone and eliminating attrition/rate case proceedings, only to discover that SRD would not justify further rate increases? If Phase II were not yet implemented, consequent damage to Pacific's stockholders and ratepayers would be minimized from such a miscalculation. Given the downside risks of implementing Phase II now, however,

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[2/] Pacific's Opening Brief on this point characterizes API witness Edwards' testimony in a manner (perhaps inadvertently) which infers his agreement that private line services are below cost. Mr. Edwards' testimony was emphatically the opposite, however. (API Ex. A-96, p. 5).

API submits that the better course is to await Phase II implementation until after the Commission has a clear picture of service costs from SRD.

The need to delay Phase II implementation for GTEC until after SRD is even more compelling. As API's opening brief noted, GTEC's proposal to include alarm grade private line services as a "category 2" service, and to subject them to serial rate increases as a result, represents a complete abandonment of cost-based pricing for these monopoly services. (Brief of API Alarm Systems, at 10-12). Indeed, as API pointed out, this particular feature of GTEC's plan appears solely designed to maximize the Company's revenues. Id. at 11. API submits that SRD will demonstrate the fallacy behind GTEC's logic on this score, since analog private line costs simply will not tell the story that GTEC's carte blanche pricing request promises.

GTEC's Opening Brief adds particular emphasis, however, to the need to delay any flexibility for analog private line pricing, as GTEC would implement it, until after SRD. In this regard, it should be noted that GTEC's proposal to flexibly price analog private line services was at least initially based upon GTEC's assertions that those services were either 'competitive or discretionary' --

criteria that API submits were thoroughly discredited on the record, by inconsistencies in GTEC's implementation scheme. (API Brief at 8-9). GTEC's Opening Brief now appears to have shifted gears entirely, by assuming, a priori, that analog private line rates are below costs, and by arguing that its plan would give users of those services price predictability, and would avoid 'policing' difficulties for those private lines which GTEC now apparently admits do not meet its own criteria for category 2 services. (GTEC Opening Brief, at 31-33).

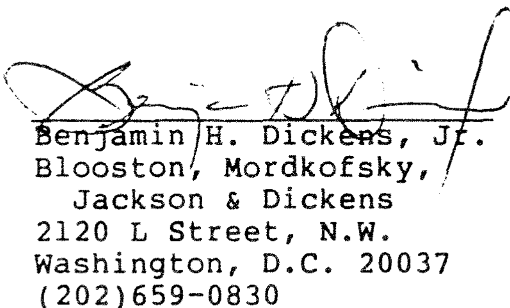
Against this background, API submits that GTEC's proposal to engage in the upward flexible pricing of analog private line services should be rejected out of hand, since GTEC apparently admits that its own criteria may not be accurate in this respect. And at the very least, API submits that to the extent that GTEC is relying upon private line revenue/cost relationships to justify its proposal, any decision on its flexible pricing request should be delayed until after SRD, where those relationships will be examined.

CONCLUSION

API submits that Pacific's request to maintain vestiges of traditional regulation (limited

tariff liability) for competitive, enhanced service operations which it seeks to enter, is inconsistent with notions of fair play and should be rejected. API also submits that the Commission should explicitly define the scope of its regulatory authority for services subject to 'streamlined,' or non-regulation, in order to maintain the Courts' ability to discipline GTEC's and Pacific's anticompetitive activities, as recommended by these companies' witnesses.

Finally, API submits that Phase II decisions should not be implemented for GTEC or Pacific, (to the extent that they are dependent on rate design factors as discussed herein), until the completion of SRD.



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CERTIFICATE OF SERVICE

I hereby certify that I am an employee of the Law Offices Of Blooston, Mordkofsky, Jackson & Dickens and that on this 30th day of May, 1989, I mailed by United States mail, postage prepaid, a copy of the foregoing "CLOSING BRIEF OF API ALARM SYSTEMS" to the following:

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* Indicates Service By Overnight Delivery.

Lanelle Campbell

CENTEX TELEMANAGEMENT, INC.
PRESENTATION to
ASSEMBLY COMMITTEE
on
UTILITIES and COMMERCE
June 6, 1989

SPECIAL HEARING on "TELEPHONE REGULATION"

I am here today to request that you remember the forgotten class of telephone customer--small businesses. In the three years since I last appeared before this Committee, the number of small businesses CENTEX serves has changed--from 600 to 6000, primarily located in California; however, our message has not. CENTEX believes small businesses should be afforded the same telecommunication services, efficiencies and expertise as are made available to their larger competitors.

As you may remember CENTEX is a telecommunications management company. CENTEX' clients are typically small to medium-sized businesses which individually lack the resources to maintain on-staff telecommunications managers such as those typically employed by larger businesses. CENTEX' business is managing the telecommunication needs of these businesses.

CENTEX favors regulatory change that will improve the local exchange telephone company's ability to meet the telecommunication needs of these <u>small business customers</u>.

I emphasize customers because many of the changes are being considered in light of their impact upon competition, either promoting it or rendering the LEC better able to participate in it. Competitors of a monopoly are concerned with entry into the market. Customers of a monopoly are concerned with being treated fairly and equally.

As customers CENTEX' clients may be adversely affected by regulatory changes which do not recognize the LEC's continuing monopoly power. The question which the California Public Utilities Commission must answer is: How can customers be assured equal access and equal pricing to the telecommunication services contained in the LEC's central offices?

In the past, concerns of customers about these services and other telecommunication issues could be addressed in any of several forums. The most important of these is the traditional rate case.

If the California Public Utilities Commission decides to reduce in any way the availability of this forum to LEC customers, the availability and improved efficacy of the other forums becomes essential. This concern is the basis for CENTEX' participation in the Commission's "Alternative Regulatory Framework" proceeding and our acceptance of your invitation to appear before this Committee.

CENTEX has suggested four safeguards to the Commission that must be made part of any changes in the regulatory process:

1. LEC services must be made available on a non-discriminatory basis. Small businesses, whether ordering services on an individual basis or utilizing an external management company such as CENTEX, must be assured equal access to the same services as any other business customer at equal rates, terms, and conditions.

2. The functional elements of the LEC network services must be made available on an unbundled basis. By unbundled we mean the ability to order the technology of the network in the smallest components which are technically feasible. The focus here should be meeting the broadest general business needs, not the convenience of the LECs.

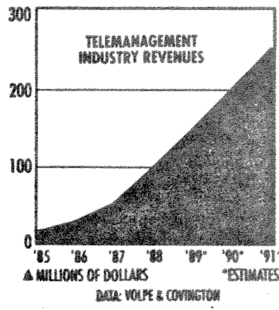
3. Any flexibility granted to the LECs should not be implemented until a more effective, timely, and less costly complaint procedure is created and made available. (CENTEX has proposed that a workshop be held, under the auspices of the CPUC, to develop such improvements.)

4. Strict procedures for establishing cost-based pricing of LEC service elements should be instituted by the Commission and made part of the upcoming rate design hearings which are part of this "Alternative Regulatory Framework" proceeding.

CENTEX supports the traditional goals of utility regulation listed in the letter of invitation which announced this hearing. The Commission is being asked to make changes in the regulatory process whose purpose it is to accomplish those goals. Our message to the Commission, to this Committee, and to the rest of the Legislature is to insure that the interests of smaller businesses, which represent the heart of California's economic health and growth, are not forgotten if any changes are made.

The inclusion of the safeguards proposed by CENTEX in any changes to the regulatory process will be a good first step in protecting the interests of small businesses as well as those of other telephone utility customers.

THANK YOU.



HOWLEY: ELBOWING INTO MORE BIG-CITY MARKETS

TELECOMMUNICATIONS

AN ASPIRIN FOR TELE-MIGRAINES

Centex sets up and supports companies' phone systems

It's a task that gives even the savviest business owner a headache: choosing telephone service. Consider the plight of Irvine Co. Two years ago the Newport Beach (Calif.) land developer bought a private branch exchange with the idea that running its own, more versatile communications network would cut overhead. Instead, Irvine's phones frequently malfunctioned, and the company that provided the PBX equipment offered little help.

But Irvine solved the problem quickly. It hired one of a new breed of so-called telemanagement companies that help businesses choose a phone system and, if needed, run it more cheaply. It's a service that many customers too small to afford a communications staff are finding irresistible. Says Peter A. Howley, president of industry leader Centex Telemanagement Inc. in San Francisco: "We're selling an aspirin."

Telemanagers do a lot more than just give advice: They maintain a phone system and program it to provide services that the phone company can't. One example is customized billing, which lets a law firm, for instance, know precisely how much phone time to bill each client. Telemanagers also typically lease Bell company switches, then route local and long-distance calls from groups of customers over shared bulk-rate WATS and high-speed digital phone lines at about half what an individual customer would pay. Customers receive up to a 20% discount, and the telemanager keeps the rest for expenses and a nifty profit.

RINGING UP SALES. Centex pioneered telemanagement from its base in northern California in 1984. Today it has 68% of an $85 million market that should grow into a $250 million market by 1991, says Mark S. Bergman, telecommunications analyst at San Francisco investment bank Volpe & Covington. Centex earned $4.8 million on revenues of $57.9 million in 1988. This year, Morgan Stanley & Co. analyst L. Keith Mullins expects sales to jump 49%, to $86 million. Reflecting that outlook, the company's stock has risen from its initial offering price of 9 in September, 1987, to about 17 recently.

So far, the key to such success has been to operate in California. There, regulation has limited competition from alternative carriers and resellers, which in many other states offer the same discounts as telemanagers. Moreover, California's large calling areas and steep basic rates leave lots of room for high-volume discounting. As telemanagers expand into the Northeast and Midwest, they'll face tougher conditions. In New York, for instance, regulation and geography make for a lower spread between regular and discounted local rates. This could cut Centex' pretax margins, 24% in California, to only about 15% elsewhere, says Morgan Stanley's Mullins.

Another problem is rising competition. Because telemanagers don't have to buy or maintain equipment, "the barriers to entry are zero," notes Donald G. Prigmore, a telecommunications consultant and former president of now-defunct GTE Sprint, the forerunner of U.S. Sprint. Already, telemanagers say they're battling MCI Communications Corp. and some big service resellers, such as Teleconnect U.S.A. in Cedar Rapids, Iowa, which are offering discounted long-distance service. Such rivals can't offer local service and don't manage phone networks. But they can provide a few things that telemanagers don't yet offer, such as toll-free 800 numbers and access to cellular service.

PENNY-PINCHING. The battle is even fiercer among the independent telemanagement companies. Because of inroads by Centex, in part, American Telemanagement Inc., of Santa Ana, Calif., recently reduced its estimate of revenues for the fiscal year ending in April by 50%, to less than $6 million. But American Telemanagement still plans forays into New York, Chicago, and Dallas. Centex also will be challenged by International Tele-Management Corp., a Vienna (Va.) start-up that has raised $6 million in venture capital to manage combined voice and data networks.

> The competition among 'telemanagers' is fierce because 'the barriers to entry are zero'

To head them off, says Howley, "we have to get into the best markets as quickly as possible." Centex entered New York and Boston in 1987 and Chicago and Stamford, Conn., last fall, with three more cities planned for this year. The company also is hewing to the penny-pinching ways crucial to a discount service business. The 49-year-old veteran of Stamford-based Citizens Utilities Co., AT&T, and MCI makes his own coffee and is proud of his worn and inexpensive offices and six-day workweek. He drives his low-paid phone sales people so hard to close new accounts that high turnover briefly stalled sales early last year.

Howley is being even tougher on his competitors. On Jan. 19, for example, Centex gobbled up SNAP Communications Inc., a $3 million Los Angeles rival. Howley says he only wishes there were more companies to buy. And no wonder. To avoid becoming a target himself one day, he's going to have to sell a lot more aspirin.

By Robert D. Hof in San Francisco

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B1&3

Centex Telemanagement Brings Back The Phone Company

By John A. Jones, *Investor's Daily*

For business people who miss the simpler times of the old Bell System, a young outfit called Centex Telemanagement Inc. has reinvented the one-stop telephone company. For a management fee, the San Francisco-based company analyzes the communications needs of its small and medium-sized business clients, picks out the best combination of services and equipment from today's often confusing array of choices, and sets up the system through the client's local telephone company.

Centex doesn't own any switches, phone lines or other equipment. The company acts something like a wholesaler or a distributor, forming local groups of business phone users to get reduced, bulk rates from long-distance carriers, normally available only to large corporations.

☐Of the 197 industry groups tracked by *Investor's Daily*, Telecommunications Services ranks 60th based on stock-price performance over the latest six-month period. In this series, leading companies within the group are reviewed.

Centex profits on the spread between the bulk rates and the rates it charges clients — but those are still lower than clients could get on their own.

Clients are connected to their local telephone company through its Centrex switching system. That's Centrex with an "R" — not to be confused with the Centex company name. Local telephone companies offer Centrex service to business users, to compete with private branch exchange systems from other suppliers.

Group Billing

The local telephone companies and long-distance services bill each Centex network center as a group. Centex in turn breaks down the charges and bills its individual clients.

