Decision **DRAFT DECISION OF ALJ BUSHEY** (Mailed 10/20/2004)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Bell Telephone Company dba SBC California to Modify D.94-09-065 to Enable SBC California to Reduce Prices to Meet Competition.	Application 04-03-035 (Filed March 30, 2004)

OPINION DENYING APPLICATION AND ADOPTING "TOTAL OF THE FLOORS" APPROACH

I. Summary

In 1989, the Commission began the process to open the local telephone market to competition and ordered the then-monopoly service providers ("incumbents") to sell wholesale services to their new competitors. To ensure that the incumbents did not underprice their services to retail customers and thwart nascent competition, the Commission adopted a complex set of rules ("imputation rules") that required incumbents' prices be equal to or greater than the wholesale prices charged to the competitors. In this application, Pacific Bell Telephone Company, dba SBC California (SBC), seeks Commission authorization to price retail services below their respective costs to meet a competitor's offer, and Verizon California Inc., (Verizon) supports this proposal. SBC Advice Letters 24278 and 24279, which request authorization to waive nonrecurring charges, were also consolidated into this docket. SBC and Verizon filed motions for summary judgment.

This decision grants SBC's and Verizon's motions to the extent they request approval of the "total of the floors" concept as a general principle underlying the Advice Letters, and adopts directives for our Telecommunications Division. In all other aspects, the summary judgment motions are denied.

II. Background

On March 30, 2004, Pacific Bell Telephone Company dba SBC California (SBC) filed this application seeking Commission authorization to "lower or waive any tariffed charge . . . to meet a competitor's legal price, irrespective . . . of the . . . price floor tests described in the IRD [Decision (D.) 94-09-065]." SBC stated that consumers would benefit from modifying the price floors to enable SBC to lower its prices to meet competitor offerings, and that pricing to meet competition is legal, irrespective of cost.

On April 27, 2004, the assigned Administrative Law Judge (ALJ) issued a ruling directing SBC to respond to requests for copies of the application and resetting the date for filing protests to May 17, 2004. Four protests were timely filed as follows:

The California Association of Competitive Telecommunications Companies, along with Anew Telecommunications Corporation dba Call America, AT&T Communications of California, Inc., MCI, Inc., Mpower Communications Corporation, and Telscape Communications, Inc. (CAAMT Parties) protested jointly. The CAAMT Parties contend that SBC's proposal would "scrap" the entire D.94-09-065 price floor concept by allowing SBC to price partially competitive services below cost, and thereby thwart emerging competition, contrary to the Commission's intent in adopting the concept. The

CAAMT Parties recommend that the Commission reject the application or undertake a comprehensive review of the price floor rules.

Cox California Telcom, L.L.C. and Pac-West Telecomm, Inc. (Cox/Pac-West) jointly protested. They contend that price floors are working well and, due to limited competition, remain necessary. Cox/Pac-West also disputes SBC's legal analysis supporting its request.

The Office of Ratepayer Advocates and The Utility Reform Network (ORA/TURN) protested jointly. They argue that SBC failed to demonstrate new facts that justify modifying D.94-09-065. Like the CAAMT Parties, ORA/TURN request that the Commission dismiss SBC's application.

Paetec Communications also protested. It contends that the local exchange market is insufficiently competitive to remove price floors for SBC, and that SBC's request amounts to shifting all partially competitive services, which are subject to price floors, to the fully competitive category, with no price floors.

SBC filed a reply on May 27, 2004. It argues that the antitrust laws are not intended to shield competitors from competition, and that the Commission processes for approving tariff rate changes will ensure that SBC does not abrogate price floors across the board.

On July 2, 2004, the Assigned Commissioner and ALJ convened a prehearing conference (PHC) and heard the parties' positions on the appropriate scope and procedural schedule for this proceeding. Verizon California, Inc., (Verizon) appeared as an interested party in support of the application.

At the PHC, the parties agreed that a motion for summary judgment by SBC would be an efficient initial means of addressing the issues raised by the application, with further proceedings to resolve any remaining issues. The purpose of the motion was to resolve policy and legal issues, and identify

disputed issues of material fact, if any, that would require future evidentiary hearings.

On July 13, 2004, the assigned Commissioner and ALJ issued the scoping memo for this proceeding. Among other things, the scoping memo consolidated SBC Advice Letters 24278 and 24279 into this proceeding.[1]

SBC's application and the consolidated advice letters seek the Commission's approval of two different mechanisms. The application seeks broad authority for SBC to lower or waive any tariffed charge to meet a competitor's price. The advice letters seek authority to waive installation service charges for customers returning to SBC from another facilities-based carrier.

As adopted in the scoping memo, the specific factual, legal, and policy issues to be resolved by the motion for summary judgment are as follows:

a. Is SBC's proposal to lower its price to meet a competitor's price consistent with the principles of IRD (D.94-09-065), and its progeny?
b. If the proposal is not consistent with the IRD decision, does the public interest otherwise justify the proposal?
c. If the proposal is not consistent with the IRD decision, have the underlying facts changed sufficiently to warrant deviation from the IRD principles?

