Decision **ALTERNATE DRAFT DECISION OF COMMISSIONER KENNEDY**
(Mailed 10/16/2003)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Roseville Telephone Company (U 1015 C) to Review Its New Regulatory Framework.	Application 99-03-025 (Filed March 8, 1999)

DECISION GRANTING PETITION TO MODIFY DECISION 01-06-077

I. Summary

On May 3, 2002, Roseville Telephone Company (Roseville) filed a petition to modify Decision (D.) 01-06-077.[1] In D.01-06-077, we reviewed Roseville's new regulatory framework (NRF) structure, and addressed a variety of issues raised by an audit of Roseville's affiliate and non-regulated operations conducted by the Commission's Office of Ratepayer Advocates (ORA).

In the petition, Roseville asks the Commission to modify the sharing mechanism under which it operates. Roseville proposes that the Commission eliminate the 50/50 sharing requirement in the earnings band between the benchmark return of 11.50% and the ceiling rate of return of 15%. Roseville

[1] Petition for Modification of C.01-06-077 by Roseville Telephone Company (U 1015 C), May 2, 2002 (Petition).

would, however, retain a ceiling rate of 15%, and all earnings above this level would accrue to ratepayers.

By this decision, we grant the petition. Roseville has shown that retention of this sharing policy, in contravention of earlier Commission policy pronouncements, has coincided with a decrease in Roseville's investments in California's telecommunications infrastructure. Retention of the 50-50 sharing mechanism is no longer reasonable.

II. Roseville's Petition

Under Roseville's current NRF, there is no sharing below the benchmark rate of return (11.5%). There is 50% sharing between the benchmark rate of return and the ceiling rate of return (15%). Above the ceiling of 15%, Roseville returns all earnings to ratepayers.[2] Under Roseville's proposal, there would be no sharing below the ceiling rate of return, and 100% sharing above it.

Roseville argues:

> The primary problem continuation of the sharing mechanism is its serious risk of distorting operating and investment decisions, as the Commission has recognized since the inception of NRF. (See D.98-10-026, pp. 30-31.)[3]

Roseville attaches the declaration of Dr. William Taylor that asserts, from the perspective of economic market theory, that sharing adversely affects investment decisions. In addition, Roseville attaches the declaration of its President and Chief Executive Officer, which states that the continuation of

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[2] The percent sharing refers to the amount of earnings returned to ratepayers. For example, 50% sharing means that 50% of the earnings are returned to ratepayers.

[3] Petition, p. 4

sharing "places our company at a disadvantage. . ."[4] He further states that because of a continuation of sharing Roseville "may necessarily fall back from its leadership position with respect to the use and deployment of telecommunications infrastructure."[5]

In addition, Roseville represents that, due to increased competition, it has lost over 13% of its business access lines to competitors. It also says it has lost 11% of its residential customers to wireless competitors. Roseville says that its growth in access lines has declined to one percent per year rather than the six to eight percent of previous years. As a result, Roseville says that it is essential that all telecommunications providers be subject to non-discriminatory and economically correct investment incentives. Roseville represents that sharing (i) dilutes incentives to invest in new infrastructure and technology, (ii) distorts pricing decisions for regulated services, (iii) does nothing to mitigate theoretical incentives to misallocate costs and subsidize competitive services, and (iv) continues to impose regulatory costs and inefficiencies. Roseville further contends that the current sharing mechanism will discourage investment in non-regulated plant that will provide new services to customers.

In support of its argument, Roseville says that its board of directors decided not to consider funding for projects involving non-regulated wireless and video services that would have utilized Roseville's network.[6] In addition, its

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[4] Petition, Exhibit 2, p. 5.

[5] *Ibid.*

[6] Roseville is owned by SureWest Communications, a holding company.

board of directors reduced Roseville's 2002 capital budget by $10 million.[7]

However, Roseville maintains that it continues to make the investments necessary to maintain service to its customers.

III. Discussion

In its petition, Roseville utilizes some of the arguments made in its original application wherein it requested complete elimination of sharing. In addition, Roseville provides a paper by Dr. William E. Taylor that analyzed the incentives on investment that arise from regulatory sharing mechanisms. Further, Roseville provides new information attesting to an increase in competition and the actions of its board of directors to reduce its capital budget.