Analysts said the local telephone companies gain from having Centex bring their local area networks business that might otherwise go to independent carriers, as well as getting the clients'

Since it began operations in 1984, Centex has built its membership to about 3,500 clients. The company now serves six major California markets, and it has expanded to the East Coast with service in New York and Boston.

Howley

Peter A. Howley, president and chief executive, told *Investor's Daily* the company plans to open three new network centers and 10 new switches a year for the next three to five years.

"Our focus is to continue to concentrate on the East and West Coasts, because those are the largest markets for small businesses and for telecommunications," Howley said.

He said Centex also is developing new services for small-business clients. Besides basic phone service Centex already offers some extras, such as detailing long-distance calls, and a business traveler's credit card.

Centex began to report operating profits this year after a string of startup losses. In the first quarter the company earned $674,000, or seven cents a share, compared with a loss of $901,000, or 14 cents a share, a year earlier. Billings to clients more than doubled to $12.9 million from $6.3 million.

The company cut its 1987 loss to $1.9 million, or 26 cents a share, from a loss of $2.6 million, or 47 cents a share, the year earlier. Billings jumped 147% to $34.9 million from $14.1 million.

As the business has grown, Centex has trimmed its expenses as a percentage of sales. General and administrative expenses fell to 12% of billings in the first quarter from 15% a year earlier, while client acquisition expenses fell to 17% of billings from 24%.

Analysts said Centex seems set for strong growth, because it's practically the only operator in a relatively new market that could yield billings of $350 million to $450 million a year.

"There are 500,000 small to medium-size businesses in the top 25 markets alone," said analyst James P. Hickey of William Blair & Co. in Chicago, "and probably 40 or more urban regions meaningful for this kind of business. Those 500,000 clients generate $7 billion a year in long-distance revenues."

Assuming Centex gets only 5% of the business, which "looks pretty certain," Hickey estimated it can bill $350 million a year just from the top 25 markets.

Local Phone Firms Barred

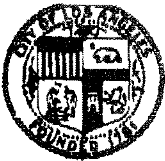
"The (local) phone companies are legally prohibited from doing what is the central thrust of Centex's business," he said — that is, acting as a distributor for a package of services including long-distance calls.

Hickey said Centex can contract for long-distance services at an average of 50% of AT&T's direct-dial rates, and sell them to Centex clients for 80% of the AT&T rate. The clients still make substantial savings.

"The risks are that they don't have any capital investment" in equipment, Hickey said. "Entry barriers are quite low, so competition could appear. To date they've seen three or four competitors try this and fail. Execution is a pretty difficult thing."

Tuesday: MCI Communications

140B



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June 13, 1989

Assemblywoman Gwen Moore
Chairperson, Assembly
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Dear Assemblywoman Moore:

Thank you very much for the invitation to speak before your committee on June 6, 1989 regarding "The PUC and Telephone Service in the 90's" and the opportunity to submit this response to the five "Key Questions of Interest to the Committee".

First, the traditional goals of utility regulation should not be changed. What is required is a reaffirmation and a greater emphasis on the goal of just and reasonable rates and the goal of preventing abuse of monopoly power. In light of recent technological breakthroughs, these two goals should be the focus of utility regulation in the 1990's because these areas present the greatest opportunity for abuse by the telephone companies ("Telco's").

Second, the traditional rate of return ("ROR") regulation should not be abandoned as several Telco's have proposed and as the California Public Utilities Commission ("CPUC") appears to have endorsed. ROR regulation was designed to achieve the traditional goals of providing a utility with the ability to attract capital on reasonable terms and to enable regulators to set just and reasonable rates which are fair to the utilities, shareholders and ratepayers. It has served the public interest well.

Our office is a participant in the CPUC investigation, OII 87-11-033 wherein the advocates of "Alternative Regulatory Frameworks" propose to abandon ROR regulation and substitute new approaches which permit the utilities to set their own rates. We filed a brief opposing the changes for several reasons of which the following are key:

1. No party has demonstrated, with any credible evidence, the need for a change. Apparently, the CPUC has ordered its staff and the Telco's to present alternative methodologies without any studies to determine whether change is necessary or desirable. The Division of Ratepayers

Advocates ("DRA") (the CPUC staff created to protect ratepayers) was ordered to develop a plan rather than study the issue and decide what is in the ratepayers best interest. In other words, the DRA in this instance has been instructed to function not as a ratepayer advocate but rather as another arm of the CPUC.

The record in OII 87-11-033 does not demonstrate that ROR regulation is not working nor does it demonstrate that the alternative methodologies would work better. Our office is not opposed to change, but we believe that change of such a fundamental methodology which has served the public so well must be carefully considered and supported by evidence in the record.

2. The telecommunications industry has recently driven down the cost of service in a most dramatic fashion. With the advent of fiber optics and digital computers for high speed switching the cost to provide service has plummeted and will continue to do so in the future. Rates should likewise drop and parallel the reduced cost of service. ROR regulation ensures that rates and cost of service match. If cost of service rises or drops, so should rates.

Unfortunately, the alternative methodologies proposed in OII 87-11-033 provide mechanisims whereby the primary decision to set rates is taken out of the public hearing process and is placed in the hands of the utilities. Such proposals, if adopted, are dangerous because the utilities have no motivation to reduce rates concomitant with the drop in the cost of service. In other words, the utilities will be in the position to reap windfall profits at the expense of the ratepayers.

Advocates of such plans claim that the current rate setting process is too long and too cumbersome. It is historically true, in the 1970's and before, that rate cases lasted for as long as two or three years. However, recently the CPUC has implemented many streamlined procedures that enable utilities to raise rates at least once and sometimes twice a year. For example, the financial attrition hearings are expedited public hearings that allow utilities to

raise rates if they can prove, that such things as the cost of capital has increased. Moreover, any person that actively participates in the CPUC rate hearings can readily discern that most of the delay is attributable to the utilities themselves. More often than not the utilities themselves make the process overly burdensome by presenting too much evidence and too much rebuttal and making the discovery of evidence far too difficult for the CPUC Staff and intervenors. Such tactics increase the length of the evidentiary hearings unnecessarily.

Advocates of change claim the CPUC will still be able to review and set rates. That is just not a reasonable option under the alternative methodologies that have been submitted. The alternative methodologies would require the CPUC to institute a separate investigation to review rates if complaints arose or else approve them by some summary fashion (other than a public hearing) such as the advice letter filing. Separate investigations are too cumbersome and difficult to initiate. The advice letter filing is too superficial and the dearth of information supplied with the filing provides too convenient an opportunity for abuse. Also, the brevity of the filing limits the ability of CPUC staff and others to detect mistakes made by utilities. Most importantly, it eliminates public scrutiny and damages public confidence in the rate setting process.

3. The California Legislature approved the State Public Utilities Code which among other things mandates that the CPUC, after a hearing, set rates that are just and reasonable (See Sections 451, 454 and 728). Consistent with the Public Utilities Code, the California Supreme Court and the United States Supreme Court have developed a legal standard for just and reasonable rates based upon the ROR methodology. Regulators are required to set rates that enable utilities to attract capital based upon risks commensurate with the ROR earned by other business enterprises with comparable risks.

The alternative methodologies abandon the mandate of the Public Utilities Code and a long history of judicial interpretation. Our office believes

> that such abandonment, without authorizing legislation, would be unlawful and, if adopted by the CPUC would result in a legal challenge before the California Supreme Court.
>
> The alternative methodologies also contemplate some form of procedure where a utility sets its own rates without a public hearing. This is an inappropriate delegation of the CPUC statutory duty and in direct conflict with the objectives of Public Utilities Code. Even assuming, for purposes of argument, that ROR regulation needs to be changed, we submit that the Legislature must make any changes by way of amending the Public Utilities Code. The CPUC does not have the power to make such radical changes on its own and if it were to do so it would have clearly exceeded its authority.

Third, the current regulatory procedures are adequate to identify and consider in a coordinated fashion, the full range of issues that policymakers should be concerned with.

Fourth, the existing regulatory process, except for the recent trend away from public hearings, does adequately represent and serve the interests of California at large. We are well aware of the regulatory lag experienced by the CPUC in past years and we agree the process should be streamlined where possible. However, recently the CPUC (however well intentioned) has embarked upon a process which tends to prevent active participation by the public at large, as well as many interested parties. Too many hearings are being held in San Francisco, rather than in the affected areas, which makes it difficult and expensive for many (including municipalities) to attend and effectively participate.

The CPUC, its staff and utilities are entering into side agreements and stipulations without the benefit of public hearings. Interested parties are forced to go along with the procedure or be forced outside the decision making process. Workshops are convened absent the oversight of an administrative law judge, without cross examination of witnesses under oath and without the opportunity for the public to adequately participate. These safeguards are the very foundation of due process in a democratic government. We believe that the CPUC should be encouraged to continue to decrease regulatory lag without sacrificing the open and public nature of the process.

Assemblywoman Gwen Moore
Chairperson, Assembly
Utilities and Commence Committee
Page 5.

Finally, the approach we recommend the State Legislature to take is one of increased oversight of the CPUC and one which encourages more public hearings and less stipulations and side agreements. More evidentiary hearings should be held in the major metropolitan areas to facilitate greater participation by local consumer groups. The California Legislature should order the CPUC to continue ROR regulation unless it can prove with substantial evidence that change is needed. Finally, we believe it would be in the public interest for some form of government/private consumer advocacy, independent of the CPUC.

Thank you for the opportunity to present our views. Please do not hesitate to call if we can be of further assistance.

Very truly yours,

JAMES K. HAHN, City Attorney

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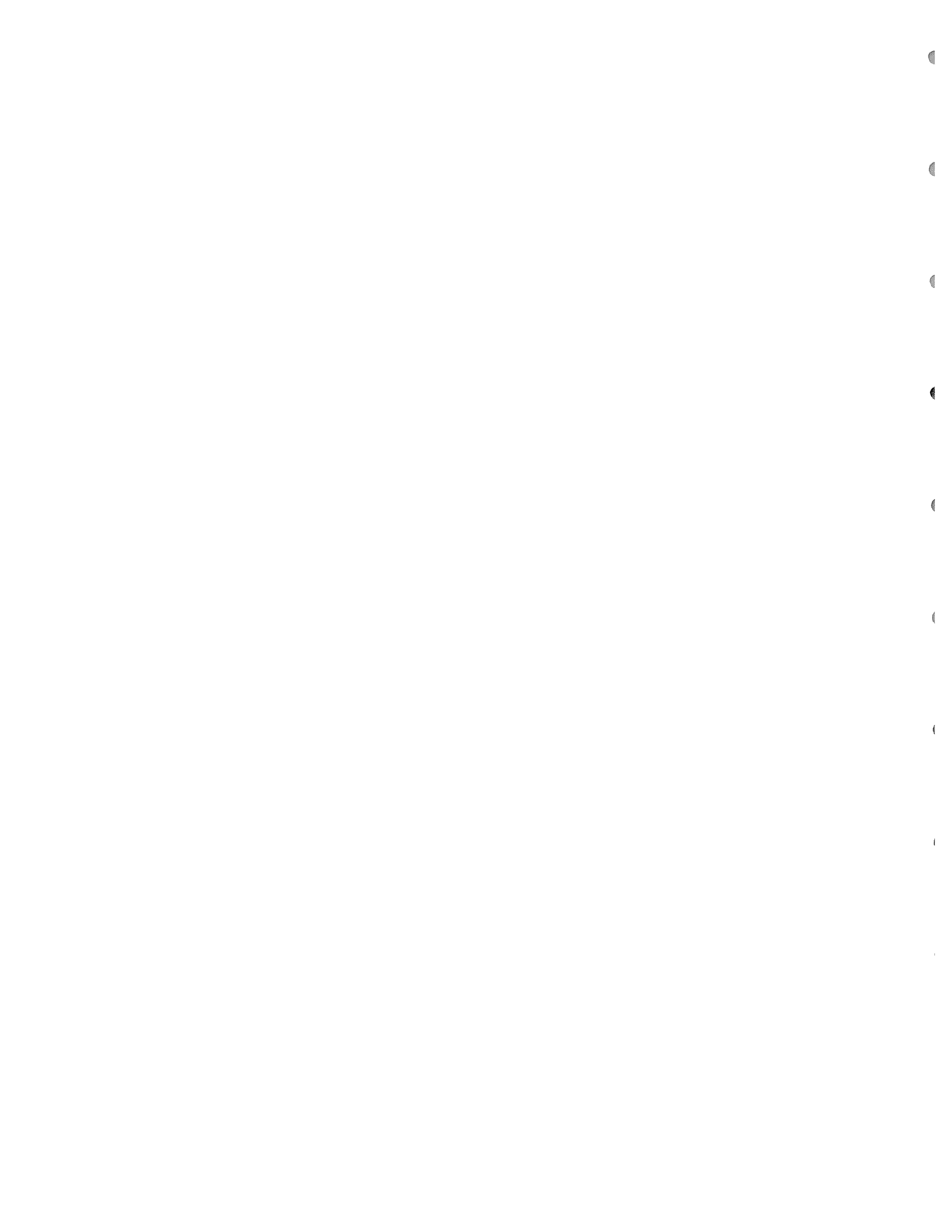


ATTACHMENT L

AMVOX

Remarks of Harry Schwedock, Vice President & Chief Operating Officer, AMVOX, Inc. Los Gatos, CA. before the California Legislature Committee on Utilities and Commerce. June 6, 1989

My name is Harry Schwedock and I am Vice President and Chief Operating Officer of AMVOX, Inc., a California based, nationwide Voice Mail Service Provider.