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[1] In Advice Letters 24278 and 24279, SBC requested that the Commission authorize SBC to file a one-year provisional tariff allowing SBC to waive the otherwise applicable installation charge for customers returning to SBC from other facilities-based carriers. A Telecommunications Division draft resolution denying the advice letters on procedural grounds, as well as an alternate draft resolution, which also denied the request on procedural grounds but affirmed Commission policy on considering non-recurring charges, were both withdrawn, with the understanding that SBC would file an application seeking similar relief. This application ensued, and the advice letters remained pending before the Commission.

d. If the proposal is consistent with the IRD principles, should the Commission approve it as proposed or with modifications?

e. Is the Telecommunications Division Staff's approach of evaluating proposed changes to a rate by considering the total of all price floors for the included (bundled) services over the expected duration of the services ("total of the floors"), consistent with the IRD decision?

f. Should the Commission adopt the "total of the floors" approach to evaluating tariff proposals? If so, should non-recurring charges be included? If non-recurring charges are included, how should the Commission set floors for non-recurring charges?

SBC and Verizon filed motions for summary judgment on August 2, 2004. Both motions argued that, as a matter law, the issues set out above should be resolved in favor of granting SBC's request for the authority to lower its prices to meet competitor's offerings and approving the advice letters to allow SBC to waive nonrecurring charges for returning customers.

On September 17, 2004, Paetec Communications, CALTEL,[2] Cox/Pac-West, AT&T Parties,[3] ORA and TURN filed responses in opposition to SBC's and Verizon's motions. All opposing parties asked the Commission to deny SBC's request for authority to lower its prices to meet competition. Paetec and Cox/Pac-West support approval of the total of the floors approach, with some caveats. TURN did not address the issue. ORA and the AT&T Parties pointed

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[2] This response includes only the California Association of Competitive Telephone Companies.

[3] AT&T Communications of California, Inc., MCI, Inc., and Anew Telecommunications

out technical and implementation issues with the advice letters, and CALTEL opposed approving the total of the floors approach.

SBC and Verizon filed reply comments on October 1, 2004. SBC stated that it was only seeking limited downward pricing flexibility, which was consistent with IRD decision and that it would be unable to recoup any losses caused by its alleged predatory pricing. Verizon added detail to SBC's anti-trust analysis and contended that broad anti-trust principles supported competition generally, and that interpreting the exact terms of the meeting competition doctrine was unnecessary. Both SBC and Verizon supported the total of floors approach and Verizon recommended using the tariffed nonrecurring charge as the price floor.

III. Discussion

In ruling on this motion for summary judgment, our analysis will follow the issues set out in the scoping memo. We conclude, as discussed below, that SBC's proposal to lower or waive any tariffed charge to meet a competitor's price irrespective of cost is inconsistent with the fundamental principles of the IRD decision, and should be denied. We determine, however, that the concept reflected in the Advice Letters, to recover the total of all nonrecurring charges and recurring rates over the life of a particular bundle of services, is consistent with the IRD decision and is a reasonable extension of past informal practices. We, therefore, grant the motion for summary judgment with respect to the concept underlying Advice Letters, and adopt implementation directives for our Telecommunications Division. Included is a directive to use the recently adopted UNE prices for determining the cost floor for basic service. (See D.04-09-063.

Set out below is our analysis of all issues, "a" through "f," as adopted in the July 13, 2004, scoping memo.

A. Is SBC's proposal to lower its price to meet a competitor's price consistent with the principles of IRD (D.94-09-065), and its progeny?

1. Positions of the Parties

SBC contends that its request for authority to lower or waive any tariffed charge to meet a competitor's price, irrespective of the price floor tests set out in the IRD decision, is consistent with the "principles that the Commission established as a framework for the IRD decision." SBC points to these principles as the "touchstone" for the relief it requests. SBC also argues that the Open Access and Network Architecture Development (OANAD) Decision, D.99-11-050, and the Telecommunications Act of 1996 set the prices for network elements necessary for competitors to provide service and ensured access, which make the imputation or rate floors unnecessary. SBC states that in the IRD decision the Commission recognized that SBC must be able to "react quickly to market conditions" and charge prices set by the market, not by regulation. Verizon echoes SBC's position that the IRD decision allows incumbent local exchange carriers to fairly meet competitor's offerings. Verizon and SBC both turn to anti-trust law for support of the proposition that robust competition benefits consumers, and that meeting a competitor's price does not harm competition. Verizon argues that the IRD price floors, which apply only to SBC and Verizon, artificially insulate competitive local carriers from price competition from SBC and Verizon. Verizon concludes that SBC's proposal to allow it to meet competitors' prices will benefit consumers.