For some time, this Commission has had concerns that the NRF sharing mechanism would reduce infrastructure investments. In particular, D.98-10-026, in addition to providing a litany of the problems that arise from the NRF sharing mechanisms, noted that sharing distorts operating and investment decisions. A new fact provided by Roseville – the decision of its board – indicates that the Commission's prior concerns are well placed. Roseville has essentially reversed decisions to invest in an upgrade to fiber-optic facilities in the Sacramento area.

Furthermore, although sharing does not affect Category III competitive services, it does affect Category II partially competitive services. At the time of the adoption of Roseville's NRF, Roseville was interconnected with only 3 CLECs. Roseville is now interconnected with 11 CLECs and 2 wireless carriers. Roseville has lost 13% of its business access lines, and access line growth, including both residential and business, has dropped from 6-8% per year to

[7] Petition, Exhibit 2, p. 3.

approximately 1%. Since it has long been a policy of the Commission to promote fair competition, the increase in competition makes the continuation of the sharing mechanism less consistent with Commission policy of promoting fair competition.

Because of these new facts, it is appropriate to grant the petition and eliminate the 50-50 sharing band between the benchmark rate of return and the ceiling rate of return.

We note that a major factor in retaining sharing in D. 01-06-077 was the fact that Roseville had misallocated costs in a way that cross-subsidized its unregulated affiliates. The Commission determined that continuation of sharing, combined with effective auditing, could serve as an important means of preventing shareholders from benefiting from cross-subsidization.

D.01-06-077 provided no discussion of how this sharing worked to prevent shareholders from benefiting from cross-subsidization. Since it is a well known fact of economic theory that sharing creates no incentive to avoid cross-subsidization (indeed, it actually creates incentives to misallocate costs to avoid rebates), we believe that D.01-06-077 envisioned a sharing requirement as a punishment for past errors in accounting.

The question that we have today is whether to continue this punishment. As a result of D.01-06-077, we ordered adjustments to accounts and corrected all instances of cross-subsidization that we found. In addition, the continuation of sharing to this point has served as a penalty applied to Roseville. As a result, we have no reason to believe that cross-subsidization has continued. Moreover, in D.01-06-077, we noted that "the Commission may apply other sanctions, including penalties, if it finds that RTC or its affiliates are engaging in practices that violate and [sic] statutes or any rules, order, or other requirements of this

Commission." Our ability to sanction any accounting fraud continues. Thus, in light of the new information on investments and the increase in the level of competition that Roseville faces, we no longer see a need to continue the regulatory penalty of sharing embodied in the 50-50 sharing band.

IV. Modifications to D. 01-06-077

To effectuate these changes to Roseville's sharing mechanism; we must adopt specific modifications to D.01-06-077. We therefore propose:

Modify the paragraph on page 63 as follows:

> Finally, we ~~reject~~ accept RTC's claim that the sharing mechanism places the company at a competitive disadvantage. As ORA points out, the sharing mechanism does not apply to any of Roseville's Category III services and therefore can have no effect on services for which RTC lacks significant market power. The services to which the sharing mechanism applies, Category I and II services, are by definition services over which RTC has significant market power. Category II, however, consists by definition of partially competitive services. Since the price cap applies to Category II services, it places RTC at a competitive disadvantage to those firms offering these services. ~~The sharing mechanism serves as a check to prevent excessive exploitation of that market power. In short, sharing only affects services for which competition is either weak or non-existent.~~ Roseville ~~does not identify~~ has identified substantial ~~any~~ competitive harm that it has suffered as a result of the continuation of the sharing mechanism in D.01-06-077.

Delete the following sentence on page 64 as follows:

> ~~This record fully supports the retention of the sharing as a means of preventing RTC's shareholders from benefiting from similar cost-misallocations and cross-subsidization in the future.~~

Delete Finding of Fact #7 as follows:

> ~~7. The sharing mechanism serves to limit the benefits that shareholders may reap from improper cost shifting.~~

Add section VII D as follows:

> **D. Further Discussion: Petition to Eliminate 50-50 Sharing Band Granted as of January 1, 2004**
>
> On October 30, 2003, the Commission adopted D.03-10-___ that granted Roseville's petition to modify D.01-06-077. Pursuant to the discussion and analysis contained therein, the Commission eliminated the 50/50 sharing band (the band between the benchmark return of 11.50% and the ceiling rate of return of 15%). To effectuate the modification, the Commission added this section to D.01-06-077, made additional findings, and modified or eliminated other findings in light of the additional information provided in the petition.