AMVOX has been providing voice mail services to residential and business customers for the last two years. We currently have about 41,000 subscribers.

At this time, AMVOX has a complaint pending before the CPUC with respect to, what we consider to be anti-competitive, monopoly abuses of Pacific Bell's voice mail service. It's interesting to note that abuses have already begun, despite the fact that Pacific has been active in the business for only two months.

It seems likely to us that Pacific will defend these anti-competitive abuses by claiming that their voice mail activity is acting under FCC and CPUC rulings which allow them to offer these services on an unregulated basis, but under their regulated, monopoly umbrella. What this means is that Pacific Bell Voice Mail will claim that it is purchasing the telephone services required to provide voice mail from Pacific Bell, just like AMVOX or any other voice mail service provider.

There is one significant difference, however. When AMVOX or any other voice mail service provider buys services from the telephone company, that company has to sign a check for its purchase. Real dollars come out of that company's bank account. When Pacific Bell Voice Mail buys these services, a bookkeeping transfer *may* take place. (:49)

I use the word may, advisedly. The consent decree which led to the breakup of the Bell System came, at least in part, as a result of the FCC's admission that it could not adequately track the telephone company's allocation of costs. This situation has not changed. As long as there are more accountants hiding the money than there are auditors looking for it, this situation will not change. Protecting against anti-competitive abuses through cost accounting is an illusion, just as it always has been.

It's not implausible to imagine a plan where the telephone company uses the profits from its monopoly services to build new operations in competitive businesses and its monopoly power to drive out competitors giving it a monopoly in these new businesses. Once a new monopoly has been built, why not then spin off the new monopoly, not to the benefit of the ratepayers, but to the benefit of the stockholders.

Now you will hear the statement that this is not the old Bell system, that this is a new telephone company. The leopard has changed its spots. Our state's experience since divestiture gives lie to this statement. In the few years since

divestiture Pacific has been required by the CPUC to refund hundreds of millions of dollars to ratepayers as the result of over-agressive marketing practices, overcharging for service and unwise investments. The leopard has not changed it's spots. To consider deregulation or flexible regulation or whatever euphemism you prefer, considering this recent history, would seem to be at best foolish, at worst criminal

But, let's look at the underlying purpose of these hearings, that is to serve the public interest. What is in the public interest? Most people would agree about the results of deregulation in the airline industry; higher fares, poorer service and less choices. Most people are aware of the results of deregulation in the banking industry; a bailout that will cost the taxpayers hundreds of millions of dollars.
Does this mean that deregulation can't work? Not necessarily. We feel that deregulation can work. In businesses characterized by large oligopolies, as with the airlines, or worse, large monopolies like the telephone company, deregulation can work *only* when accompanied by the most stringent oversight of the deregulated company's activities. What Pacific Bell is asking the citizens of the state to buy off on is the worst of all possible worlds for those citizens, that is *deregulation without oversight.*

We have heard nothing from the telephone company or the CPUC about how new methods of regulation will include the most stringent kind of oversight. We have heard nothing more than "trust us".

When we have a competitor to whom we pay over 35% of our revenues for services essential to our business, when we have a competitor who has no need to raise capital, when we have a competitor who has more lawyers than we have employees, when we have a competitor who has a long record of anti-competitive abuses, we worry. We worry, not about that competitor's ability to beat us in the marketplace, we'll take that risk. We worry about that competitor using the multitude of advantages gained from his monopoly position to dominate an emerging competitive market.

If the telephone company wishes to enter competitive markets, let them do it just like everybody else does. Let them go out and raise the capital just like everybody else, let them operate as a separate company, just like everybody else. And if they dominate, let it be because they served the public better, not because they could outlast the competition in the anti-trust courts or the CPUC.

WENDT-LOPER
Governmental Relations, Inc.

JUNE 5, 1989

TO: MEMBERS, ASSEMBLY UTILITIES AND COMMERCE COMMITTEE

FR: DENNIS L. LOPER

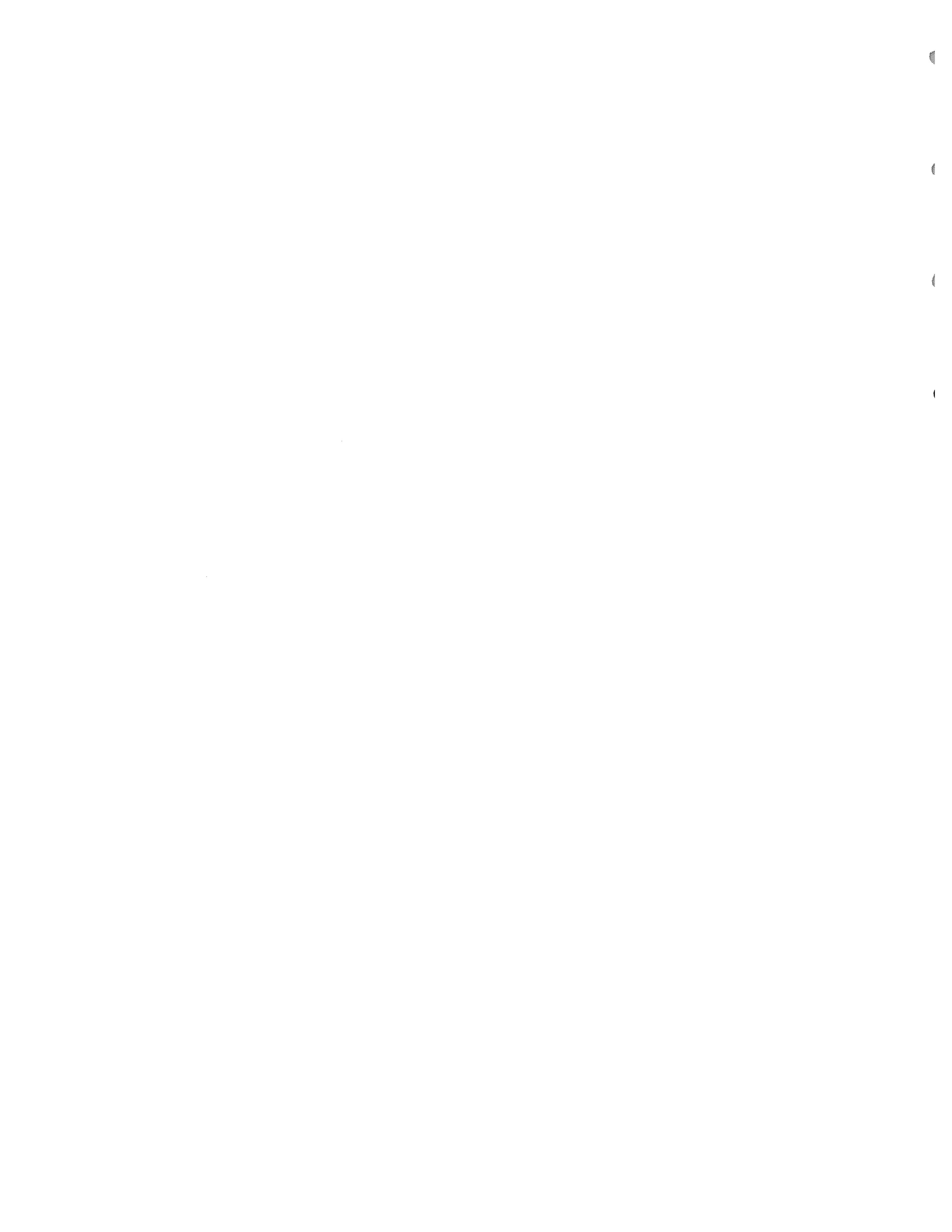
RE: US SPRINT TESTIMONY

Attached is the testimony of our client, US Sprint. Ms. Pongracz was unable to testify in person due to a conflicting schedule.

Thank you for considering her comments.

ATTACHMENT

925 L Street • Suite 780 • Sacramento, CA 95814 • (916) 446-7843



Comments of Ann C. Pongracz
Director, External Affairs, US Sprint Communications Company
Submitted to the
Assembly Utilities and Commerce Committee
June 5, 1989

US Sprint greatly appreciates this opportunity to present its comments regarding the important issues before the Committee. However, due to an unavoidable schedule conflict, I am unable to personally attend the hearings. I am thankful for this opportunity to submit my comments in writing.

US Sprint operates the nation's only nationwide 100% fiber optic telecommunications network, providing international, interstate and intrastate interLATA telecommunications services to many Californians. US Sprint is therefore vitally interested in the issues being considered by the Committee. The Committee today examines issues currently before the California Public Utilities Commission in its investigation to review and possibly change the framework for regulating intraLATA telephone services provided by local exchange carriers today, and into the 1990s. In this investigation, the Commission is considering alternatives to traditional rate-of-return regulation for local exchange companies and the extent to which competition for intraLATA services should be authorized.

This complex investigation, begun in late 1987, has been divided into three separate proceedings, Phases I, II and III. The settlement of Phase I, approved by the Commission last year, led to the opening of several peripheral proceedings needed to implement the settlement. The investigation also involves a fourth proceeding, the Supplemental Rate Design, which will consider rate changes necessitated by Commission action in the broader investigation. The Commission is also considering related issues in its review of Pacific Bell's Enhanced Services Application. In light of the considerable resources needed to participate in all of these proceedings, US Sprint has chosen to concentrate its attention in a limited number of these proceedings. US Sprint did not file testimony in Phase II, but will again be actively involved in Phase III and the Supplemental Rate Design.

The traditional goals of utility regulation identified by the Committee have continuing validity in the 1990s. Where technology permits the development of a vibrant competitive market for telecommunications services, market forces can insure the availability of quality service at appropriate rates. Developments in the technology of long distance transmission have made the development of such a market for interexchange services

possible. Since the divestiture of AT&T and the authorization by the California Public Utilities Commission in 1984 of competitive provisioning of interLATA services, California telecommunications customers have experienced an increasing diversity of interLATA services at prices which have steadily declined. Regulation of these services has appropriately been relaxed, as competition has begun to develop. While competition is viable for long distance services, the technologies necessary for the development of viable competitive alternatives in local exchange services do not exist today, nor are they likely to develop and become generally available in the near future. Continued regulation of local exchange services and long distance access services will be necessary in the 1990s and beyond.

US Sprint applauds the California Public Utilities Commission's efforts to pursue more efficient and effective methods of regulating local exchange companies. However, any framework which replaces or augments the existing framework of rate-of-return regulation must equal or exceed the achievement by the existing framework of the goals identified by the Committee. In particular, any new regulatory framework must assure that remaining monopoly services of the local exchange companies remain available at reasonable rates, and that the lack of alternatives for these services not enable carriers to charge excessive rates to customers of these services in order to finance ventures in more competitive services. Further, any new framework must assure that local exchange companies cannot use their bottleneck control over local connections to impede the development of competition for services offered or planned by the LEC. Without such safeguards, an LEC could discriminate in favor of its own services by providing competitors inferior local connections or by charging competitors more for connections than it charges itself.

The proposals set forth by various parties in I.87-11-033 and A.88-08-031 have raised several specific issues that will be of particular concern to US Sprint as these two proceedings and the Supplemental Rate Design are considered by the Commission. First, the Commission will reconsider its prohibition of intraLATA competition in Phase III of I.87-11-033. US Sprint believes that the intraLATA toll market should be opened to competitive carriers without delay. In the five years since the Commission opened the interLATA market to competitive providers, it has been clearly demonstrated that California customers can enjoy the diversity of services and prices which result from a competitive market while universal access to local and toll services is maintained with the assistance of appropriate toll access charge structures. The opening of the intraLATA toll market to competition should not be delayed or slow rolled through unnecessary staged transitions to competition.

Second, when competition is approved for intraLATA toll services, Commission oversight of LEC pricing must assure that LECs impute the same intraLATA access charge rates to their own intraLATA toll rates that the LECs charge to competing carriers. These competing carriers will continue to rely on the LEC's bottleneck local facilities to interconnect to their customers. If competition for intraLATA toll is authorized under conditions which do not provide competitors with 1 + dialing parity, then access rates for competing providers should reflect the inferior value of such access services. If when competition is authorized the LECs are allowed to charge discriminatory prices to competitors for the same services used to provide their own services, intraLATA toll will remain a monopoly to the detriment of California consumers.

