Decision 00-11-039 November 21, 2000

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Roseville Telephone Company (U 1015 C) to Review Extended Area Service Compensation and Establish Replacement Revenue Funding.	Application 99-08-043 (Filed August 20, 1999)

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Sindy J. Yun, Attorney at Law, for the Office of Ratepayer Advocates, protestant.
Colleen O'Grady, Attorney at Law, for Pacific Bell Telephone Company, intervenor.

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OPINION

1. Summary

In this decision, we authorize Pacific Bell (Pacific) to terminate its annual Extended Area Service (EAS)[1] payment of $11.5 million to Roseville Telephone Company (Roseville or RTC). We deny Roseville's proposal that the EAS revenue be recovered on a permanent basis from the California High Cost Fund-A (CHCF-A) or CHCF-B and order the assigned Administrative Law Judge (ALJ) to prepare an Order Instituting Investigation (OII) to review Roseville's revenue requirement to determine whether recovery of the $11.5 million should come from Roseville's shareholders or from its ratepayers in the form of rate increases, or a combination of the two.

We authorize replacement funding on an interim basis using the current reserve in the CHCF-B. Roseville will be eligible to receive the funding during the pendency of the OII to determine a permanent replacement mechanism for the EAS revenues that it currently receives from Pacific, as long as Roseville cooperates fully in the OII. This will protect the financial interests of Roseville and its ratepayers while the Commission conducts its OII and makes a final determination as to the proper method of revenue recovery.

We determine that Pacific is not required to refund the $11.5 million to its ratepayers, once it discontinues making its payments to Roseville.

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[1] EAS is a telephone service authorized in designated communities to extend the geographic reach of a local toll-free calling area.

2. Procedural History

Roseville filed this application asking the Commission to address the rate and revenue issues related to the current EAS arrangements between Pacific and Roseville. The current EAS compensation agreement between the companies provides Roseville with $11.5 million in annual revenues. This was a significant portion of Roseville's start-up revenues utilized by the Commission to recover Roseville's cost of providing telephone service in its General Rate Case (GRC) decision in 1996.

In March 1999, Pacific sent Roseville a letter requesting that the parties terminate the current $11.5 million EAS compensation agreement and enter into a new EAS compensation arrangement. Pacific informed Roseville that the existing agreement was not consistent with the present competitive environment. Subsequently Pacific and Roseville entered into negotiations on a new compensation agreement. The new agreement was not completed at the time Roseville filed its application, but the parties did execute a new agreement during the course of the proceeding, and on May 31, 2000, Roseville and Pacific filed a joint motion for admission of the new interconnection agreement (ICA) as a late filed exhibit.[2]

The new compensation agreement terminates the current arrangement in which Roseville receives $11.5 million annually from Pacific, and establishes a system of bill and keep for exchange of local traffic. Therefore, the new agreement does not provide any replacement funding for the $11.5 million received from Pacific. Since the new agreement does not generate revenues to

[2] The ICA was marked as Exhibit 26, effective May 30, 2000, the date the motion and ICA were filed, and Exhibit 26 was moved into evidence effective September 19, 2000.

offset the loss of the existing EAS payments, Roseville suggests other funding alternatives, including the CHCF-A or CHCF-B.

The Office of Ratepayer Advocates (ORA) filed a protest to Roseville's application, stating that the Commission should dismiss the application because it was filed prematurely. According to ORA, the terms of the new EAS agreement need to be taken into account by the Commission in its review of various funding sources.

Also, ORA finds EAS compensation to be inconsistent with the Commission's New Regulatory Framework (NRF) goals. ORA agrees with Pacific that the telecommunications market has changed since the adoption of the EAS agreement. Roseville's EAS compensation should be eliminated because it undermines the NRF goal to provide telephone utilities with incentives to increase efficiency.

On September 27, 1999, Pacific filed a motion to intervene as a party to this proceeding. In its motion Pacific indicated that the issues in the proceeding directly affect the interests of Pacific. Due to prior Commission orders, Pacific currently pays Roseville approximately $11.5 million a year for settlements relating to 0-12 mile local calling, Zone Usage Measurement (ZUM) Zone 3, and the Lincoln-Roseville and Pleasant Grove-Roseville EAS routes. Those intercompany settlement payments generally have been referred to as "EAS payments."

In its investigation into existing settlement payments from Pacific to other LECs and their impact on the implementation of a NRF, the Commission, in Decision (D.) 91-07-044, decided to freeze the EAS payments to Roseville at approximately $11.5 million annually under a transitional settlement arrangement. Additionally, the Commission ordered Pacific and other mid-sized

LECs (including Roseville) to enter into negotiations for EAS compensation with the understanding that permanent arrangements would be implemented by the end of 1997.