The AT&T Parties contend that SBC's proposal will allow it to "remonopolize" the market by driving competitors out of business. These parties state that the plain intent of the imputation or price floor rules is to

prevent anti-competitive price squeezes. These parties state that because SBC and Verizon remain dominant carriers, if they are allowed to price below cost to meet each competitor's offering, they "will soon drive their competition out of business." They also point to California's Unfair Business Practices Act, California Business and Professions Code § 17200, as prohibiting the sale of goods or products at less than cost, for the purpose of injuring competition.

ORA explains that the original intent of the price floor regime was to protect against dominant providers, like SBC and Verizon, pricing their services below cost and driving nascent competitors out of the market. TURN contends that SBC's and Verizon's ability to meet a competitor's price is not due to superior efficiency but rather due to the ability to sustain losses. CALTEL explains that in the IRD decision, the Commission was attempting to jumpstart competition in the intraLATA market by requiring SBC to price its services at no less than cost.

2. Discussion

In 1989, this Commission adopted a New Regulatory Framework (NRF), which allowed incumbent local exchange carriers, such as SBC and Verizon (then known as Pacific Bell and GTEC, respectively), flexibility in pricing competitive services but also required that these carriers provide unbundled monopoly service building blocks to competitors. Re Alternative Regulatory Frameworks for Local Exchange Carriers, (1989) 33 CPUC 2d 43 (D.89-10-033). The terms and prices at which competitors would access the networks continue to occupy this Commission, Congress, and the Federal Communications Commission to this day.

One of the fundamental concepts first stated in the NRF decision, and subsequently carried through in the IRD and OANAD decisions, is that

incumbents must impute the prices charged to competitors into their own tariff rates.[4] That is, the incumbents must "pay" the same price that the competitors pay for the wholesale or "monopoly building block" services. Where the cost to the incumbent is less than the wholesale price paid by competitors, the incumbent's retail prices could be less and "squeeze" the competitor's profit margin lower and lower:

> [I]n order to prevent anticompetitive price squeezes, the local exchange carriers should be required to impute the tariffed rate of any function deemed to be a monopoly building block in the rates for any bundled tariffed service which includes that monopoly function. . . . The bundled rate must be at or above the sum of the tariffed rates for the bottleneck building blocks and the costs of nonbottleneck components, even if there are floors for a flexibly priced service lower than the tariffed rates.
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> The imputation requirement is adopted to ensure that competitors are not unfairly disadvantaged by anticompetitive price squeezes. Re Alternative Regulatory Frameworks for Local Exchange Carriers, (1989) 33 CPUC 2d 43, 121 (D.89-10-033) ("NRF Decision").

In Re Alternative Regulatory Frameworks for Local Exchange Carriers, (1994) 56 CPUC 2d 117, 228 (D.94-09-065) ("IRD Decision"), the Commission refined the concept of limiting the downward pricing ability of the incumbent

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[4] The decision created three categories of services based on the level of competition. Category I services are monopoly services with no competition, and prices can only be changed upon authorization of this Commission. Category II services are have limited competition, and limited downward pricing flexibility is allowed. Category III services are fully competitive and have full pricing flexibility. The imputation and price floor mechanisms discussed in today's decision apply only to Category II services.

local exchange carriers by adopting three tests. The Commission recalled the purpose of the imputation requirement, noted that accurate rate element cost studies were not available, and adopted three tests to determine whether the proposed price equals or exceeds the price floor.

The Commission first summarized the rationale behind the imputation rules:

> If the [incumbent local exchange carrier's] cost of providing a particular monopoly building block is lower than the tariff rate that competitors must pay for the identical service, the [incumbent local exchange carrier] could easily beat the competitors' prices for products using the service, and competition would be nipped in the bud. To ensure that competitors were not subject to this type of anticompetitive price squeeze, we imposed a general requirement that the [incumbent local exchange carriers] should impute the tariffed rate of any monopoly building block function to the rate, rather than the cost, of monopoly building blocks included in its own competitive offerings. (IRD Decision, 56 CPUC 2d at 228.)

The Commission then went on to discuss the two means by which the imputation requirement achieves its primary purpose of "serv[ing] as a safeguard against potential anticompetitive abuses by the incumbent local exchange carriers." First, it requires that the tariff price at least recover the incumbent local exchange carrier's costs, such that monopoly customers are not subsidizing competitive offerings. Second, it promotes fair competition by preventing the incumbent local exchange carrier from under pricing its competitive offerings to the detriment of competitors. (*Id.*)

To further refine and provide practical implementation of these objectives, the Commission went on in the IRD Decision to adopt three tests to ensure that a proposed price equals or exceeds the appropriate price floor.

The first rule is a refinement of the general imputation rule and requires each Category II service that includes monopoly building blocks to be priced equal to or greater than the sum of the tariffed rates of the monopoly building blocks and the long run incremental cost of the competitive rate elements. In the alternative, the tariffed rates of the monopoly building blocks can be replaced by "contribution," which is the difference between the tariffed price of the monopoly building blocks and their long run incremental cost.

Algebraic manipulation of the formula results in a restatement of the general rule that combines the long run incremental costs of both the monopoly building blocks and the competitive rate elements, which is convenient due to the lack of disaggregated cost studies. (*Id.*) The restated formula also includes "contribution," which is important for the third test, discussed below.