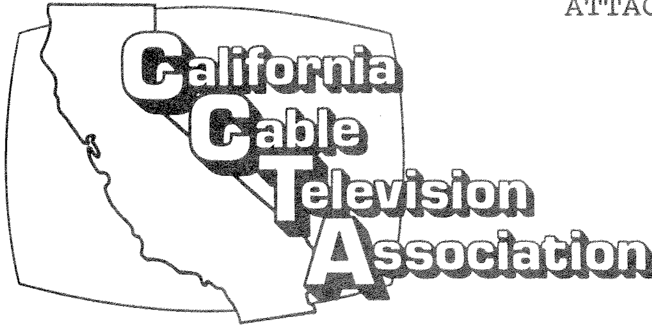
Third, oversight of LEC pricing must also assure that interLATA toll customers do not subsidize the LECs competitive intraLATA services. InterLATA toll customers indirectly pay for the interLATA access costs charges by LECs to interLATA carriers. When interLATA access rates were established in 1984, rates were set substantially above cost to assure the continued availability of local service to all in California. Access service rates have not been systematically reviewed in the past five years except as part of companywide earnings reviews; a procedure that several parties have proposed be eliminated. LEC proposals currently under consideration in Phase II do not guarantee that customers of LEC interLATA services will share equally in any efficiency gains a new regulatory framework may bring. Further, these proposals hold out the real possibility that the interLATA access reductions of the past five years would be taken back in the Supplemental Rate Design or diverted to competitive LEC services unrelated to universal service availability. WHatever the framework ultimately adopted, that framework should guarantee that all toll customers, whether they be intraLATA toll customers of the LEC or the interLATA or intraLATA toll customers of a competing carrier, bear equally any burden necessary to assure continued universal access to the telephone network.

Finally, LEC entry into the field of information services should be conditioned upon assurances that customers of an LEC's monopoly services do not subsidize the LEC's competitive offerings and that necessary LEC services are not made available only to the LECs own services or to competitors on a discriminatory basis. While hearings in A.88-08-031 are still ongoing, it is apparent that Pacific's proposals fall short of these assurances in several respects. First, Pacific proposes that its own enhanced services be allowed to utilize Pacific Bell billing and collections services, services developed at Ratepayer expense at artificially low, discriminatory prices. In regards

to Pacific's Public Packet Switching service, upon which hearings begin today, there is a serious question of whether Pacific's proposed service is offered at rates which cover costs, or whether Pacific's ratepayers will be required to subsidize a competitive offering which will not become profitable for many years, if at all. Continued Commission oversight of LEC rates is needed when, as in the case of enhanced services, an LEC enters a competitive marketplace.

This concludes my comments. I again thank the Committee for allowing US Sprint to share with you its comments on these important issues facing the telecommunications industry and California customers in the 1990s.

ATTACHMENT N



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Vice President Governmental Affairs
DENNIS H. MANGERS

May 31, 1989

The Honorable Gwen Moore, Chairwoman
Assembly Utilities & Commerce Committee
State Capitol, Room 2117
Sacramento, CA 95814

Dear Assemblywoman Moore:

We are delighted that the Assembly Utilities and Commerce Committee will hold a hearing on Monday, June 5 at 1:30 p.m. to discuss the California Public Utility Commission's proceeding to revamp California telephone company regulation.

On behalf of the cable industry in California, I need to let you know why we view this hearing as so important.

As you know, current regulation of telephone service occurs because the local telephone company is a monopoly provider of a necessity service for residential and small business customers. Therefore, regulation seeks to insure that prices are fair and that competition for those non-monopoly services offered by the telephone company is fair. Fair competition requires preventing subsidy of competitive services by monopoly services and insuring that the power of telephone companies, which is the power to put virtually any consumer service business into bankruptcy by denying it telephone service, is not abused.

The danger of unfair competition is growing because every day telephone companies seek to enter new competitive fields: voice mail, data transport, data gateway service, more yellow page services, and cable television.

For many years Assemblywoman Moore, Senator Rosenthal, and others have proposed legislation to strengthen CPUC scrutiny of subsidy. While many legislators have not supported these bills, the basis for opposition has always been that the CPUC already watched for subsidy and unfair practices.

No one ever dreamed that all the existing CPUC protections against subsidy and consumer gouging would be discarded.

But in an unbelievable proposal, Pacific Telephone and General Telephone propose to discard totally the rate case, which has, for decades, been the sole effective mechanism for dealing with these issues.

It is important to understand how crucial the rate case is. For consumers and competitors, it has provided an opportunity for careful examination of utility records, discovery of necessary information, cross-examination of utility witnesses, support from the CPUC staff if the CPUC staff believed that legitimate issues had been raised, and many other procedural protections.

Most important, however, was the simple fact that the rate case was sufficiently important to billion dollar monopoly providers that even with all their power, they took the rate case seriously and avoided conduct which led to criticism in the rate case. Remember how difficult it is for competitors and consumers: the utility controls the books, has dozens of lawyers and experts hired at ratepayer expense, sees the CPUC staff daily and provides services which every business must have.

No one has demonstrated that there is a need to replace the rate case. We have had fifty years of rate cases and excellent telephone service. The only change is that in its last rate case Pacific caused the case to go on for years by claiming for the first time that much of the information sought by PUC staff and other parties was proprietary.

Now Pacific and General propose to throw out the rate case. So we asked what safeguards there would be to insure that cable television facilities, voice-mail, data transmission and other competitive services are not offered at prices subsidized by telephone services, i.e., that Pacific and General did not offer competitive services by charging off the cost to the basic telephone service.

Pacific has said that there will be "oversight capability". (Their words, not mine.) Oversight capability, we have gleaned, consists of a few reports which state little of value, because anything of value in setting rates or discerning predatory pricing Pacific now considers "proprietary". It consists of occasional workshops where people talk about things. Other than these two elements, nothing more has been ascertained.

A CPUC staff armed with "oversight capability" against the state's largest employer, largest monopoly provider and most powerful corporation is like replacing NATO with two boy scout troops armed with a book of good intentions. The body count of competitive businesses destroyed by the "unleashed" telephone company will be the only meaningful piece of data left.

But Pacific goes beyond abolition of the rate case. Pacific proposes to enshrine a new doctrine: investment of ratepayer money in facilities which are not cost-justified but sound high-tech. Pacific concurrently seeks CPUC approval of an investment of $400,000,000 in fiber-optic facilities which are not currently cost-justified and can and will be used for competitive services, including cable television distribution.

Pacific's plan may cost ratepayers more money that Diablo Canyon, since Pacific's own estimate of the cost of upgrading its network to fiber-optics is about $25,000,000,000, and such investment produces no additional revenue. It could destroy or severely damage many of California's telecommunications businesses including cable television, none of which could compete with a subsidized telephone assault.

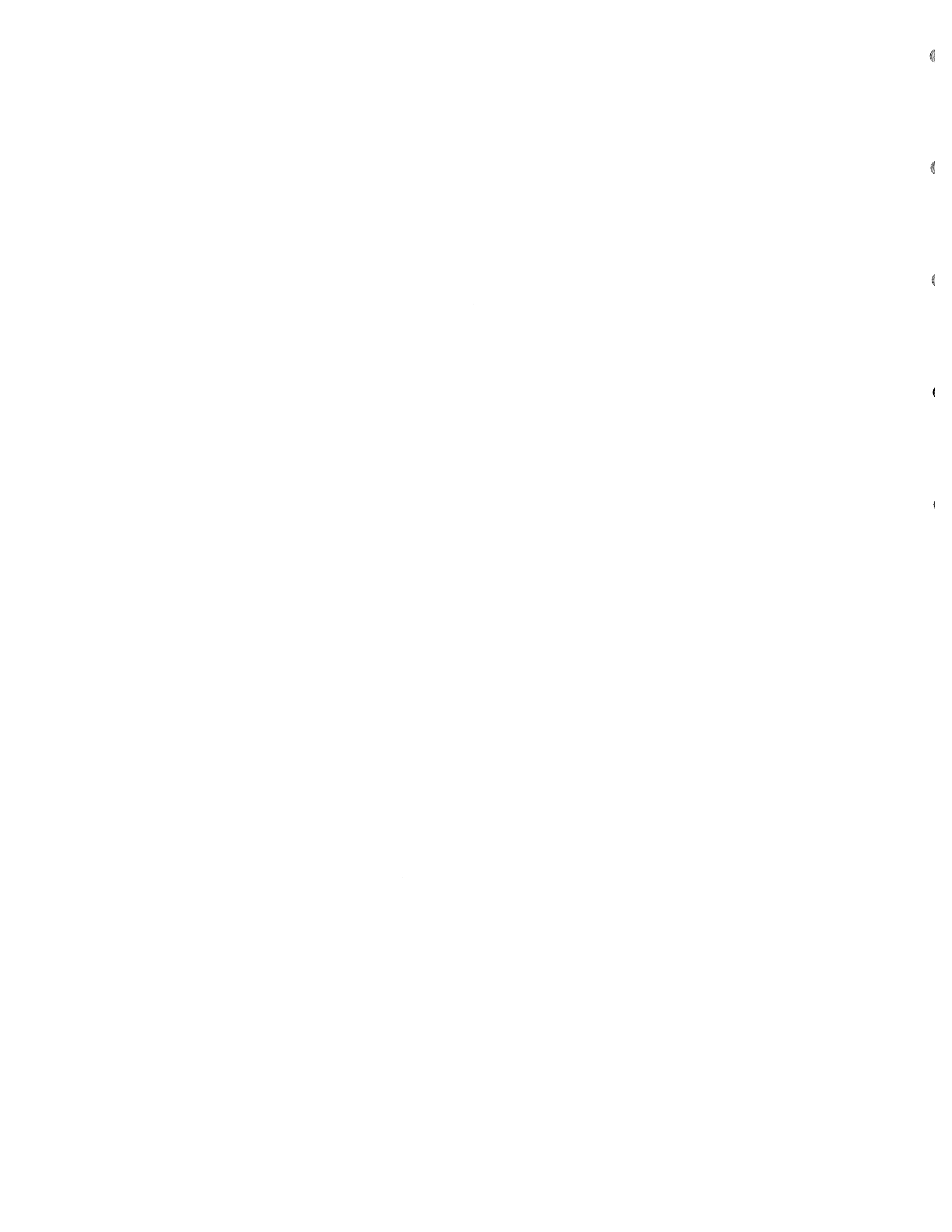
The need for legislative oversight was never greater! We look forward to seeing you at the hearing next Monday.

Sincerely,

Dennis Mangers

DHM/mb

cc: Members, Assembly Utilities & Commerce Committee



THE RATE CASE:
OVER 50 YEARS OF RATEPAYER PROTECTION

RATE CASE PROTECTIONS

- Public hearings on rate change proposals.
- Testimony/cross-examination under oath by utility to examine proposed rate changes.
- Regular schedule for periodic rate changes.
- Significant rate increases only by formal application, with proven justification.
- Utility expenditures subject to disallowance if imprudent or not "used or useful" for telephone service.
- Burden of proof on utility to justify rate changes.
- Submission of expert testimony, rate proposals, and cost studies by CPUC ratepayer advocate staff and interested parties, to be considered along with utility proposals.
- Detailed cost studies required to justify rate changes.
- Detailed tracking by CPUC auditors of utility service costs from rate case to rate case.

PAC BELL'S CPRS PROPOSAL

- Closed-door briefings of CPUC commissioners on rate change proposals.
- Informal "workshops" to explain proposed rate changes.
- Rate change proposals submitted at utility discretion.
- Significant rate increases by advice letter, effective "conditionally" unless a protest can show "irreparable harm."
- No prudency review; could eliminate prohibition of using ratepayer monies for "image" advertising, political lobbying, etc.
- Burden of proof on protesting party to show rate changes would cause "irreparable harm."
- Response by CPUC ratepayer advocate staff and interested parties to utility proposals only by filing of "protests."
- Rate changes at utility option within "zone of flexibility."
- Utility submission of service costs for CPUC auditors' review on a piecemeal, sporadic basis.

ATTACHMENT O

LAW OFFICES OF

JACKSON, TUFTS, COLE & BLACK

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PARTNER

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June 7, 1989

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Ans'd..........

FEDERAL EXPRESS

Mr. Robert Jacobson
Principal Consultant
Assembly Committee on Utilities and Commerce
State Capitol
P.O. Box 942849
Sacramento, CA 94249-0001

Re: California Bankers Clearing House Association
Special Hearing

Dear Mr. Jacobson:

Enclosed please find six copies of the Comments of California Bankers Clearing House Association with respect to the hearing on telephone regulation. As you know, we had intended to provide Mr. Gerard F. Milano, executive director of California Bankers Clearing House Association, to testify at your hearing scheduled for Monday, June 5, 1989. When the date was changed at the last minute, a conflict precluded his attendance.

If you have any questions in regards to this matter, please do not hesitate to call.

Very truly yours,

William H. Booth

WHB/cmk
Enclosures
03/WHB4CK

CALIFORNIA LEGISLATURE

ASSEMBLY COMMITTEE ON

UTILITIES AND COMMERCE

HEARINGS ON TELEPHONE REGULATION

COMMENTS OF THE CALIFORNIA BANKERS CLEARING HOUSE ASSOCIATION

JUNE 5, 1989

The California Bankers Clearing House Association ("CBCHA") is pleased to have this opportunity to present its comments to the Assembly Committee on Utilities and Commerce with respect to the current state of telephone regulation in California and, more specifically, with regard to the California Public Utilities Commission ("CPUC") investigation of alternative regulatory frameworks for local exchange companies ("LECs"). The focus of the CPUC's investigation has been on the question whether the CPUC should abandon its long-standing, successful system of rate of return regulation in favor of some alternative form of regulation, including variants of the FCC's recently adopted proposal for price-cap regulation.