Pacific has established such permanent arrangements with all large and mid-sized LECs except Roseville. Pacific has also negotiated traffic compensation agreements with the small LECs in California, which have been submitted to the Commission for approval in Application (A.) 99-09-044.

Pacific states that its participation in this proceeding as a party will not unduly broaden the issues set to be considered. Roseville responded to Pacific's motion to intervene stating that it acknowledged Pacific's strong interest in the outcome of the proceeding and did not oppose Pacific's motion to intervene. Pacific's motion to intervene was granted by ALJ Ruling on November 23, 1999.

A Prehearing Conference (PHC) was held on December 6, 1999. The purpose of the PHC was to determine the scope of issues to be addressed, the schedule for resolving the issues identified, and to determine whether or not evidentiary hearings were required.

On December 22, 1999, Assigned Commissioner Carl Wood issued a Scoping Memo, which established the scope and timetable for the proceeding. Roseville was ordered to provide interested parties with the cost information and cost model developed for its last GRC, and to provide updated volume information by January 28, 2000. Interested parties filed briefs on use of the CHCF-A and CHCF-B on March 21, 2000, as ordered in Commissioner Wood's Scoping Memo. Evidentiary Hearings were held April 24-25, 2000, with Opening Briefs filed on May 25, 2000 and Reply Briefs on June 9, 2000. Two Public Participation Hearings were held in Roseville on June 27, 2000.

3. History of EAS Arrangements between Pacific and Roseville

Service territories of local telephone companies are divided into local exchanges. Each local exchange has a point designated as a rate center, which is used to measure the distance of calls for billing purposes. If the rate centers for two local exchanges are within a prescribed number of miles of one another, or the Commission has determined that calls between two exchanges should be rated as local, all calls between those exchanges are local calls. Otherwise, they are toll calls. In Roseville's case, the EAS routes extend the local calling area of its exchanges into Pacific's exchanges.

Roseville's EAS arrangement with Pacific goes back many years. On April 9, 1958, Case 6087 was filed by a group of Roseville's subscribers residing in the Citrus Heights area seeking EAS between that exchange and Pacific's Sacramento, Folsom, Rio Linda and Fair Oaks exchanges. Subsequently, the Commission instituted an investigation (Case No. 6339) to determine whether EAS was in the public interest. In 1961, the Commission issued D.62949 which concluded that the public interest required the introduction of EAS between Roseville's Citrus Heights district and Pacific's Fair Oaks, Rio Linda, and Folsom exchanges as well as the North Sacramento area of Pacific's Sacramento exchange. Roseville and Pacific instituted this EAS service on December 15, 1963.

The Commission held further hearings with respect to EAS issues and the intercompany settlements related to EAS and in February 1963, ordered Pacific and Roseville to attempt to negotiate an EAS settlement agreement. On August 2, 1963, Roseville filed Application (A.) 45640 alleging that Roseville and Pacific had been unsuccessful in their negotiations and asking the Commission to prescribe and impose a method of settlement and division of revenues. In D. 67172, the Commission adopted Roseville's proposed form of Extended Service Traffic Agreement as the basis for intercarrier compensation for the exchange of EAS traffic.

ZUM replaced EAS as the term used to describe these routes when ZUM was implemented in much of Sacramento County in 1984. In D.84-06-111, the Commission authorized Roseville to continue to recover the costs of implementing ZUM with Pacific through the EAS Settlement Agreement.

ZUM calling areas are divided into zones, which form concentric circles around the point from which a customer's call is measured and rated. As originally established, calls from 0-8 miles were ZUM Zone 1 local calls, calls from 8-12 miles were ZUM Zone 2 calls, and calls from 13 to 16 miles were ZUM Zone 3 calls.

In 1989, the Commission ordered the expansion of the local calling area for all LECs to include all routes of 0-12 miles, which meant that ZUM Zone 2 was subsumed into the local calling area. According to Pacific this resulted in the conversion to local calling of all EAS and ZUM routes between Roseville and Pacific, with the exception of the Citrus Heights to Lincoln and Citrus Heights to Pleasant Grove ZUM Zone 3 routes. In 1996, the Commission converted the Citrus Heights to Lincoln and Citrus Heights to Pleasant Grove routes to local. (D.96-12-074 [70 CPUC2d 88, 150].) Thus, Pacific states, all of the inter-company traffic covered under the current EAS settlement agreement is now classified as local calling.