The second test recognizes that the monopoly building blocks purchased by the competitive provider may be different from the actual monopoly services used by the incumbent local exchange carrier to provide the service. The second test requires that the imputation formula be based on the type of monopoly building blocks that a competitor would use in the competitive service.

> The reason for requiring imputation of the tariff rate for the monopoly building block component is to put all competitors, including the [incumbent local exchange carrier], on the same basis. All competing parties will set prices based on the same cost (or imputed cost), the tariff rate, for this component. *(Id.* at 234.)

The third test follows through with the basic concept of the imputation - the price floor must be equal to or greater than cost – and applies it to the restated general rule. The third test requires that the "contribution" component of the formula be a positive number. This means that the tariff rate for a

monopoly building block must be equal to or greater than the long run incremental cost of the service.

To summarize, when the Commission authorized competition, it separated telephone services into three categories based on the level of competition. In Category II, both monopoly and competitive elements are present, and the competitors must purchase the monopoly elements from the incumbent. To put all competitors on the same cost basis, the Commission required that the incumbents use the same price charged to competitors in pricing their own tariffed offerings. The Commission adopted a complex set of pricing rules to ensure that the cost used to set the incumbent's rate was never less than the tariffed rate paid by the competitors. The Commission found that these "price floors" were necessary to protect competition, which would otherwise be "nipped in the bud."

In the context of this now decade-old concept, SBC proposes to add what amounts to an exception to this rule.[5] SBC requests authorization to lower its tariff rate for a Category II service "to meet a competitor's legal price, irrespective . . . of the price floor tests described in the IRD." SBC argues that since adopting IRD, the Commission's OANAD decision and the Telecommunications Act of 1996 have set the prices that competitors pay for monopoly building blocks,[6] such that the incumbents can no longer artificially inflate the prices to competitors to subsidize the incumbent's own competitive offerings. Verizon supports SBC's request and contends that because the

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[5] SBC characterizes it as a "fourth test."

[6] Now called UNEs, for Unbundled Network Elements.

incumbents will be limited to meeting competition, but not initiating it, the competitors would be protected from anticompetitive conduct. Both Verizon and SBC conclude that the proposed change will benefit consumers through lower prices and is also consistent with IRD decision.

We disagree.

As set out in some detail above, the Commission has spent over a decade devising complex formulae to put both the incumbents and the competitors on the same cost basis for Category II services. SBC's motion offers little in support of its proposed exception to this long-standing rule. The clearly articulated purpose of the rule is to protect "nascent" competition by requiring the incumbents to use the same cost basis as competitors. SBC proposes to disregard the cost basis, and price below cost to meet competition. Such a proposal is fundamentally at odds with the cost-based price floor principles of the IRD decision. Consequently, we conclude that SBC's proposal is inconsistent with the IRD decision.

B. If the proposal is not consistent with the IRD decision, does the public interest otherwise justify the proposal?

1. Positions of the Parties

SBC states that the public interest favors its proposal because California consumers will benefit from more competitive choices and lower prices. Verizon agrees.

ORA argues that allowing SBC to price below cost to meet competitors' offerings will have a deleterious effect on competition and ultimately on consumer choice. ORA notes that incumbent local exchange carriers, such as SBC, have the resources necessary to sustain long-term losses in one market

while profits are earned in another. Such conditions provide the opportunity to drive out competitors in target markets. ORA concludes that the public interest would not be furthered by SBC's proposal.

CALTEL echoes ORA's claim that below-cost pricing by SBC will harm competition and is contrary to the interests of California consumers. CALTEL argues that competitors can offer lower priced services to customers in some arenas, but if SBC is allowed to price below cost, it will drive those competitors from the marketplace.

The AT&T Parties also agree that the SBC proposal is not in the public interest, and these parties undertake a thorough analysis of the antitrust law to support their conclusion. They begin by noting that SBC's reliance on the "meeting competition" tenet from antitrust law is inapplicable because "meeting competition" is a defense to a charge of price discrimination between two similarly situated customers, which is not alleged here. The AT&T Parties then turn to Section 2 of the Sherman Act, which prohibits both predatory pricing and price squeezes.[7] The AT&T Parties argue that the "meeting competition" defense, to the extent it is available to SBC at all, [8] would not apply to allegations

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[7] Predatory pricing is where a firm offers goods or services at rates below its costs, with the intention of recouping the short-term losses after it has eliminated the competitors. Price squeeze is where a firm prices an input over which it has market power at such a high level that its competitors cannot profitably compete.

[8] The AT&T Parties quote from a noted antitrust treatise that argues that the "meeting competition" defense to price discrimination should not be available to a dominant firm matching a new entrant's price until the new entrant has a substantial presence in the market. See AT&T Parties' Comments at page 19, citing 3 Areenda & Hovenkamp, Antitrust Law, para. 748b at p. 508 (2d ed. 2002). No party disputes that SBC and Verizon are dominant firms.

of predatory pricing and price squeezes. The AT&T Parties also point to California Business and Professions Code, § 17200, which prohibits selling articles or products at less than cost, with the intent to harm competition.