The CBCHA, which is an industry association comprised of eight of California's largest banks, all of whom are substantial users of regulated telecommunications services, has fully participated in the CPUC's investigation. It has vigorously challenged the notion that rate of return regulation should be abandoned, both by submitting expert testimony and by questioning the positions taken by the LECs and other parties. In

particular, it has tried to impress upon the CPUC the fact that rate of return regulation has been extremely successful in the past and has provided numerous benefits to California's ratepayers.

The CPUC's regulation of LECs over the course of the last 70 years has provided Californians with a high quality, universally available and reasonably priced telecommunications system. While it is not perfect -- technological changes will need to be incorporated on an ongoing basis, and the rates for some services are unnecessarily maintained in excess of cost while rates for other services are held below cost -- the existing scheme of regulation has admirably served California's telephone customers.

The existing regulatory framework allowed the CPUC, the utilities and their ratepayers to survive remarkably well the trauma of the AT&T divestiture in 1983 and 1984. In the past several years, the existing regulatory scheme has resulted in significant rate reductions, the most notable being the 1986 reduction in PacBell's rates of $121 million, ordered in the face of an application by PacBell to <u>increase</u> its rates by <u>$1.362 billion</u>. In light of such rate reductions, it is not surprising that the LECs are working so hard to change the method of regulation.

In response to the CPUC's investigation, the two largest LECs in California, Pacific Bell and GTEC, submitted proposals to the CPUC, as did the CPUC's Division of Ratepayer Advocates ("DRA"). The PacBell proposal, entitled the "California Plan for Rate Stability" or "CPRS," embodied PacBell's concept of how the

regulatory system should be revised. In a nutshell, PacBell proposed a moratorium on all rate cases through 1992 and the establishment of a benchmark rate of return, with a 50/50 sharing of profits above the benchmark. PacBell proposed to freeze residential rates for four years, as well as to provide free Touch-Tone service and expanded local calling areas. In exchange, it sought pricing flexibility on most other services it provides, particularly services provided to businesses, with substantial rate increases for business customers. The PacBell plan was proposed to be instituted in 1989 and kept in place until 1992, when it would be reviewed by the CPUC.

At first glance, CPRS is an attractive program. It does away with expensive and time consuming rate cases, it offers a sharing of "excess" profits with ratepayers and it freezes all residential rates for several years. However, upon closer analysis it became clear to CBCHA that CPRS is not such a good deal for ratepayers and, in fact, involves substantial risk that ratepayers will be substantially worse off with CPRS than they would be under the CPUC's traditional rate of return, cost of service regulation.

In the past 5 to 10 years, the LECs have realized enormous productivity gains resulting from investment in new technology. The cost of doing business in this industry is declining on a unit basis. Ratepayers should be entitled to more and better services for less money than was the case as recently as 1980. Indeed, under the existing rate of return system, ratepayers have seen aggregate rate reductions in this decade amounting to

hundreds of millions of dollars. The problem with CPRS is that it fails to ensure that ratepayers will continue to see the benefit of these technology-based productivity improvements. By placing a moratorium on rate cases, the LECs hope to retain a larger portion of such cost reductions.

Another problem with CPRS is that it is potentially very discriminatory against business customers. During the CPUC hearings, PacBell acknowledged that its proposal to freeze residential rates would maintain in place an existing $2 billion annual subsidy to residential local exchange access rates. Such a subsidy is not necessary. Because of the fine work of this body in enacting the Moore Universal Lifeline Telephone Service Act, California enjoys the benefit of an efficient and fair program of subsidizing basic telephone service for the poor. The Moore Act provides for a targeted subsidy, which amounts to only a few hundred million dollars compared to the $2 billion subsidy which would be frozen into the CPRS. This $2 billion subsidy has to be paid by users of other services, including residential and business users of local and interexchange usage services, so it artificially depresses the use of the network to the detriment of all Californians.

GTEC's proposal, while also seeking a form of price cap regulation, differed in substantial measure from the PacBell proposal. In particular, GTEC sought to divide its services into two categories, essentially monopoly services and competitive services. No freeze of residential rates was proposed; instead, GTEC stated that it would move all below-cost services gradually

toward cost. However, GTEC sought extensive pricing flexibility for its competitive services, with regular, indexed increases for its non-competitive services. GTEC also proposed a 50/50 sharing of profits over a benchmark rate of return.

The GTEC proposal ties the increases for its non-competitive services to an inflation index, which is adjusted for productivity and extraneous factors. The problem is in defining the appropriate index. The rate of productivity gains in the telecommunications industry has been steadily increasing over the past number of years and can be expected to continue this trend. If the index is based on historical productivity levels, rather than expected levels of future productivity, the forecast will be far too low and the ratepayers will not get the appropriate benefit from these productivity gains. The correct forecast of the productivity factor, which is extremely difficult to determine, is crucial to the workability of the GTEC proposal.

With respect to its competitive services, GTEC sought tremendous pricing flexibility. For example, while it limited increases to no more than 10% per year, it requested to be able to make such increases without the need for any approval from the CPUC. Moreover, it requested authority to make pricing changes on only 10 days notice to its customers, and requested that such changes go into effect even if a protest was filed with the CPUC. In short, GTEC proposed that it be given *de minimus* regulation of those services that it considered to be competitive.

The DRA's proposal also sought to move away from rate of return regulation. The DRA proposed division of the LECs into

two autonomous units, one providing monopoly services and one providing new and competitive services. It called for price-cap regulation of the monopoly services, with prices set in a supplemental rate design proceeding and then subject to indexed increases, with the same productivity problem found in the GTEC proposal. Unlike GTEC's proposal, however, the DRA did not offer any specifics as to how the index for price increases would be computed.

The DRA proposed that monopoly earnings in excess of a benchmark rate of return would be split 50/50 with ratepayers, while earnings in excess of an upper figure would be given 100% to ratepayers. The DRA plan offered downside protection to LECs for monopoly services, with a rate of return floor that would trigger reexamination of the regulatory framework by the CPUC. Finally, it offered full pricing flexibility for new and competitive services, with the LECs splitting earnings above a benchmark rate of return 50/50 with ratepayers and no floor on earnings.

The DRA entered into Phase II of the CPUC's investigation very reluctantly and its position demonstrated its ambivalence on the underlying issues. Its witnesses expressed concern about the amount of time and increased workload that would be necessary to implement the DRA's own proposal. Moreover, in the briefs that were filed, most of the parties agreed that the DRA's proposal was far too unclear to be implemented. The DRA's forced attempt to justify a regulatory change, which it obviously believes is

not necessary, suggested that the DRA only proposed an alternative framework because it felt pressured into doing so.

In the hearings, the CBCHA strongly advocated that rate of return regulation should not be abandoned unless and until there is clear evidence that actual competition exists. Its expert witness, Dr. Lee Selwyn of Economics and Technology, Inc., testified in depth about this issue. He explained that the dominant LECs have an enormous advantage in terms of economies of scope and scale, due to the noncompetitive monopoly they have maintained in the market for local services. If that monopoly continues to exist, the LECs will be able to use their monopoly advantage under price cap regulation to drive out would-be competitors and maintain rates at artificially high levels.

Dr. Selwyn also demonstrated that the telecommunications industry is in a period of substantially declining costs and increasing productivity. He explained that the ratepayers have financed the lion's share of investment by the utilities, but the LEC proposals would take away the benefits of such cost decreases and productivity increases from the users. Under rate of return regulation, LECs have been steadily decreasing their rates under orders from the CPUC, due largely to the cost decreases and productivity increases that have been occurring. During the next several years, costs should continue their steady decline and productivity should continue to improve. The LEC proposals, however, would improperly hold the LEC rates steady or would even allow the LECs to increase their rates.

Unfortunately, the CPUC decided prior to the commencement of the hearings last fall that Phase II of the investigation would not consider the question of whether to eliminate the ban on intraLATA competition. The settlement in Phase I of the investigation had permitted the introduction of intraLATA competition for high speed private line services, but all of the parties to Phase II had anticipated that this second phase would address the elimination of the ban in its entirety. The CPUC instead chose to defer the issue until Phase III, thereby confusing the procedure and throwing into doubt some of the fundamental assumptions upon which the parties had been proceeding.

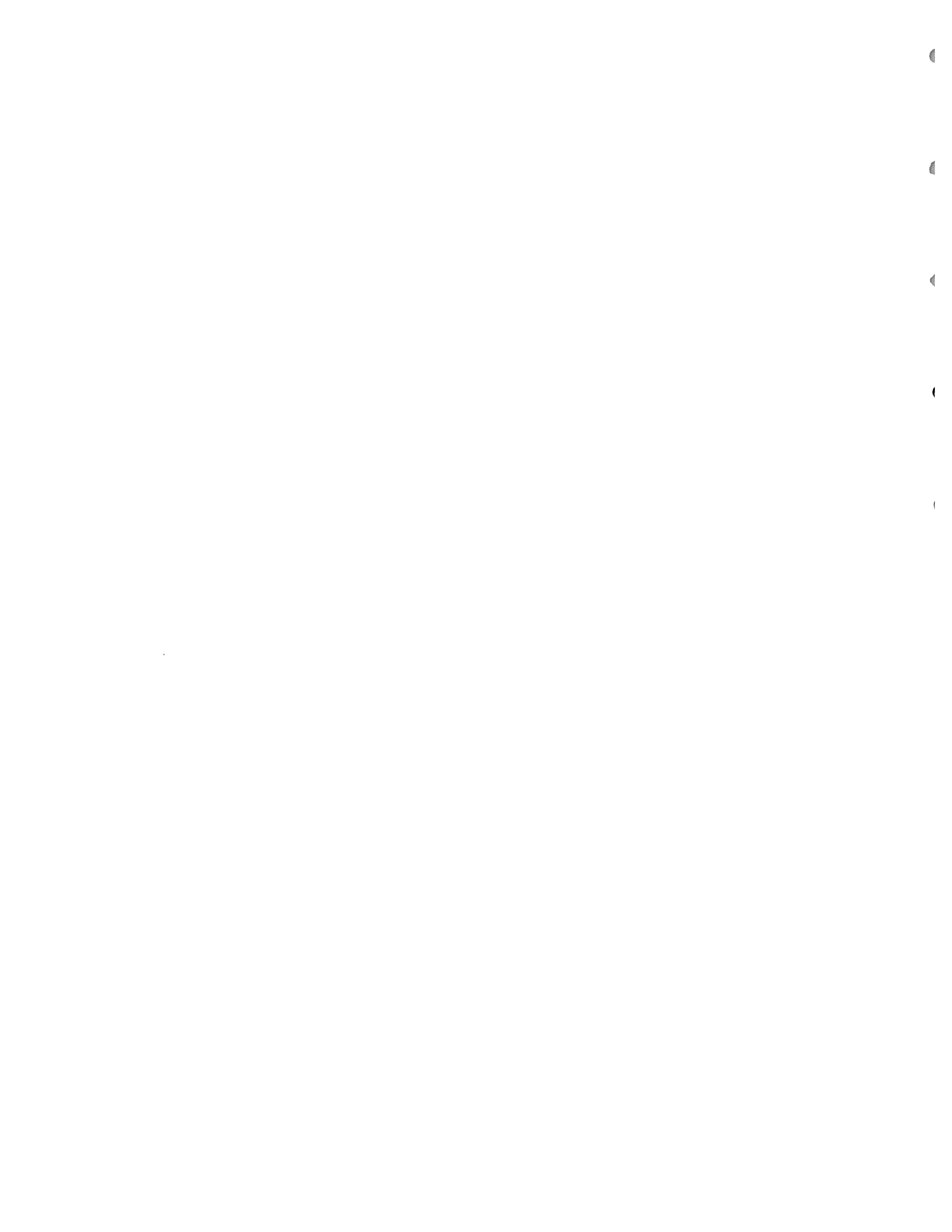
As could have been expected, the elimination of this issue created some confusion in the hearings. In particular, both PacBell and GTE had based their proposals in large part on the expectation that the ban on intraLATA competition would be eliminated (and, correspondingly, that the LECs would be allowed to compete in the interLATA market). Faced with the CPUC's ruling, they simply removed this underlying assumption and retained their entire proposals.

Dr. Selwyn's testimony, however, went right to the heart of this issue. He had correctly recognized that the LEC proposals had to have been based on an assumption that competition actually exists. Absent such competition, he testified, the dominant LECs would simply use their market power and prior, ratepayer-based investment to increase their profits at the expense of their customers. The CBCHA is extraordinarily concerned that by

excluding the issue of intraLATA competition from Phase II of the investigation, the CPUC may be headed toward a diminished form of LEC regulation at a time when the necessary price-constraining competition does not exist. If so, the LECs will be able to use their market power to drive out competition and reduce, rather than expand, the choices faced by California's ratepayers.