4. The Settlement Transition Agreement

In its investigation into existing settlement payments from Pacific to other LECs and their effect on the implementation of NRF, the Commission in

D.91-07-044 decided to implement a phase-out of toll support payments from Pacific to the mid-sized LECs over a transition period ending in 1997.

Effective January 1, 1992, Roseville and Pacific entered into a Settlement Transition Agreement (STA) which provided for replacement of existing settlement arrangements, including EAS, with a different method of mutual compensation for interconnected telephone traffic. This transitional settlement agreement provided that Pacific pay Roseville $11.5 million per year for EAS. After July 1996, Pacific and Roseville were to mutually agree to continue the EAS payment or the parties could submit the EAS arrangement to the Commission for a decision.

5. Should the Current EAS Payment from Pacific to Roseville be Discontinued?

5.1. Roseville's Position

Roseville states it is not opposed to termination of the current agreement with Pacific, as long as the Commission establishes replacement funding for the EAS revenues which Roseville currently receives from Pacific. According to Roseville, the Commission determined in Roseville's GRC that the payment from Pacific recovers a significant portion of Roseville's annual revenue requirement. If the $11.5 million annual payment had not been available to Roseville, the Commission would have been required to fund that amount in another way to cover the NRF start-up revenue requirement the Commission determined was necessary for Roseville to provide utility service.

5.2. Pacific's Position

Pacific supports termination of its $11.5 million annual EAS settlement payment to Roseville. Pacific states the payments to Roseville are anti-competitive. The EAS payments that directly replaced support payments occurring through toll revenue pooling, are used by Roseville to support its operations. This places Pacific in the unique position of funding the operations of a potential competitor, Roseville, thereby making it more difficult for Pacific to compete with Roseville. According to Pacific, this results in a significant anti-competitive impact on Pacific vis-à-vis both Roseville and other potential competitors in Roseville's service territory since Pacific is the only company required to subsidize its competitor.

Pacific indicates that Pacific and Roseville have now entered into an ICA, which covers the local traffic previously covered under the STA. The new ICA is essentially a bill-and-keep arrangement, which will result in no payments to Roseville for local and EAS traffic. Pacific states it will cease making payments under the STA the earlier of: (a) January 1, 2001, or (b) the date the Commission determines replacement revenues for Roseville, if any. The new ICA was filed in this docket, as required in the scoping memo issued in this proceeding.

5.3. ORA's Position

ORA agrees with Pacific in supporting termination of the EAS arrangement between Pacific and Roseville, and recommends that the Commission not establish any replacement funding.[3] According to ORA, Roseville should not be permitted to continue receiving $11.5 million in EAS revenues from Pacific. The EAS payments were intended to be temporary; the payments were never intended to be a permanent arrangement. Clearly, in D.91-07-044, the Commission intended for the EAS payments to end by 1997.

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[3] The issue of replacement funding will be addressed in following sections.

According to ORA, the Commission should end the EAS payment because it raises serious competitive concerns. Roseville is the only mid-size LEC that is still receiving a subsidy from Pacific. Both Citizens Telecommunications Company of California (Citizens), another mid-size LEC, and GTE California (GTEC) ended their EAS arrangement with Pacific in 1997. It would be anti-competitive to allow Roseville to continue to receive a subsidy while its competitors do not. EAS payments may have been appropriate years ago, but they are not appropriate now because the payments are used by Roseville to support the company's operations, presumably by allowing the company to lower local and access rates to its customers or realize higher profits. (ORA quoting Peters for Pacific, Exh. 10, p. 9.) ORA says the EAS payments also raise other competitive issues such as barriers to entry and cross-subsidization.

5.4. Discussion

We agree that the $11.5 annual EAS payment from Pacific to Roseville should be discontinued. As stated in D.91-07-044, we anticipated that the EAS payments would end in 1997. It is three years past the time we set for terminating the EAS payments, yet those payments are still in effect.

It is not sustainable in a competitive environment, for one company (Pacific) to make subsidy payments to its competitor. It also disadvantages other companies wishing to compete in Roseville's service territory and which must compete against a company with an outside source of revenue to fund its operations.

Pacific states its intent to suspend payments to Roseville the earlier of January 1, 2001 or when the Commission establishes replacement funding. We appreciate Pacific's desire to end the payments to Roseville as soon as possible, but we remind Pacific that it does not have the authority to unilaterally terminate payments under the STA. The STA was submitted as a proprietary exhibit in this proceeding so we are not able to quote directly from the agreement between the parties. However, the STA is clear that Pacific must continue to make its payments to Roseville until a permanent EAS funding arrangement is implemented. In the STA, the parties agree that if they are unable to reach agreement, either or both parties may request the Commission to establish a permanent EAS funding arrangement. (Exh. 4C at 15.)