Cox/Pac-West agrees that the relief sought by SBC in its application is contrary to the public interest because it would substantially diminish rules necessary to protect against incumbent anticompetitive behavior. Cox/Pac-West states that purpose of the Category II price floors was to ensure the incumbent prices would not go below actual or imputed costs, and that a UNE-based competitor could not remain in the market where the dominant carrier and sole source for monopoly elements engages in a classic price squeeze.

TURN also contends that consumers will suffer as competition is diminished. TURN points out that due to the limited areas in the state with active competition, most Californians would end up paying higher rates to subsidize the below-cost prices, rather than enjoying the lower prices.

2. Discussion

SBC and Verizon have focused on the benefits to consumers of lower prices, should we authorize pricing Category II services without regard to imputed cost to meet a competitor's offer. The Commission, however, has already balanced higher short-term prices with the benefits of creating a competitive market, and determined that the benefits of a competitive market outweigh the short-term economic considerations:

> We acknowledge that this rule may require the LEC to price a bundled service higher than it would in a truly competitive market. If the LEC's costs for the monopoly building block it actually uses are below the tariff rate of the monopoly building block most appropriately used by a competitor in providing its competing service, for example, the LEC in a fully competitive

> world would maximize its profits by pricing its service just below the lowest cost-based price offered by a competitor. The LEC's ability to outprice the competition because of its lower costs would allow it to capture a large share of the market, and this would be an economically efficient result. At this stage of the development of the competitive market for telecommunications services, however, this approach would also have a high probability of killing off the competition. We therefore choose to promote competition at the temporary expense of theoretically pure economic efficiency. We made the same choice in the Phase II decision when we required the LECs, though application of the imputation formula, to price the monopoly building block monopoly building block in bundled services at the tariff rate. Both the decision to impute the tariff rate of monopoly building block and today's decision to focus on the monopoly service used by the competitor reflect our choice to overlook for the moment the LECs' potential cost advantages for the sake of allowing an opportunity for nascent competition in these areas to mature. (IRD Decision at footnote 51.)

Thus, we have previously considered and rejected the short-term economic considerations that form the basis for SBC's and Verizon's contention that SBC's proposal furthers the public interest. AT&T's analysis of the antitrust laws and California Business and Professions Code also raises serious legal questions about SBC's proposed pricing policy. Therefore, we conclude that the public interest does not otherwise justify SBC's proposal.

C. If the proposal is not consistent with the IRD decision, have the underlying facts changed sufficiently to warrant deviation from the IRD principles?

1. Positions of the Parties

The cornerstone of the Commission's long history with Category II services is the implicit recognition that the incumbents have the market share

and financial wherewithal to sustain below cost pricing in order to "nip competition in the bud." SBC stipulated, for purposes of this proceeding, that it remains a dominant firm.

SBC, however, contends that the regulatory environment and the marketplace have changed significantly since the IRD decision was issued in 1994. SBC claims that the OANAD decision and the Telecommunications Act of 1996 have rendered "rigid enforcement" of the IRD decision no longer necessary, and that technological advancement has brought more competitive options to consumers. SBC seeks a level playing field to compete with these new options. Verizon notes that inter-modal competition, including wireless, cable, and internet-based providers, was not contemplated at the time the IRD decision was issued.

Cox/Pac-West counters that if the market for Category II services is fully competitive, then the incumbents should apply to re-categorize these services, rather than use the indirect route contemplated by this application. The AT&T Parties point out that SBC and Verizon serve over 90% of the residential and small business customers in their service territories, and Paetec agrees that Verizon and SBC are dominant firms. ORA states that robust competition sought by the IRD decision has yet to arrive.

2. Discussion

As our earlier extensive discussion of the NRF and IRD decision shows, the fundamental fact forming the Commission's rationale for the imputation rules was SBC's and Verizon's domination of the telecommunications market, and their ability to "nip competition in the bud." The Telecommunications Act of 1996 did not change this, nor did the OANAD decision. At this time, the availability of other modes of telecommunications service has not substantially

changed this fact.[9] Consequently, we conclude that the underlying facts have not changed sufficiently to warrant deviation from the IRD principles.

D. If the proposal is consistent with the IRD principles, should the Commission approve it as proposed or with modifications?

As set out above, the proposal is fundamentally inconsistent with the IRD principles. No party has put forth a modification that would cure this deficiency. Therefore, we conclude that we should not approve it as proposed or with modifications.

E. Is the Telecommunications Division Staff's approach of evaluating proposed changes to a rate by considering the total of all price floors for the included (bundled) services over the expected duration of the services ("total of the floors"), consistent with the IRD decision?

F. Should the Commission adopt the "total of the floors" approach to evaluating tariff proposals? If so, should non-recurring charges be included? If non-recurring charges are included, how should the Commission set floors for non-recurring charges?