Amend the Findings of Facts as follows:

Replace finding of Facts 10 and 11 as follows:

10. The sharing mechanism creates incentives for improper cost shifting.

11. The record shows that the sharing mechanism has had an adverse impact on RTC's new investment.

Amend Conclusions of Law as follows:

Replace Conclusion of Law 2 as follows:

2. RTC's sharing mechanism should be modified to eliminate 50-50 sharing between the benchmark rate of return and the ceiling rate of return as of January 1, 2004.

Amend the Ordering Paragraphs as follows:

> 8. RTC's sharing mechanism shall be modified to eliminate the 50-50 sharing in the band between the benchmark rate of return and the ceiling rate of return commencing January 1, 2004.

V. Comments on Draft Decision

A. Summary of Comments on Draft Decision

The draft decision of the Administrative Law Judge (ALJ) in this matter was mailed to the parties in accordance with Section 311(g)(1) of the Public Utilities Code and Rule 77.7 of the Rules of Practice and Procedure. Comments were filed by Roseville, ORA and TURN.

Roseville notes that it filed the petition on May 3, 2002, and argues that the decision should become effective with the end-of-year 2003 price cap filing. Roseville also propses specific revisions in the text, many of an editorial nature.

ORA's comments argue that adopting the alternate draft decision constitutes legal error, stating that Section 1708 of the Public Utilities Code prohibits the Commission from rescinding orders of previous decisions without notice and evidentiary hearings "in cases such as this."[8] In addition, ORA argues that the Petition to Modify violates the Commission's own rules.

TURN filed a motion of leave to intervene, citing its interest in the NRF proceedings underway for SBC and Verizon. Roseville argues that TURN's argument raises no points substantively different from those raised by ORA. ORA, however, supports TURN's motion. According to the Commission's Rules

[8] ORA, Opening Comments, p. 2.

of Practice and Procedure, “Leave [to intervene] will not be granted except on averments which are reasonably pertinent to the issues already presented, but do not unduly burden them.” We grant leave to intervene because of the relevance of TURN’s comments.

TURN argues that granting the petition would violate Section 1708. In addition, TURN states that “readily available statements by Roseville’s holding company raise serious doubts about the veracity and accuracy of the utility’s statements in support of its petition.”[9]

B. Discussion of Comments

We decline accept Roseville’s proposal to make this decision effective for calendar year 2003. Such an action would render the decision effective before its adoption.

Concerning ORA and TURN, we find no merit in their arguments pertaining to limitations on “due process” or legal error. On procedural grounds, we note that ORA never requested hearings. Although TURN admits in its filing that it has been long aware of this proceeding, it failed to take any action concerning its due process rights. Both have essentially waived any concerns regarding due process.

Besides their procedural weaknesses, we find that ORA and TURN’s objections also have no substantive merit. In the original record of this proceeding, Roseville created a record that was sufficient to permit the ALJ to write a proposed decision to suspend Roseville’s sharing mechanism. That record remains adequate to support a policy preference to maintain, eliminate or

[9] TURN, Opening Comments, p. 2.

modify sharing depending on the policy preferences of the Commission. The testimony provided in this record by Roseville simply supplements that record. We also note that neither ORA nor TURN elected to provide any testimony to rebut that of Roseville's witnesses.

Furthermore, the authority that ORA cites to support its request for a hearing notes that parties who fail to request an evidentiary hearing at the appropriate time waive any right to a hearing.[10] ORA did not request such a hearing. In addition, where a petition for modification presents predominantly legal and policy issues, as in the present case, evidentiary hearings are not mandatory.[11] There is no legal reason for additional hearings.

Concerning ORA's objection to the petition, we find that the petition does not violate Commission rules.

All other comments were considered, and the proposed decision was amended as appropriate.

[10] See *California Trucking Association v. Public Utilities Commission*, 19 Cal.3d 240, 245, fn7 (1977) ("the failure of parties to request a hearing or to seek review of the Commission's refusal to grant this right waives any error in this regard); *see also Investigation Into the Reguyation of Cellular Radiotelephone Utilities*, 56 CPUC.2d 525 (1994) (D.94-09-076) (petition for modification upheld despite lack of evidentiary hearings since party asserting § 1708 violation did not request a hearing).

[11] *See Application of Southern California Edison Company for Authority to Institute a Rate Stabilization Plan*, 2003 Cal.PUC Lexis 120, at *6-7 (2003) (D.03-02-033); *Order Instituting Rulemaking Into Competition for Local Exchange Service*, 60 CPUC.2d 611 at *32-33 (D.95-07-054).