Accordingly, the CBCHA has encouraged the CPUC to reexamine the process by which rate of return regulation has been implemented in order to determine if procedural corrections should be made. It has also strongly argued, however, that the policy itself should not be abandoned. California's ratepayers are in many ways held captive by the LECs, which completely dominate the market for local telephone services and thus the market for connection to almost all other type of services. Unless the CPUC maintains a process whereby the LECs are precluded from using the traditionally predatory practices available to a monopolist, these captive ratepayers will face the risk of increased, uneconomic prices and reduced alternatives. Such a situation can not be in the interest of either residential or business customers.

IBMIRD/A



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American Newspaper Publishers Association
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Offices: The Newspaper Center, 11600 Sunrise Valley Dr., Reston, Va 22091 (703) 648-1000

revised May 3, 1989

THE AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION* SUPPORTS INFORMATION DIVERSITY AND OPPOSES H.R. 2140, THE "CONSUMER TELECOMMUNICATIONS SERVICES ACT OF 1989"

o ANPA opposes legislative efforts to allow the 7 Regional Bell Operating Companies (RBOCs) to engage in electronic publishing, including H.R. 2140 introduced April 27, 1989 by Congressmen Swift and Tauke.

o ANPA believes that the owners of monopoly transmission lines (the Regional Bell Operating Companies) should not own or control the content that goes over those lines because of their incentive and ability to engage in anti-competitive behavior. The local telephone lines of the regional phone companies are a bottleneck through which electronically published information must pass. The 1982 consent decree prohibits RBOC entry into electronic publishing for good reason. The prohibition was imposed because of the inability of the FCC to prevent anti-competitive behavior by the phone companies.

o We urge the Congress to reaffirm its commitment to a public policy that encourages a diversity of information sources for the American consumer.

Under H.R. 2140, the RBOCs would be allowed to provide electronic publishing in a state if they offered a gateway within that state. The existence of a gateway does not measure the ability of an RBOC to act anti-competitively. If the phone companies are allowed to offer electronic publishing, they will have the incentive and ability to engage in anti-competitive conduct. This will mean less - not more - information sources for the American consumer, since the monopoly phone companies have a track record of discrimination against other competitors. It will also mean that the ratepayer will bear the brunt of phone company entry into these services, as cross-subsidies from the ratebase have been virtually impossible to prevent. H.R. 2140 actually would weaken the FCC's existing ratepayer protection measures.

ANPA supports the development of a diversity of electronic information services, but if this is to happen, there must be a level playing field. Public access to information and international competitiveness will not be improved by RBOC involvement in information services content. If allowed, it would present unacceptable anti-competitive risks in an emerging market that would result in less information for the public and a reduced ability to compete in international markets.

* The American Newspaper Publishers Association is a non-profit trade association representing more than 1,400 newspapers throughout North America. Its membership comprises approximately 90 percent of the daily and Sunday circulation in the U.S. Many nondaily newspapers also are members.

At this point, the local exchange is the only viable means of distribution for most electronic information services. There is no alternative. Information content services remain particularly vulnerable to manipulation and discrimination by the monopoly phone company that provides the only means of transmission. The history of the AT&T case points to the ability of the phone company to discriminate in favor of its own operations and the inadequacy of accounting safeguards to prevent cross-subsidization. This later point was admitted by FCC officials during the AT&T litigation. That is why the prohibition on RBOC entry into content should remain. The so-called safeguards in H.R. 2140 are much weaker than those applied to AT&T in the past, and would not prevent discrimination and cross-subsidy.

The U.S. District Court's March 7, 1988 decision gave the RBOCs a tremendous opportunity to offer a wide array of information services including a variety of "gateway" services, voice storage and retrieval, voice messaging, electronic mail and electronic white pages. ANPA believes that development of these infrastructure services by the RBOCs will help spur consumer access and use of information content services, and this is their proper role in the information marketplace. These services are in addition to the wide range of information sector services the RBOCs already provide, including basic exchange service, provision of consumer services and equipment and printed white and yellow pages, to name just a few.

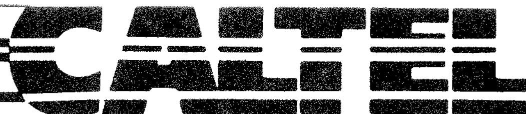
The electronic information services marketplace for both voice and data is developing. Numerous newspapers and other entrepreneurs are providing voice and text information services for consumers. These services are proving extremely popular.

The advertising market is just as susceptible as any other form of electronic publishing to RBOC abuses. Electronic yellow pages fall within the realm of information content and should be off limits for an RBOC to offer for the reasons set forth above. There are a number of businesses, large and small, which are entering this market. Entry of the RBOCs would stifle this marketplace evolution.

The U.S. is a world leader in the development of new electronic information services. The U.S. exports three times the amount of information services that it imports. With respect to the French Minitel system, it is important to note that information content comes from competing service providers independent of the French telephone company. The French PTT has increased penetration of home terminals by distributing millions of them as part of the Minitel system. It should be noted that the AT&T Consent Decree today does not prevent the RBOCs from distributing terminals. In fact, under current law, one Regional Bell Operating Company, Southwestern Bell, is already distributing terminals in connection with its new gateway in Houston.

While oversight of telecommunications policy has been and remains an important function of the Congress, legislation to lift the restrictions on RBOC provision of content would present anti-competitive risks in an emerging market. The information age will continue to grow only if those who control the basic facilities have no incentive or ability to prefer certain entrepreneurs above others.

We strongly urge you to support information diversity and oppose H.R. 2140 or any legislative attempts to cripple true competition in the information services marketplace.



ATTACHMENT Q

California Association of Long Distance
Telephone Companies
925 L Street, Suite 220
Sacramento, CA 95814
(916) 441-4166

Hand Delivered

June 14, 1989

The Honorable Gwen Moore, Chairwoman
Assembly Committee on
Utilities and Commerce
State Capitol, Room 2117
Sacramento, CA 95814

Re: Interim Hearings on Regulation of Local Exchange Carriers

Dear Assemblywoman Moore:

On behalf of the California Association of Long Distance Telephone Companies (CALTEL) I would like to extend my thanks to you for conducting a highly informative (and extremely timely) hearing last week on the regulation (or prospective lack thereof) of local exchange carriers. You and your staff obviously spent a great deal of time preparing for the hearings as was evidenced by your questions.

Your hearing provided an excellent forum for those of us who are concerned about the relaxation or abandonment of the traditional rate case structure for large local exchange carriers such as Pacific Bell and General Telephone. While I understand that it was not possible for you to hear from everyone, I did want to write to let you know that CALTEL is also very concerned over this development and generally shares the views expressed by the witnesses from AT&T and MCI.

While there are problems with the present rate case structure, to a large degree those problems are fostered by the local exchange carriers themselves. As Ms. Seigel pointed out, it is a bit disingenuious for Pacific Bell to respond to any intervenor claim with a barrage of discovery requests and rebuttal witnesses and then argue to the Commission that the rate case takes too long. Believe me, those of us less handsomely funded than Pacific Bell would desire nothing more than to reduce the time and expense associated with participating in a rate case.

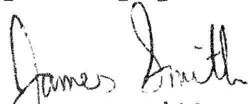
The Honorable Gwen Moore
June 14, 1989
Page 2

Nonetheless, we cannot endorse a proposal which would attentuate the rate case process at the expense of ratepayer protections. We all know that the unit cost of providing telecommunications services is dropping and it is essential to ensure that as many telephone customers as possible (whether they be large or small users of local exchange and/or long distance services) share in the benefits. The cost justification attendant to the rate case process ensures that this will occcur. We have yet to hear any compelling reason for abandoning the long-standing requirement that local exchange carriers justify their rates on an on-going basis to the Public Utilities Commission.

Again, you are to be congratulated for an excellent hearing. Thank you for your continuing oversight of the fashion in which local exchange carriers are regulated.

With best wishes.

Very truly yours,



James A. Smith, President
California Association of Long
Distance Telphone Companies

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ATTACHMENT R

MEMBERS
William Bradley
Jerry Eaves
Bob Epple
Nolan Frizzelle
Frank Hill
Lucy Killea
Ted Lempert
Willard Murray
Pat Nolan
Richard Polanco
Lucille Roybal-Allard
Cathie Wright

California Legislature

Assembly Committee on Utilities and Commerce

GWEN MOORE
CHAIRWOMAN
MEMBER OF THE ASSEMBLY
FORTY-NINTH DISTRICT

STAFF
William Julian
Principal Consultant
Robert Jacobson
Principal Consultant
Carolyn Veal
Principal Consultant
Yvonne Wilson
Committee Secretary

State Capitol
P.O. Box 942849
Sacramento, California
94249-0001
(916) 445-4246

June 7, 1989

Mr. Gregg Cook
Pacific Telesis Group
925 L Street, Suite 850
Sacramento, CA 95814

Dear Gregg:

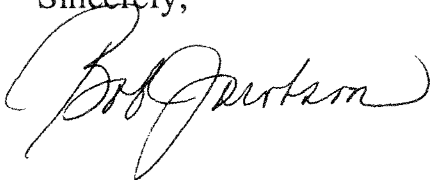
In his written testimony submitted to this Committee yesterday, Mr. Bruce Jameson, Pacific's witness, makes comments in a footnote which require further amplication.

Mr. Jameson states, in response to the Background Paper I prepared, that "The paper...is in error in its characterization of this subject." He is referring to my remark in the Background Paper that "the PUC twice rejected" Pacific's CPRS plan. My Webster's defines "reject" as "to refuse to acknowledge, acquiesce in, or submit to." Mr. Jameson is one-third right and two-third's wrong: the PUC certainly *acknowledged* Pacific's proposal, but it did not *acquiesce* or *submit* to it. Nor did the PUC *use* Pacific's plan. ("Not to use" is another definition of "rejection.")

In the same footnote, Mr. Jameson states that the Background Paper "also contains other errors of fact." I would appreciate Mr. Jameson's enumeration of these errors, so that the readers of the Committee's hearing report can be properly informed. I fear that readers may find Pacific's written submission tantalizingly incomplete without this elaboration.

Can we have this addendum prepared before next Wednesday, when our report will go out to print? Thank you for your assistance.

Sincerely,



ROBERT JACOBSON
Principal Consultant

B. F. Jamison
Executive Director

State Regulatory
140 New Montgomery Street, Room 908
San Francisco, California 94105
(415) 542-[illegible]

ATTACHMENT S

PACIFIC BELL
A Pacific Telesis Company

June 13, 1989

Mr. Robert Jacobson
Principal Consultant
Assembly Committee
on Utilities and Commerce
State Capitol
Sacramento, CA 94249-0001

Dear Mr. Jacobson,

In your letter of June 7, 1989 to Gregg Cook you asked for further amplification of my recent comments to the Utilities and Commerce Committee. The following are major comments, but are not all inclusive.

First, page 5 of your paper entitled "'Don't Hang Up!': The PUC and Telephone Service in the 90's -- Regulation, Deregulation, or Reregulation?" contains the following: "The PUC twice rejected Pacific Bell's "California Plan for Rate Stability,...".

As I stated in my filed testimony, the PUC has not rejected Pacific's proposal. In June 1986, after the hearing on Pacific's Rate Projection filing, the forerunner to the California Plan for Rate Stability, Commissioner Donald Vial issued a ruling stating that Pacific's Rate Projection filing merits further consideration and inviting Pacific to propose a proper forum for the PUC to consider the matter. (A copy of Commissioner Vial's ruling is attached.) The ruling clearly did not reject Pacific's proposal on the merits; it simply delayed consideration of it. The current Commission OII is the second occasion for Pacific's proposal to be considered. Again the Commission has not rejected Pacific's proposal. Some aspects of Pacific's proposal were adopted by the Commission in their Phase I decision (D. 88-09-059) of this OII and other aspects of the proposal are pending in Phase II and Phase III.

Second, there are several other errors in your paper which need to be corrected. For example, on page 5 of your paper, you state: "This year, after extensive investigation of Pacific Bell's technology investments revealed that some of these investments were not necessary, the PUC directed Pacific Bell to reduce its rates by more than $120 over the next three years." You should be aware that the Commission has not decided anything. The settlement agreement between Pacific and DRA did not find that any "investments were not necessary". Further, this proposed settlement is pending before the Commission.

On page 6 of your paper, you state: "In 1988, the PUC completed Phase One of the Investigation, allowing for...(3) less scrutiny for special contracts negotiated between Pacific and GTE and their largest customers." In D. 88-09-059, the PUC did not provide for less scrutiny for special contracts. Indeed each contract requires PUC preapproval before the services for which the contract is written can be installed. Thus, Phase I tightened contract scrutiny by now requiring that contracts with governmental agencies be preapproved whereas previously such contracts did not require preapproval.

Your letter indicated you wished to include more complete information in the Committee's report. I would appreciate this letter and its attachment being included in its entirety in the report.