We will address these closely-related questions together.

1. Positions of the Parties

SBC contends that the proposed total of the floors test is consistent with the IRD decision, as interpreted and implemented by Telecommunications

[9] We also note that SBC and Verizon have a substantial presence in the market for other modes of telecommunications services as well. For example, SBC's Cingular affiliate and Verizon's wireless affiliate serve a significant share of the wireless market.

Division on an informal basis using the advice letter process. SBC explains that while nonrecurring charges do not have explicit cost floors, in SBC's previously approved advice letter filings, where the nonrecurring charge was below cost, the uncharged portion was recovered over the location life of the service through the recurring rate. SBC concludes that this process ensures total cost recovery, and is consistent with the IRD decision.

Verizon provides a detailed analysis of the Commission's past practice with regard to waiving or discounting nonrecurring charges over a limited promotional period. Verizon points to 1991, 1994, and 1995 Commission resolutions, and a 2004 Advice Letter that required Verizon to demonstrate that the revenue generated was sufficient to cover the cost of the promotion, including waiving the nonrecurring charge. Verizon recommends against adopting stand-alone price floors for nonrecurring charges, but supports treating nonrecurring charges as cost components to be recovered by the total revenue generated by the promotion.

Cox/Pac-West states that a properly calculated total of the floors test is consistent with the IRD decision, and is an appropriate mechanism for the Commission to use to review permanent or promotional rates for individual services or bundles of services to ensure that incumbent prices do not fall below the total cost of the service. Cox also states that supporting cost studies for nonrecurring charges have already been completed for SBC, and soon will be for Verizon. Cox, however, opposed using the total of floors approach until the Category II price floors have been updated to reflect the same costing methodology used in setting UNE rates.

ORA also contends that the total of the floors approach is consistent with the IRD decision, and that nonrecurring charges should be included. ORA stated

that setting a price floor for a nonrecurring charge was not necessarily controversial, especially if the incumbent provided reasonable, verifiable cost support. ORA points out, however, that SBC's advice letters show an annual loss of $22,112,000, with no specific analysis of how these costs would be recovered. ORA recommends that prior to approving the advice letters, the Commission should require SBC to demonstrate how these costs would be recovered.

CALTEL opposes using the total of the floors test as just another means of allowing SBC to price below cost. CALTEL argues that SBC's objective with both the application and Advice Letters is to drive out competition, and it is that objective, not long-term cost recovery, the makes the SBC proposal improper.

The AT&T Parties also oppose the total of the floors test because it fails to protect nascent competition, and it is administratively unworkable due to the needed cost studies and "life of the service" determinations.

2. Discussion

As set out in more detail below, we find that the total of the floors approach is consistent with the IRD decision, and is a reasonable policy to implement. To provide guidance to our Telecommunications Division, and to the parties, we will adopt specific requirements for future advice letter filings as set out in Attachment A. Because the total of the floors approach ensures that services (bundled or otherwise) recover costs, we adopt the total of the floors approach as a general policy.

a. Consistency with the IRD Decision

Most parties agree that the total of the floors approach is consistent with the IRD decision. Those parties that find it inconsistent with the IRD decision argue that it fails to sufficiently protect competition.

As discussed at length above, the cornerstone of the IRD decision's imputation rules is the requirement that an incumbent price its services equal to or greater than its costs. Historically, the Telecommunications Division, on an informal basis using the advice letter process, allowed both the nonrecurring charge and recurring rate for a particular service to be considered together for cost recovery purposes for promotional and new service offerings (the "burden" test). We find that this is a reasonable and normal business analysis approach to cost recovery, which is consistent with the IRD decision.

The parties who oppose the total of the floors approach contend that it fails to sufficiently protect competition. The AT&T Parties state that the "problem with this approach is that SBC can drive its competition out of business before it recovers the total cost of the service." The IRD decision's imputation rules, however, do not extend blanket protection from SBC and Verizon competition. Rather, the purpose of these rules is to ensure that the incumbents are not pricing below cost to "nip competition in the bud." The total of the floors approach meets the IRD decision's requirement that the incumbent price its Category II offerings equal to or greater than its costs.

b. Price Floors for Nonrecurring Charges

Having concluded that the total of the floors approach is consistent with the IRD decision, we next turn to the issue of the appropriate floor rate for nonrecurring charges. The Commission has not previously established price floors for nonrecurring charges for basic exchange services and no party has offered a source of well-supported cost data to conveniently do so.

We note, however, that implicit in all the resolutions cited by Verizon and SBC is the assumption that the cost basis or "price floor" for the nonrecurring charge <u>is</u> the nonrecurring charge itself. No party cited to any resolution or

advice letter that used some other cost basis. However, we note that in the IRD decision, costs associated with the installation of basic services were specifically discussed in setting basic exchange services installation charges. (IRD Decision, 56 CPUC 2d at 161.)