We are aware that the parties have negotiated a replacement agreement, submitted as an exhibit in this proceeding, which includes a bill and keep arrangement for exchange of local traffic. However, we believe that the terms of the STA require Pacific to make its payments to Roseville until a replacement arrangement is implemented. That arrangement must include action on replacement funding for the $11.5 million, which Roseville currently receives from Pacific. The new bill and keep arrangement cannot go into effect until we have approved an alternative funding arrangement.

In its Comments on the Proposed Decision (PD), Pacific asserts the PD would allow Roseville to collect EAS payments in contravention of Roseville's interconnection agreement (ICA) with Pacific. A specific term that Pacific and Roseville negotiated was the start date for the ICA. Both companies agreed that the start date for the ICA would be "the <u>earlier</u> of (a) January 1, 2001, or (b) the date the Commission determines replacement revenues for Roseville, if any." Pacific states that the PD modifies the start date for the ICA by providing that Pacific should continue payments until 60 days after the Commission

Decision in this proceeding becomes effective, thus potentially rewriting a term of the ICA.

According to Pacific, the PD is also inconsistent with other provisions of the negotiated ICA. The PD states that the STA is clear that "Pacific must continue to make its payments to Roseville until a permanent EAS funding arrangement is implemented." Pacific states this misreads the STA and was not the intent to the parties. The ICA is the permanent EAS arrangement, and the ICA abrogated Pacific's obligations under the STA. The STA states "…the term of this Agreement shall commence as of January 1, 1992 and shall end on the final year of the Transitional Contract payments, except that EAS payments shall continue until the implementation of the permanent EAS arrangement." (STA p. 16.) Therefore, Pacific's insists that its obligations under the STA ended when Pacific and Roseville negotiated and signed the ICA.

Pacific is incorrect that the ICA between Pacific and Roseville was effective when signed. The ICA becomes effective when approved by the appropriate State Commission, as described in the 1996 Telecommunications Act, Section 252(e)(1). The ICA was submitted to this Commission on October 13, 2000 and is expected to be on the Agenda for Commission approval at its meeting on January 4, 2001. The ICA is not in effect until approved by the Commission, and the terms of the STA are currently in effect.

The language Pacific cited above from the STA reads as follows: "…EAS payments shall continue until the implementation of the permanent EAS arrangement." As we stated previously, that language requires that Pacific make payment until the alternate funding is implemented. Pacific shall be required to continue to make payments to Roseville until the CHCF-B is able to take over that function.

However, it is our intent to terminate the payments Pacific makes to Roseville, and we will order that those payments be terminated as follows: Pacific shall remain obligated to Roseville under the STA's EAS arrangement through the calendar month in which this order is adopted. Pacific shall pay all amounts owed to Roseville within 60 days of the effective date of this order.

6. Should the Commission Adopt Replacement Funding for the EAS Revenues Roseville Receives from Pacific?

6.1. Roseville's Position

Roseville asserts the Commission must replace the EAS payment that it now receives from Pacific. As the Commission itself stated when it approved Roseville's annual revenue requirement and rate design in Roseville's last GRC, the $11.5 million payment is used to pay for a significant portion of Roseville's cost of doing business to serve utility customers. In Roseville's most recent GRC decision (D.96-12-074), the Commission approved Roseville's NRF start-up revenues to recover its revenue requirement and indicated that the annual payments from Pacific should be used as a source for recovering Roseville's costs to provide utility service. According to Roseville, if the $11.5 million annual payment had not been available to Roseville, the Commission would have been required to fund that amount in another way (e.g., through external funding support or increased rates) to cover the NRF start-up revenue requirement that the Commission determined was necessary for Roseville to provide utility services.

Furthermore, Roseville states, the Commission was aware that the $11.5 million payment would eventually end and included language in the GRC decision describing the possible scenarios for replacing the payment. The Commission contemplated that replacement funding might be accomplished through a universal service funding mechanism or rate rebalancing. (D.96-12-074 at 151.) Explicit in the GRC decision's discussion is the principle that some form of revenue replacement must occur in the absence of the $11.5 million payment from Pacific to Roseville.

In Roseville's last GRC, ORA proposed elimination of the EAS payment from Pacific to Roseville. The Commission rejected ORA's proposal. According to the Commission,

> We disagree with ORA to the extent ORA argues these payments represent a subsidy to Roseville's ratepayers. Rather, there is a cost for providing EAS service between Pacific and Roseville. The historic determination of this cost is a net flow of funds from Pacific to Roseville. Pacific and Roseville have agreed to freeze these payments at the 1991 level until the parties agree to, or the Commission determines, a new payment level. (Id.)