Sincerely yours,

B.R. Jamison
Executive Director
State Regulatory Proceedings

Attachment (1)

AC/vdl

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of PACIFIC BELL, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone service furnished within the State of California.	Application 85-01-034
And Related Matter.	I.85-03-078

ASSIGNED COMMISSIONER'S RULING ON CORPORATE OFFICER TESTIMONY

On May 27, 1986, a hearing was held before the full Commission in the rate design portion of this proceeding. The hearing was held pursuant to a Ruling of this Commissioner dated April 1, 1986 which in relevant part required Pacific Bell (Pacific) to present corporate officers having first-hand knowledge of Pacific's present long-run investment strategy and overall business plan to testify under oath and subject to cross-examination on Pacific's projected rates over the next five to 10 years. The Ruling also held that Pacific's regular rate case showing could go forward except that the proposed rate shift from intraLATA toll to local exchange rates would be limited to an amount not greater than that recommended by Public Staff Division (PSD) in its February 7, 1986

compromise proposal[1] unless another order or ruling allowed a greater shift after the Commission had more information as to long-range rates.

Pacific produced three executive witnesses, T. J. Saenger, its president and chief executive officer; Lee G. Camp, its vice president-marketing; and George F. Schmitt, its vice president of operations north.

Rather than present a current projection, Saenger presented a conceptually new proposal for regulation of Pacific which contends that the presently scheduled rate design hearings should go forward and the Commission should adopt Pacific's proposal. Then Pacific would freeze basic residence rates at the levels proposed in its latest filing ($10 for one-party unlimited local service, up from the present $8.25) through 1989. He added that Pacific predicted that it would need to request only modest basic residence increases through 1995.

Saenger maintained that this freeze and possible modest increase would be possible if, in addition to adopting Pacific's pending rate proposal, this Commission agrees to the following:

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[1] Pacific's proposal shifts over $400 million in revenue from intraLATA toll service to local exchange rates. The PSD compromise proposal shifts about $71 million out of message toll rates via a SPF to SLU transition, realigns certain northern San Francisco Bay Area calling rates (decreasing them by about $12 million), and spreads the amount of revenue removed from these two sources along with the amount of the current authorized billing surcharge of about $120 million, uniformly for all service categories except coin, Lifeline, and Centrex.

1. Replacing the present Notice of Intent (NOI) and attrition procedures with an approach which allows no reexamination of rates until 1989 when Pacific and the Commission would jointly consider the underlying assumptions and the new regulatory framework itself.
2. Allowing Pacific and its ratepayers to equally share any earnings in excess of Pacific's authorized rate of return.
3. Reshaping the present rate structure to move "vulnerable revenue sources" toward cost, and to implement a bulk rate plan for the recovery of nontraffic sensitive (NTS) costs from interexchange carriers for access to Pacific's switched network.
4. Maintaining the Commission's present policy of allowing Pacific a monopoly in intraLATA markets.
5. Allowing Pacific to adjust prices for certain services within a predetermined price range with a floor at "relevant costs" and a cap set with regard to market factors.
6. Replacing "time-consuming hearings" for the authorization of new offerings or rate change requests with a more rapid procedure.
7. Allowing Pacific to move capital recovery to the actual rate of capital consumption and to eliminate its "depreciation reserve deficiency" as quickly as possible.
8. Allowing Pacific the option of using its share of earnings over the authorized rate of return to offset the depreciation reserve deficiency.
9. Allowing Pacific to expand its network offerings, or as the witnesses described it, "be all that it can be."
10. Continuing to oversee Pacific, but with "appropriate continuing surveillance" and with a "mission and goals" of Pacific and the Commission which are "compatible."

Camp's testimony "supports and amplifies" that of Saenger. Schmitt's testimony describes Pacific's goals and objectives for long-term investments with a fairly flat level of capital expenditures targeted through 1990.

The most immediate problem created by this testimony is the concern expressed by many of the interested parties in the rate case and related Pacific proceedings.[2] Formal responses protesting Pacific's filing were received from User's Group, MCI, AT&T, GTE Sprint, and PSD. Some parties are concerned about whether the Commission plans to consider Saenger's proposal and, if so, whether that will change the course of the access case which is presently being heard. They are also concerned about apparent inconsistencies between Saenger's proposal and the detailed amended rate design proposal Pacific filed with the Commission on May 19, 1986. They need to know which one(s) to respond to in their prepared testimony due on July 20. (In the case of the independent telephone companies, the filing date is June 30.) If the Commission plans to consider Pacific's proposal, parties want an opportunity to conduct discovery, further cross-examine the three corporate witnesses, and file comments and briefs. Further, if the Commission decides to permit additional shifts from toll to local exchange and/or to accept Pacific's proposal, these parties point out that Pacific would be entitled to amend its proposed rate design so that hearings should be held on the new rate design.

I think some of these concerns can be alleviated immediately. First, the proposal and testimony presented on May 27, although indicative of how Pacific sees the future, does not provide

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[2] A letter to ALJ Colgan from Alan L. Pepper, attorney for Western Burglar & Fire Alarm Association, describes these concerns clearly and succinctly.

sufficient detail to justify an order or ruling allowing a revenue shift between intraLATA toll and local exchange greater than that permitted in the Assigned Commissioner's Ruling of April 1, 1986.

Pacific's proposal is a broad-brush, provocative departure from the status quo. It merits further consideration, but it does not mesh with the present rate proceeding since it proposes reviewing issues, some of which have recently been addressed (e.g. depreciation reserve), others of which are the subject of other proceedings (interexchange carrier access to the local network). Further, we are not prepared, as Pacific proposes, to abandon our current review of Pacific's modernization plan, its utilization factors, and other related matters still pending in this general rate case. As staff's response points out, millions of dollars of potential revenue reductions are under consideration.

In the area about which we were expecting to be better informed, we did learn from Pacific that it has a relatively flat long-term investment policy. This is the sort of information that the April 1 Ruling asked for. More details of this sort are still needed to give the Commission a picture of how Pacific sees itself in five to 10 years, and to help the Commission formulate its own concept of what direction regulation of Pacific should take. We must remain cautious and cannot consider major regulatory change when we have so little on which to base a vision of the future.

While it appears possible for local exchange rate stability through 1989 to be attained by a modest amendment to Pacific's pending rate design testimony even within the limitations of the revenue shift that has been imposed earlier in this proceeding, the bulk of Pacific's proposal constitutes a far-reaching departure from present ratemaking procedures. It is not appropriate to expand the scope of this rate proceeding to consider such a new concept of regulation, especially in view of the proposal's complex interrelationships with other major proceedings. There are two

possible forums for considering such an overhaul. One is an application proceeding where Pacific would file a detailed request to make such changes, and the other would be an Order Instituting Investigation where, perhaps, we would address the impact or applicability of such changes on all local exchange carriers. I will leave it to Pacific to take the next step as far as its proposal goes.

Therefore, IT IS RULED that:

1. Except for the concept of local exchange rate stability through 1989, the overall proposal put forth by T. J. Saenger at the hearing on May 27, 1986 will not be considered in the present proceeding.

2. Because of the proximity of their filing date, and the confusion engendered by the May 27 hearing, independent telephone companies' filing date is extended from June 30, 1986 to July 14, 1986.

3. If Pacific wishes the Commission to further consider its proposal for a new type of ratemaking regulation, it shall file an application or otherwise take responsibility for proposing a proper forum for considering the matter.

Dated June 12, 1986, at San Francisco, California.

/s/ DONALD VIAL
DONALD VIAL
Assigned Commissioner

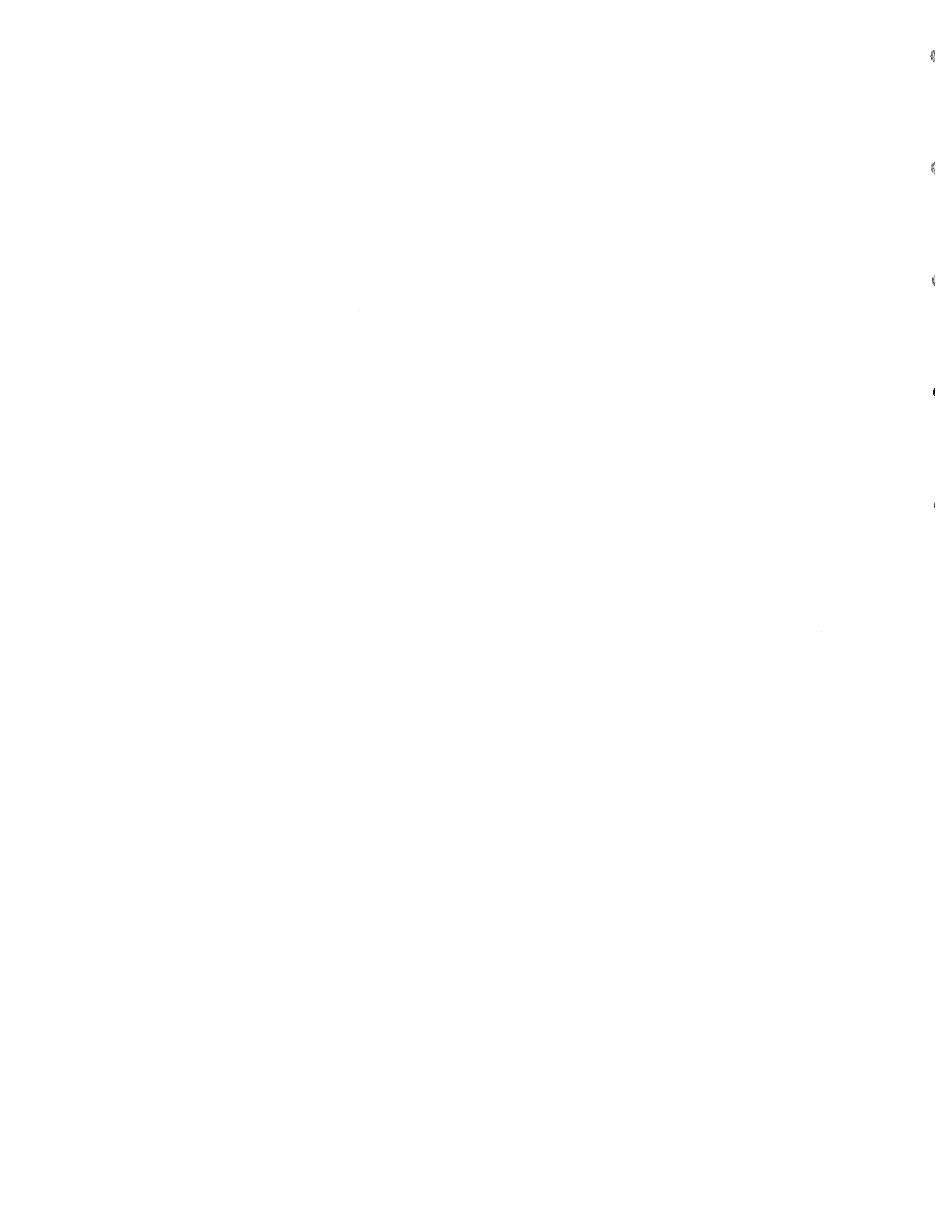
A.85-01-034, I.85-03-078 AC/vdl

CERTIFICATE OF SERVICE

I certify that I have by mail this day served a true copy of the original attached Assigned Commissioner's Ruling on Corporate Officer Testimony on all parties of record in this proceeding or their attorneys of record.

Dated June 12, 1986, at San Francisco, California.

/s/ VIRGINIA D. LAYA
Virginia D. Laya



Attachment T

12 Glen Lane
Novato, CA. 94947
(415) 898 4400

From: Dennis E. Love
President
The Extension Connection, INC.
12 Glen Ln
Novato, CA. 94947

To: Assemblywoman
Gwen Moore

Ref: Anti-competitive activities in deregulated business.

Dear Ms. Moore,

Five years ago the justice department made a decision that a monopoly telephone system was not in the best interest of the United States Government or the public. That decision was one that bore no teeth. Although legally we have a deregulated telephone system in this country, in reality, the deregulation has created an environment giving telephone utility companies a license to steal.

My name is Dennis Love and I run a small independent telephone service company in Marin County California. I started the company in March of 1985 inspired by the governments intention to create a competitive free market system through which the American dream could be realized. Unfortunately, my dream has turned into a nightmare full of both the bad aspects of a regulated industry as well as the bad aspects of a deregulated industry. I find it hard to believe that this was the true intention of the federal government when it first took its historic step in telephone deregulation.

On November 17th 1986 I filed a complaint with the California Public Utilities Commission (CPUC) charging anti-competitive practices in violation of federal antitrust law on the part of Pacific Bell and General Telephone of California. I was represented in this filing by Marty Mattis of Graham and James, a well respected law firm involved in administrative law in the San Francisco bay area. It has been two years and six months since that filing, but because of legal maneuvering on the part of the giant utilities and the conspicuous absence of a decision on the part of the CPUC, the original intent of deregulation has not yet materialized in the state of California or the United States of America, although on March 22nd the FCC

some cost allocation issues. The issues they did correct were issues that I brought up in our original filing with CPUC.

New business's like mine fight to stay afloat in a sea of anti-competitive giants and the public continues to be milked by those giants who have actually said in court that their concerns were not with what the public wanted, but rather with stockholders and profits.