We, therefore, conclude that using the nonrecurring charge itself is a reasonable cost proxy for the purposes of analyzing compliance with the IRD imputation rules. We recognize, however, that detailed cost studies could also provide a reasonable basis for the required analysis, as could the approved costs from other jurisdictions. Attachment A includes the specific information that must be included in an advice letter seeking authorization to waive a nonrecurring charge or otherwise rely on the total of the floors approach to demonstrate compliance with the imputation tests.

c. Bundles of Services

To meet the requirements of the total of the floors test the incumbent must demonstrate, with well-supported cost studies, that all nonrecurring charges and recurring rates will recover all costs over the location life. As ORA points out, SBC showed a loss of $22,112,000 caused by waiving the nonrecurring charges in Advice Letters 23880 and 23879. ORA states that SBC presents no plan for recovering these losses.

One option for SBC might be to offer customers a bundle of services when waiving or discounting the nonrecurring charge. Normal and reasonable business practices would look to all services sold to the customer to recover total costs. If the bundle, taken as a whole, would recover costs over the location life, it is consistent with the IRD principles.

When the Commission adopted the imputation rules in 1989, incumbents did not and, under certain circumstances, could not, bundle different service

elements. Now, however, such bundling is common practice. Our regulations should evolve to reflect current market conditions and not remain stagnant. Therefore, we will allow incumbents to include multiple services in an offering that provides for waiving any nonrecurring charge so long as the revenue from all the services over the expected location life is equal to or exceeds the total of the recurring and nonrecurring price floors for each service. Attachment A sets out the specific information required in the advice letter.

d. Updated Cost Studies

Cox/Pac-West and other parties contend that the cost basis for the imputation floor rates should be comprehensively reviewed and revised. Such a request exceeds the scope of this proceeding. However, the Commission has recently completed an extensive review and updating process for several UNEs. In D.04-09-063, the Commission adopted updated and final rates for the following UNEs: loops (including deaveraged rates for 2-wire, DS-1 and DS-3 loops), switching, dedicated transport, signaling system 7 (SS7) links, and the DS-3 entrance facility without equipment. To the extent an incumbent offers Category II services that use these UNEs, these updated rates should be used in the demonstration of cost recovery using the imputation rules.

e. Provisional Rates

SBC's advice letters sought approval for "provisional" rates. The Commission's tariff rules, however, generally recognize only permanent rates and promotional rates, which have a limited duration. Any advice letter seeking approval pursuant to this decision should select between permanent or promotional.

f. Other Incumbent Local Exchange Carriers

This decision only applies to NRF-regulated incumbent local exchange carriers with: (a) approved wholesale rates for basic exchange service or, (b) wholesale rates for basic exchange service filed with the Commission, pending approval. All such carriers seeking authorization pursuant to this decision may file advice letters consistent with the requirements set out in Attachment A.

IV. Conclusion

As stated in the scoping memo, SBC's application raises legal and policy issues. No party has identified a disputed issue of material fact necessary to resolve these issues. We, therefore, find that SBC's application is not consistent with the IRD decision, and is not otherwise justified as being in the public interest. SBC's application should be denied. Although we adopt the total of the floors concept from SBC's Advice Letters, we will also reject the Advice Letters, without prejudice to refiling consistent with the requirements found in Attachment A.

V. Categorization and Need for Hearing

In Resolution ALJ 176- 3132 dated April 22, 2004, the Commission preliminarily categorized this application as ratesetting, and preliminarily determined that hearings were necessary. No party challenged the categorization, and we see no reason to alter it.

The parties have presented no disputed issues of material fact that must be resolved for today's decision, and we conclude that hearings are not necessary. Accordingly, as provided in Rule 6.6 of the Commission's Rules of Practice and Procedure, Article 2.5 of those Rules ceases to apply to this proceeding. However, the *ex parte* communication rule found in Rule 7(c) shall continue to apply.

VI. Comments on Draft Decision

The draft decision of the ALJ in this matter was mailed to the parties in accordance with Public Utilities Code Section 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure.

VII. Assignment of Proceeding

Geoffrey F. Brown is the Assigned Commissioner and Maribeth A. Bushey is the assigned ALJ in this proceeding.

Findings of Fact

1. SBC Advice Letters 24278 and 24279 have been consolidated with this proceeding.
2. The scoping memo adopted a summary judgment process and set out the specific factual, legal, and policy issues to be resolved.
3. The proposal in SBC's application is, in substance, a proposed exception to the cost recovery requirement embodied in the imputation rule.
4. Neither SBC nor Verizon dispute that their share of the residential and small business telephone market and financial resources, as compared to their competitors, have not materially changed since this Commission adopted the NRF and IRD decisions.
5. No party has proposed a modification to SBC's proposal that would make it consistent with the IRD principles.
6. Considering nonrecurring charges and recurring rates, as well as other services, is a reasonable and normal business approach to analyzing cost recovery.
7. No hearing is necessary.

Conclusions of Law

1. In D.89-10-033, the Commission adopted the NRF, which allowed incumbent local exchange carriers pricing flexibility but required those carriers to provide unbundled monopoly service building blocks to competitors.