Roseville asserts that because the Commission included the $11.5 million payment in Roseville's NRF start-up revenue requirement, the Commission must ensure that an adequate replacement exists before the payments are discontinued. A utility whose rates are regulated by a government agency is entitled to the opportunity to earn a reasonable rate of return. Bluefield Water Works Improvement Co. v. Public Service Common of West Virginia, 262 U.S. 679, 692-693 (1923); Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944); Duquesne Light Co. v. Barasch, 488

U.S. 299, 314-315 (1989). Utilities may not be required to charge a rate so unjust as to be confiscatory. If the rates adopted for a utility do not afford sufficient compensation, ". . . the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments." Duquesne Light Co., supra, 488 U.S. at 307-308.

Roseville states that the $11.5 million payment recovers approximately 15% of Roseville's state-regulated costs based on the cost levels adopted in the GRC decision. (Exh. 1C, p. 20, Direct Testimony of Gierczak for Roseville.) To demonstrate the significance of the $11.5 million to Roseville, that payment represents approximately 9% of Roseville's total revenue.

In addition, Roseville states that its recent sharing advice letter, Advice Letter No. 489, establishes that Roseville experienced a 10.53% rate of return in 1999. (Exh. 2, p. 6, Rebuttal Testimony, Gierczak for Roseville.) Without the $11.5 million payment, Roseville's rate of return for 1999 would be less than 6% which is below Roseville's floor rate of return as established by the Commission in Roseville's NRF.

As demonstrated above, states Roseville, the $11.5 million payment from Pacific was an integral part of the Commission's rate design for Roseville. To simply eliminate $11.5 million of Roseville's revenue, without an alternate means of recovery would result in confiscatory rate levels and in turn lead to a taking of Roseville's property. To avoid this result, the Commission must provide Roseville with a substitute revenue source upon the elimination of the $11.5 million payment.

Roseville argues that the Commission should not embrace ORA's unconventional proposal that Roseville not be authorized to recover replacement revenues since it is a "financially healthy company." Roseville believes ORA's proposal would improperly alter the Commission's NRF policies. First, ORA cites evidence regarding revenues earned by Roseville's parent, Roseville Communications Company (RCC), in support of its position. However, such evidence is irrelevant to the determination of whether RTC has the opportunity earn a reasonable rate of return. Under the analysis required by Supreme Court decisions, the obligation to ensure a utility has an opportunity to earn a reasonable rate of return extends only to those facilities needed to meet the utility's obligation to provide regulated services. D.96-09-089 [68 CPUC2d 209, 224].) Consistent with this principle, the proper scope of the analysis regarding the adequacy of a utility's rate of return includes only those revenues obtained from regulated assets. (Id. at 225.) According to Roseville, the Commission should ignore ORA's discussion regarding the earnings of RTC's parent, RCC.

Second, states Roseville, without the annual $11.5 million EAS payment, Roseville's rate of return would fall to below 6%. Notwithstanding ORA's assertions, a rate of return below 6% due to a rate design adopted by the Commission yields an inadequate rate of return for Roseville and requires that the Commission authorize replacement revenues.

Third, ORA points to the recent audit of Roseville's non-regulated operations recently performed by ORA's consultant, which is currently under review in Roseville's NRF Review proceeding (A.99-03-025), as further evidence of Roseville's financial health. As Roseville discussed in its opening brief, Roseville extensively litigated the merits of those audit results. Accordingly, Roseville vigorously disputes any suggestion in this proceeding that Roseville will realize substantial shareable earnings in either 1999 or 2000 as referenced in

ORA's opening brief. Furthermore, Roseville states that its Advice Letter 489 demonstrates that Roseville had no shareable earnings for 1999. The Commission has not ruled on the issues asserted in ORA's audit, and Roseville remains confident the Commission will find Roseville complied with applicable cost allocation requirements. ORA's contentions pertaining to Roseville's audit should be disregarded in this proceeding because they lack sufficient evidentiary foundation and are speculative.

Fourth, Roseville rebuts ORA's contention, based on Pacific's witness Peters' oral testimony regarding Sugarland Telephone Company (Sugarland), that Roseville has excessive costs and should not recover replacement revenues. According to Roseville, a comparison of Roseville to Sugarland lacks credibility given that a more appropriate comparison exists between other California LECs and Roseville. For example, Peters decided not to compare Citizens, which has comparable corporate operations costs to Roseville. Because Citizens is also located in California, with corporate offices in Sacramento, Roseville argues that Citizens faces a similar operating environment from a regulatory perspective which might explain why a carrier in California has higher corporate operations costs than a carrier in Texas.