VI. Assignment of Proceeding

Loretta M. Lynch is the Assigned Commissioner and Jeffrey P. O'Donnell is the assigned ALJ in this proceeding.

Findings of Fact

1. Since the adoption of NRF regulation for Roseville, the number of companies interconnecting with Roseville has increased to 13 companies.

2. Roseville estimates that it has lost 13% of its business lines and 11% of its residential customer lines to competitors.

3. Sharing applies to Category II partially competitive services.

4. Since Roseville is facing increased competition, sharing places it an increasing competitive disadvantage.

5. The Commission has previously identified "sharing" as a regulatory mechanism that distorts investment decisions.

6. Following the Commission's decision to continue sharing, Roseville's Board elected to decrease the level of infrastructure investments.

7. In D.01-06-077, a major factor in the Commission's decision to retain sharing was the fact Roseville had misallocated costs in a way that cross-subsidized its unregulated affiliates.

8. Sharing creates no financial incentives to ensure the proper allocation of costs.

9. D.01-06-077 ordered accounting adjustments to eliminate all of the cross-subsidization that the Commission found.

10. TURN filed a motion to intervene, which was supported by ORA and opposed by Roseville.

Conclusions of Law

1. Roseville has provided new facts that convince us to change D.01-06-077.
2. Hearings on this matter are not necessary.
3. TURN's motion to intervene should be granted.
4. Roseville's petition to modify D.01-06-077 should be granted.

O R D E R

IT IS ORDERED that:

1. The petition of Roseville Telephone Company (Roseville) to modify Decision 01-06-077 is granted to the extent discussed herein.
2. TURN's motion to intervene is granted.
3. Decision 01-06-077 is modified as follows:

   Modify the paragraph on page 63 which begins "Finally, we reject RTC's claim" to read as follows:

> Finally, we accept RTC's claim that the sharing mechanism places the company at a competitive disadvantage. As ORA points out, the sharing mechanism does not apply to any of Roseville's Category III services and therefore can have no effect on services for which RTC lacks significant market power. The services to which the sharing mechanism applies, Category I and II services, are by definition services over which RTC has significant market power. Category II, however, consists by definition of partially competitive services. Since the price cap applies to Category II services, it places RTC at a competitive disadvantage to those firms offering these services. Roseville has

identified substantial competitive harm that it has suffered as a result of the continuation of the sharing mechanism in D.01-06-077.

Delete the following sentence on page 64 as follows:

~~This record fully supports the retention of the sharing as a means of preventing RTC's shareholders from benefiting from similar cost-misallocations and cross-subsidization in the future.~~

Delete Finding of Fact #7 as follows:

~~7. The sharing mechanism serves to limit the benefits that shareholders may reap from improper cost shifting.~~

Add section VII D, as follows:

D. Further Discussion: Petition to Eliminate 50-50 Sharing Band as of January 1, 2004 Granted

On October 30, 2003, the Commission adopted D.03-10-___ that granted Roseville's petition to modify D.01-06-077. Pursuant to the discussion and analysis contained therein, the Commission eliminated the 50/50 sharing band (the band between the benchmark return of 11.50% and the ceiling rate of return of 15%). To effectuate the modification, the Commission added this section to D.01-06-077, made additional findings, and modified or eliminated other findings in light of the additional information provided in the petition.

Replace finding of Facts 10 and 11 as follows:

10. The sharing mechanism creates incentives for improper cost shifting.

11. The record shows that the sharing mechanism has had an adverse impact on RTC's new investment.

Replace Conclusion of Law 2 as follows:

2. RTC's sharing mechanism should be modified to eliminate 50-50 sharing between the benchmark rate of return and the ceiling rate of return as of January 1, 2004.

Amend the Ordering Paragraphs as follows:

8. RTC's sharing mechanism shall be modified to eliminate the 50-50 sharing in the band between the benchmark rate of return and the ceiling rate of return commencing January 1, 2004.

4. This proceeding is closed.

This order is effective today.

Dated______________, at San Francisco, California.

CERTIFICATE OF SERVICE

I certify that I have by mail this day served a true copy of the attached Alternate Proposed Decision of Commissioner Kennedy, on Application (A).99-03-025 on all parties of record in this proceeding or their attorneys of record.

Dated October 16, 2003, at San Francisco, California.

/s/REBECCA BACON
Rebecca Bacon

N O T I C E

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address to insure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

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