2. A fundamental concept first stated in the NRF decision, and subsequently carried through in the IRD and OANAD decisions, is that incumbents must impute the prices charged to competitors into their tariff rates, i.e., the incumbents must "pay" the same rate that the competitors pay for the wholesale or "monopoly building block" services. This concept is called "imputation."

3. The imputation requirement's primary purpose is to safeguard against two types of potential anticompetitive abuses by the incumbent local exchange carriers: (1) by requiring that the tariff price at least recover the incumbent local exchange carrier's costs, such that monopoly customers are not subsidizing competitive offerings, and (2) by promoting fair competition by preventing an incumbent local exchange carrier from under pricing its competitive offerings to the detriment of competitors.

4. The imputation rule comprises three complex tests that each Category II offering must pass.

5. The proposal in SBC's application is fundamentally at odds with the cost-based price floor principles of the IRD decision.

6. The Commission has determined that the benefits of creating a competitive market outweigh short-term economic interests.

7. SBC's and Verizon's domination of the residential and small business telephone market has not materially changed since the Commission adopted the IRD principles.

8. Considering nonrecurring charges and recurring rates, as well as other services, is a reasonable and normal business approach to analyzing cost recovery, and thus is consistent with IRD principles.

9. The total of the floors approach meets the IRD decision's requirement that the incumbent price its Category II offerings equal to or greater than its costs.

10. Because the total of the floors approach ensures that services (bundled or otherwise) recover costs, we adopt the total of the floors approach as a general policy.

11. The tariff nonrecurring charge is a reasonable proxy for a cost-based price floor for IRD imputation purposes. Detailed cost studies or adopted amounts from other jurisdictions are also acceptable.

12. In D.04-09-063, the Commission adopted updated and final rates for the following UNEs: loops (including deaveraged rates for 2-wire, DS-1 and DS-3 loops), switching, dedicated transport, signaling system 7 (SS7) links, and the DS-3 entrance facility without equipment.

13. To the extent an incumbent offers Category II services that use the UNEs with rates updated by D.04-09-063, the updated rates should be used in the demonstration of cost recovery using the imputation rules.

14. The issues raised by this application are suitable for resolution by summary judgment.

15. SBC's application should be denied.

16. SBC's Advice Letters should be rejected without prejudice to refiling consistent with this decision.

17. To enable customers to quickly benefit from today's decision, this decision should be effective immediately.

O R D E R

IT IS ORDERED that:

1. Pacific Bell Telephone Company dba SBC California (SBC) Application 04-03-035 is denied.
2. SBC's Advice Letters 24278 and 24279 are rejected without prejudice to refiling consistent with today's decision.
3. The "total of the floors" approach discussed above and set out in more detail in Attachment A is adopted.
4. No hearing is necessary.
5. This proceeding is closed.

This order is effective today.

Dated _____, at San Francisco, California.

ATTACHMENT A

Total of the Floors Test for Compliance with Imputation Rules

A service offering by NRF-regulated incumbent carrier will comply with the IRD decision imputation rules where the Telecommunications Division finds that the offering is consistent with the following equation:

General Rule: Σ Floors $\leq \Sigma$ Revenue

Expanded Form:

Σ (Nonrecurring Charge Floors + Recurring Rate Floors) $\leq$ Location life x Σ Revenue

Definitions:

Nonrecurring Charge Floors are the tariffed nonrecurring charge for each included service, unless calculated otherwise, as set out below.

Monthly Recurring Rate Floors are the price floors for each recurring rate as established by Commission. For residential basic and business service, the UNE-P rate shall be used.

Location Life is the average duration of customer subscription to this or similar offerings, as demonstrated with detailed analysis of best available, relevant, actual customer subscription data. Expressed in months. In the event a bundle or service is offered on a term basis, the term shall be used.

Revenue is the total monthly amount (in dollars) paid by each customer for the service(s).

Alternative Showings for Non-Recurring Charge Price Floors:

There are three ways in which a Non-Recurring Charge Price Floor may be established. All options are subject to Commission approval:

- Use the current tariffed nonrecurring charge as a proxy (this is the default method).

- Use an average of nonrecurring charges for that service, in all other states in which the carrier provides service, that were filed, and adopted, based upon cost data. The supporting cost data must be made available to this Commission as part of the filing.
- Provide cost data to the Commission to support a different price floor.

Data Provision and Reporting Obligations

Any NRF-regulated incumbent carrier that seeks authorization to meet the Commission's imputation rules by relying on the total of the floors shall provide all necessary data and analysis in support to the request in a timely and complete manner. Any deficiencies shall be corrected promptly. Failure to do so may result in rejection of the proposed tariff.

Any carrier authorized to use the total of the floors approach shall provide quarterly reports to the Telecommunications Division Director showing on a monthly basis, the number of customers, total revenue, actual location life, and any other data as directed by Telecommunications Division.

(END OF ATTACHMENT A)