In addition, Roseville asserts Sugarland is listed as a utility receiving an excessive number of customer complaints by the Texas regulatory commission. Pacific's witness did not rebut or deny the evidence of Sugarland's deficient service quality. Roseville, in contrast, consistently meets or exceeds the Commission's General Order 133-B service quality standards. Instead of relying on a sketchy comparison to a Texas LEC, Roseville believes the Commission need look no further than its own decision in Roseville's GRC/NRF start-up proceeding, in which the Commission determined that Roseville's NRF start-up costs were reasonable.

Finally, Roseville contends ORA suggests Roseville should not recover replacement revenue because it is a different company from what it was when its GRC/NRF start-up was adopted. ORA's suggestion conflicts with the principles underlying NRF regulation. NRF places risk on the LEC and through earnings incentives expects that LECs will become more efficient than they would normally be under traditional rate of return regulation, as Roseville's witness Gierczak noted in his rebuttal testimony.

> One of the core principles of the NRF is that companies are to be provided a significant incentive to do all the good things that companies in the American economy will attempt to increase their profits, such as reduce costs, introduce new products, provide outstanding customer service, and so on. By contrast, Jarjoura is incorrect that its proposed confiscation of Roseville's revenues will induce Roseville and competing carriers to increase productivity and provide the services at competitive rates. (Jarjoura Testimony, page 3). Rather than a positive incentive, the message delivered by confiscation is that a company that achieves increased earnings will be penalized by having them taken away.

Roseville asserts that ORA's proposal to "confiscate" Roseville's revenues would force the Commission to drastically alter its NRF. Currently, NRF LECs bear the risk of under-performance in a given year balanced by the potential benefit of additional revenues in those years when they out-perform their established rate of return. For example, to experience the possible upside of NRF regulation, Roseville had to endure a down year in 1997 when it earned only 9.11 %. ORA's proposal to "confiscate" the $11.5 million EAS payment, in contrast, would require that Roseville bear the risk for under-performance while eliminating any benefits to Roseville when it out-performs its market rate of return. In effect, Roseville claims, ORA's proposal would eliminate any incentive for Roseville to be efficient, and incentive is the centerpiece of the Commission's NRF.

6.2. ORA's Position

ORA recommends termination of the EAS arrangement between Pacific and Roseville without establishing any replacement funding. ORA states that the Commission implemented NRF regulation in 1989 to create a regulatory approach that is more efficient than traditional rate-of-return regulation. The purpose of NRF regulation is to foster competition and to encourage telecommunications carriers to manage their operations in the most efficient manner.

ORA recommends that no replacement funding be established because Roseville is a financially healthy company that can absorb the loss of $11.5 million. According to ORA, the evidence in the record shows that Roseville is a financially healthy company whose financial status has dramatically improved since its GRC.

ORA cites RCC's 1999 annual report, which says the company's operating revenues and income have grown tremendously in the last three years as follows:

A. **Total Operating Revenues** (Exh. 9, p. 36):

Year	1997	1998	1999
Amount	$114.9 million	$126.7 million	$140.8 million
% increase over prior year	N/A	10%	11%

B. **Total Net Income** (Exh. 9, p. 36)

Year	1997	1998	1999
Amount	$22.9 million	$25.04 million	$31.7 million
% increase over prior year	N/A	9%	26.7%

According to RCC's 1999 annual report, RTC's total operating revenues constituted approximately 80%, 80% and 83% of RCC's total operating revenues in 1997, 1998 and 1999 respectively. (Id.) More specifically, RTC's rate regulated revenues increased $10.7 million or 11% in 1999 compared to 1998. (Exh. 9, p. 30.) In 1998, its rate regulated revenues increased $5.8 million or 6% compared to 1997. (1 R.T. 84, Gierczak for Roseville.) Similarly, Roseville's access lines grew 7% from 1997 to 1998 and 5% from 1998 to 1999. (Id.; Exh. 9, p. 30; See also Exh. 24.) In the face of such a significant growth in revenues and net income, says ORA, there is no reasonable basis for Roseville to be entitled to continue receiving any EAS subsidy.

ORA rebuts Roseville's assertion in its testimony that because the revenue was included in Roseville's start-up revenue requirement in 1996, the Commission must replace the $11.5 million through another permanent source of funding. ORA does not dispute that the EAS revenues were included in Roseville's initial revenue requirement. However, Roseville's revenues and income have significantly grown since the GRC. Roseville's financial situation is not the same as it was five years ago. Based on Roseville's current financial status, it should be able to absorb the loss of $11.5 million.