Ms. Moore, by the CPUC's own rules and regulations, they are bound to pass judgement on these matters three months after final briefs have been filed. April 20th I spoke with ALJ (Administrative Law Judge) C. Ford who informed me that she had other cases and could not possibly even think about a proposed decision until July of this year. That would mean nearly three years before the CPUC made the judgement on this case.

Other issues are pending that will have lasting harmful effects and cost the rate-payers (the voting public) millions of dollars in wasted revenues. One such issue is a box that utilities, not just in California, but across the entire nation are installing on the outside wall of all new homes. This box, called an SNI (Standard Network Interface) has a modular jack in it ,compatible with all standard telephones so that anyone who is desirous of using your phone service can walk right up, plug right in and run up your phone bill. The longer this decision takes, the greater the damage and the higher the cost of modification, removal or replacement of these boxes. It is estimated this cost for California alone will be one billion one million dollars over the next ten years, to be paid for by your voters. While we wait for a decision the damage continues.

Should this pending decision go the only logical way that it should, Pacific Bell and General Telephone of California will have quite a lot of explaining to do about their real intentions. The time has come for their license to steal to be revoked and the simultaneous squashing of the small business ,trying to enter the deregulated markets, be halted. I have fought this battle without the support of elected officials and I have asked for no support until now. I realize that this is a complex issue and that most politicians will not want to take the time to come up to speed on these issues currently in administrative legislation. But in light of recent emphasis in the media concerning ethics in big business and government and the publics heightened awareness of this, I would think that a concerned and responsible legislator would not want to let something like this brew until it boiled over on his/her lap. Lets try on some preventive measures before this issue does just that.

It is true, I am concerned with doing what I can to insure the success of my company. That is the American Dream, is it not? But I am also concerned with the vast amounts of money that is unnecessarily being taken from the voting public. I am at the end of my patience. I have tried to be

reasonable for three years but have been unsuccessful in my patience. I ask that you at least take the time to inquire as to the reason this decision making process, on issues raised in my complaint, (case *8611028 and related matters, application 85-01-034, 185-030-78, OII 84 before the CPUC), is being tucked away in the bowels of the bottomless pit of the legislation.

I am asking for your assistance in this matter in whatever form it may take and would like to include you in our list of supporters during our next media campaign. We simply must speed up this process! I would be happy to speak with you in length on the subject and provide you with whatever materials you may request. Please feel free to call me at (415) 898-4400.

Thank you for your consideration of this matter.

Sincerely,

Dennis Love

EXTENSION CONNECTION, Inc.
Novato, CA. 94947
(415) 898 4400

4/24/89

«DATA CPUC MERGE»
«TITLE»
«PUC»
«NAME»
«ADDRESS»
«CITY», «ST» «ZIP»

Dear Commissioner,

I am writing this letter to inform you of a procedural problem that has caused me great grief and burdened my business of inside wire installation financially. First let me state the facts.

1. On Nov 17, 1986 I filed a complaint with this commission alleging anti-competitive conduct on the part of Pacific Bell and General Telephone of California. (case #86-11-028)

2. On March 27, 1987 my complaint was consolidated with application OII 84 and related matters. (the commissions long standing investigation of inside wire issues)

3. We participated actively in all phases of the proceeding. We filed comments on the DRA workshop report, I submitted testimony and was a witness at the evidentiary hearings. Parties filed opening briefs on Jan 27 1988.

4. We and other parties filed our reply briefs on Feb 23 1988, constituting the date of submission

5. Section 311(d) of the public utilities code allows 90 days for the ALJ to issue a proposed decision on a proceeding after the date of submission.

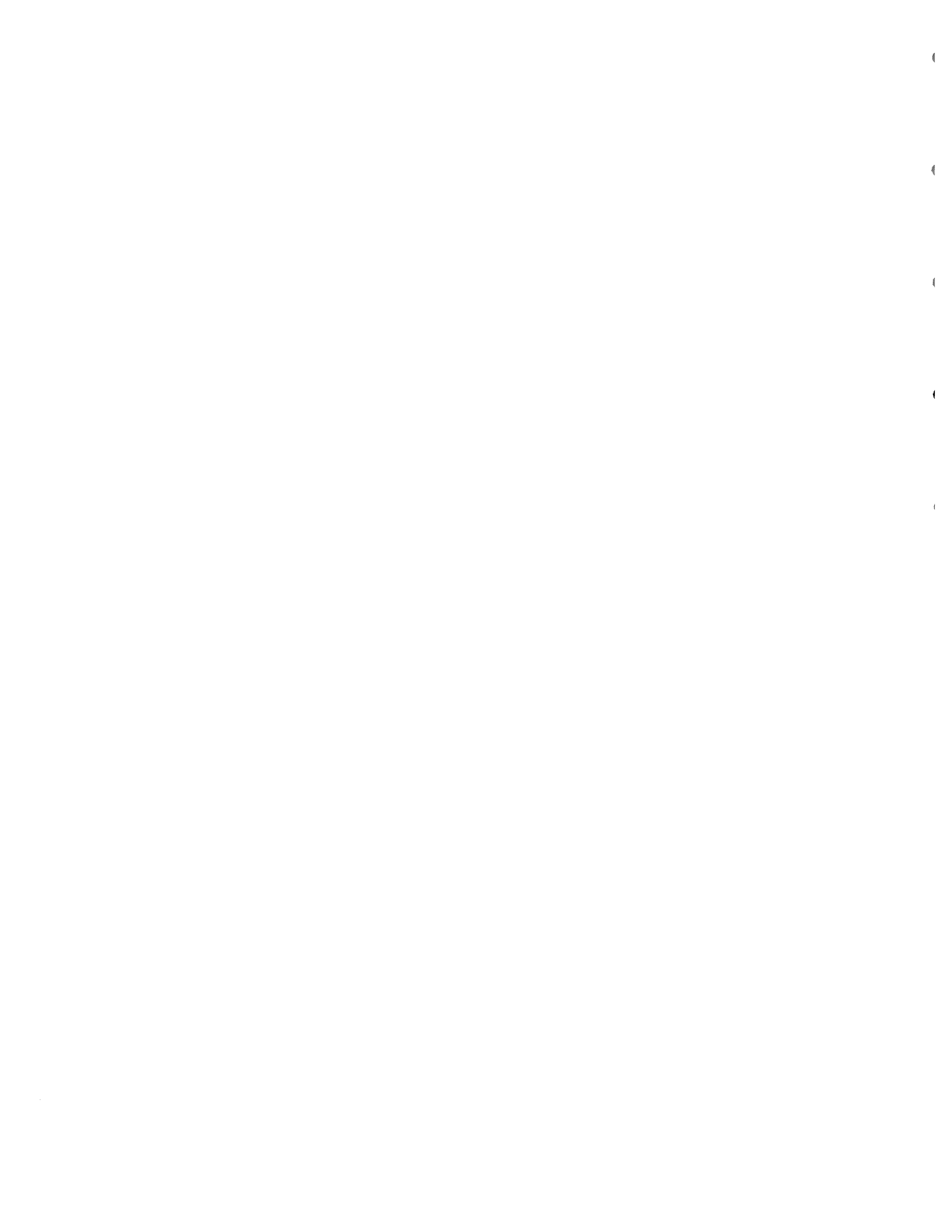
Based on these facts I respectfully request that the commission require that ALJ C. Ford or another ALJ be directed to draft, as expediently as possible, the proposed decision. It has been 426 days since the date of submission. Under any scenerio I find it hard to believe that this commission could have intentionally allowed such a delay on my case. Therefore I will assume that the commission has been unaware of the injustices I have endured over this 426 day period. I am no longer willing to sit silent while the commission "fries it's bigger fish." I understand that the

commission may feel that it has "bigger fish to fry", but that does not change my right to a decision on the matters in question.

Until this case is resolved, any decisions on other cases will be based on a foundation of quick sand, as this case will have a permanent effect on utilities regulated operations. Would it not be better to have a strong foundation in place before building your new house?

Dennis E. Love
President
The Extension Connection, Inc.

cc: All commissioners,
Ms. Bonnie Packer Pacific Bell,
Ms. Blunt Esq G.T.E.
Mr. Marty Mattes, Grahm & James
C. Ford, ALJ
Carol Matchett, DRA



ATTACHMENT U

TESTIMONY

of the

CALIFORNIA TELEPHONE ASSOCIATION

BEFORE THE

ASSEMBLY COMMITTEE ON UTILITIES AND COMMERCE

June 6, 1989

Good morning. My name is Barry Ross and I am the Executive Vice President of the California Telephone Association, a trade association representing all of the local exchange carriers in the state. Today my testimony is focused on the impact of alternative regulation of the telephone industry and specifically how such changes may affect the smaller companies.

With twenty three local exchange carriers providing service in the state, it's noteworthy that only two, the largest two, have filed proposals before the California Public Utilities Commission for alternative regulation. The remaining twenty one companies will be significantly affected by the outcome of the proposals under consideration and it is for that reason that these other companies have been following closely the proceedings of I. 87-11-033.

The small and medium sized companies within California have individually and collectively provided input into this lengthy decision process. Specifically they have sought to have the Commission consider that the impacts of the proposals to their companies have not been quantified and they believe it is important that some further study be done to show what those impacts may be. The changes in zone calling rates and the redefinition of what is basic service (ie. free touch-tone service) as proposed by Pacific Bell would have an impact on the services provided by the small and medium sized companies. Additionally, the freezing of local service rates for a period of time also has an impact that has yet to be measured. The same would be true if the Commission were to adopt all or parts of the GTE California plan.

It is interesting to note that the California High Cost Fund, a mechanism with which the Chairwoman is familiar, is the method most of the small and medium sized companies have recommended as the mechanism to adjust for revenue requirement changes brought

about by alternative regulatory procedures. The High Cost Fund is proving to be a worthy regulatory tool in the Commission's tool chest.

The scope of this hearing opens an immense number of policy questions on which I'm sure those participating will provide an equally immense number of solutions. The small and medium sized local exchange carriers, as represented by the California Telephone Association, would hope to provide three recommendations for those who may be shaping telecommunications policy. First, understand and appreciate the dynamic nature of the telecommunications industry and the background from which these dynamics come. Second, appreciate that the policy decisions made today may not be appropriate next year. And finally, be flexible enough in your processes to accommodate those who may not share the same zest for change.

The California Public Utilities Commission's investigation into alternative regulation of the telephone industry, I. 87-11-033, comes at the urging of the state's telephone industry, principally the larger segments, following three-plus years of experience in the post-divestiture environment. This relative short time frame, roughly 1984 until 1987, was time enough for industry leaders to understand that the telecommunications industry is much more dynamic than previously thought. It was time enough to grasp that technology was the driving force in the industry and that this drive is expanding in an exponential fashion. Finally, it was time enough to grasp that without some fundamental changes in our business practices, there were segments of the industry that could readily be compared to the dinosaur.

I. 87-11-033 is a start in the right direction. The investigation represents the first proposals for alternative forms of regulation submitted to telecommunications policy makers in California. Will the alternatives proposed in Phase II by Pacific Bell, GTE California or the Division of Ratepayer Advocates be the answer to our regulatory bottleneck? Probably not. But similar to the game of chess, it's important that we make a beginning move.

California, uncharacteristically, lags far behind the national transition curve in formulating and implementing alternative forms of regulation for the telephone industry. At this time more than three fourths of the states, thirty seven, have put into place or are considering significant forms of regulation or less regulation for local exchange carriers. All of these actions are a departure from the traditional forms of rate base/rate of return regulation. Of the thirteen remaining states, seven have studies of regulatory reform under way. California, because we have at least initiated I.87-11-033, is considered to be among those thirty seven, but we would be hard pressed to say we're leading the pack. In fact, we're considerably behind the more progressive states when considering implementation.

Are the proposals here in California or the myriad of national proposals of alternative regulation the final regulatory answers? The answer is a definite no. Will there be modifications and changes along the way? The answer is yes. Is it possible for California to make changes once it decides on some alternative form of regulation? The answer is yes. Contrary to what many here today may have you think, the process will not be cast in stone. The requests made by Pacific Bell, GTE and the DRA are each limited in time and come with modifiers that preserve the Commission's power to assure consumer's interests are properly weighed against the company's interests.

The small and medium sized companies find significant benefit to proceeding forward with the current investigation. We believe that an adequate record has been established that these companies are all affected by the outcome of the Commission's decision. Just as the small and medium sized companies have not filed actual proposals for alternative regulation, it would be inappropriate to apply the resolutions found in this proceeding in a broad brush manner to these companies. Additionally, the small and medium sized companies believe they should be permitted at some later time to exercise an individual option on whether to come under such alternative forms of regulation.

Depending on who you are and what you want out of this process, the Commission investigation may be either very burdensome and cumbersome or exceedingly swift and lacking in consumer and customer input. But that's the nature of a regulated vs. competitive environment. We in the industry trust that we will be able to persuade the policy makers that this process, as laborious and burdensome as it is, should and must result in a better mouse trap, a better way to address the traditional goals of regulation for the telephone industry. We believe that a very strong argument can be made that we should try.

Thank you for the opportunity to present our views on this very important issue.