Furthermore, ORA asserts a Commission-mandated audit supports its contention that Roseville is a financially healthy company. Pursuant to

Commission order, Overland Consulting audited Roseville's operations from 1997 through June of 1999.[4] According to the audit results, Roseville's 1999 shareable earnings are estimated at $11.4 million. The shareable earnings for year 2000 are expected to exceed $14 million. (Exh. 19, p. 4, Jarjoura for ORA.)

More importantly, states ORA, the audit revealed that there was a severe cost misallocation problem with Roseville, which has directly impacted Roseville's regulated earnings and costs. The audit demonstrated that Roseville grossly overstated regulated expenses and over-allocated regulated revenues to its affiliates thereby lowering the overall regulated earnings. Pacific witness Peters also testified about Roseville's cost misallocation problem. He stated as follows:

> It's really hard to figure out how they [Roseville] can spend that kind of money, or they're misallocating their costs and/or some of both. And it's just hard for me -- I have never come across a company in my 30 years in this business that has costs of this magnitude for this size of a company. . . You've got to come to a conclusion that either Roseville is the most inefficient company in the United States, the ORA's audit has just reached the tip of the iceberg. . . (1 R.T. 134, Peters for Pacific.)

ORA states that during the hearings in this proceeding, Peters testified in detail about how inefficient Roseville's operations are. Based on his comparison study of Roseville's costs to those of comparable companies in the United States, he stated that Roseville's costs are twice the costs of comparable

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[4] The Audit Report prepared by Overland Consulting is currently being reviewed in Roseville's NRF Review proceeding, A.99-03-025.

companies in the United States. (Id. at 119.) He testified that Roseville's corporate operations expense was the highest in the country and that Roseville's plant expense was also unreasonably high in comparison to other companies comparable to Roseville. (Ibid.) Specifically, he compared Roseville to a Texas telephone company, Sugarland. Sugarland's operations are very similar to Roseville's in that it is located outside of a metropolitan area (Houston) and has local calling into the Houston area. Roseville is also located outside of a metropolitan area (Sacramento) and has local calling into the Sacramento area. The comparison study showed that Sugarland's corporate operations expense was $5.23 per loop per month compared to Roseville's cost of $12.50, which is more than twice that of Sugarland. (Id. at 120.) The study also showed that Sugarland's plant expenses per loop per month was $8.86 compared to Roseville's of $18.49. (Id. at 121.) Peters testified that Roseville's corporate expense is "the highest in the country by quite a bit." (Id. at 119.)

ORA shares Peters' sentiments and concurs with him that Roseville's costs are unreasonably high. As such, any replacement funding for EAS would only encourage Roseville to continue operating inefficiently to the harm of ratepayers.

In its Reply Brief, ORA asserts that Roseville mischaracterizes ORA's discussion of Roseville's shareable earnings as a "shareable earnings proposal." ORA recommends that the Commission eliminate the EAS arrangement without establishing any replacement funding for Roseville. In support of this recommendation, ORA pointed out Roseville's shareable earnings to highlight the fact that no replacement funding is warranted because Roseville is a financially healthy company. Thus, contrary to Roseville's assertion, ORA is not making a "shareable earnings proposal" in this proceeding.

ORA states it is not proposing that Roseville use its shareable earnings to replace the loss of its EAS revenues. However, if the Commission nonetheless determines that Roseville should be allowed replacement funding and considers Roseville's shareable earnings as a recovery method, ORA does not dispute that this recovery method could result in a permanent reduction of $11.5 million in revenues for Roseville. But the potential reduction of $11.5 million in revenues that could result for Roseville is still reasonable and appropriate given Roseville's strong financial stance. According to the results of the Overland Consulting audit, Roseville's earnings for 1998 and 1999 exceeded its sharing benchmark, and ORA projects that Roseville's earnings for year 2000 will also exceed the benchmark. Thus, says ORA, even if Roseville's shareable earnings are used to replace the EAS revenues, Roseville would not be financially harmed.

ORA's Reply Brief rebuts Roseville's assertion that ORA's shareable earnings proposal relies on "unproven assertions and claims." During the course of a five-day hearing in the NRF proceeding, where ORA and Roseville litigated Overland's audit findings, Overland provided overwhelming evidence which demonstrated that Roseville's earnings for the past two years have reached the sharing benchmark and therefore Roseville should have shared its revenues with ratepayers. According to ORA, Roseville did not even question the majority of Overland's specific shareable earnings calculations during the hearings. In fact, Roseville agreed with and accepted over one-third of Overland's audit calculations. If ORA's representations of Roseville's shareable earnings are "unproven assertions and claims" as Roseville says they are, Roseville would have challenged them in the NRF hearings.

ORA criticizes Roseville's assertion that Roseville's earned rate of return for 1999 is only 10.53%. This figure is not correct, contends ORA, because it is based on Roseville's unsupported "pro forma" adjustments that it incorporated into the calculation for regulated results of operations. Roseville's pro forma results are based on a misallocation of revenues and expenses between regulated and non-regulated operations and is nothing more than an attempt by Roseville to eliminate the earnings Roseville owes to its ratepayers under the NRF sharing rules.

In its Reply Brief, ORA states it does not dispute that its forecast relies on RCC revenues. However, this is because RTC's revenues for year 2000 are not yet available as we are still in the calendar year. Furthermore, ORA asserts that even though its forecast relies on RCC's revenues, a significant portion of RCC's revenues are derived from RTC, not from other non-regulated operations. Since RTC's revenues constituted approximately 83% of RCC revenues in 1999 according to RCC's annual report, it is entirely reasonable to project RTC's regulated revenues based on a proportion of total RCC revenues.

ORA states Roseville erroneously asserts that ORA's analysis did not consider the trends regarding competitive entry and its impacts on Roseville's regulated revenues. ORA supports the Commission's NRF goals and the fostering of competition in the telecommunications market. Because ORA supports those goals, ORA believes Roseville should not be allowed to receive any permanent subsidy. By seeking a recovery of $11.5 million in subsidy through an external funding source, Roseville is essentially asking the

Commission to deter competition from ever flourishing in its service territory. This is so because other potential competitors in Roseville's service territory are not receiving the type of permanent subsidy that Roseville is seeking in this proceeding. As long as Roseville receives a financial subsidy that its competitors are not, there will be no level playing field for competitors.

ORA rebuts Roseville's statement that the Commission should not give any weight to Peters' testimony because he is not familiar with Roseville's actual costs and that the Commission should find Roseville's costs to be reasonable. ORA states the Commission should reject Roseville's arguments about the reasonableness of its costs, since Roseville acknowledged during the hearings that it has not performed any actual cost study since 1991. (1 R.T. 54-55, Gierczak for Roseville.) Neither the Commission nor ORA knows what Roseville's actual costs are. Until Roseville can demonstrate what its actual costs are, the Commission should dismiss Roseville's allegations about the reasonableness of its costs. Peters' estimate of Roseville's costs, based on a comparison to costs incurred by a like-sized, similarly situated company, is not only appropriate, it is the only defensible existing information of Roseville's costs available to the Commission.

According to ORA, Roseville's attempt to undermine Peters' testimony only highlights the unreasonableness of Roseville's costs and demonstrates how inefficient its operations are. Roseville asserts that its operations costs should be compared to the other mid-sized incumbent LEC in California, Citizens. Even though Citizens is not receiving $11.5 million in the form of a subsidy as Roseville is, Citizens' costs are still comparable to Roseville's. ORA wonders how Roseville, which is receiving an $11.5 million subsidy, has costs that are still equivalent to a company that is not receiving such a subsidy.

6.3. Pacific's Position

Peters states in his testimony, "I question whether Roseville requires any replacement funding for the loss of the $11.5 million EAS payments. There is growing evidence that by reasonably increasing its efficiency Roseville can reduce its costs by at least an amount sufficient to offset the loss of the $11.5 million in EAS payments from Pacific." (Exh. 10 at p. 14.)

In his testimony, Peters describes how the Federal Communications Commission (FCC) began disallowing more than one-third of Roseville's Corporate Operations expenses, beginning in 1998, in its determination of the amount of federal support funding for which Roseville was eligible. This expense was disallowed due to the fact that Roseville's Corporate Operations expenses were over 50% higher than the FCC's guideline amounts, which the FCC considered reasonable. This year, Roseville's federal support amounts have been reduced by approximately $2.6 million due to this disallowance. (Id. at 16.)

Peters goes on to say that in 1999 the FCC developed a high-cost support model (as described in FCC 99-036) to estimate the costs that an efficient carrier would incur to provide universal service to various service areas. This model shows that Roseville's booked costs were severely in excess of those which would be incurred by an efficient carrier. Peters concludes that this chain of evidence strongly supports the contention that Roseville has the ability to absorb the discontinuance of Pacific's $11.5 million EAS payments by reasonably increasing the efficiency of its current operations. (Id. at 16-17.)

Peters also stated that the FCC determined that its new high-cost support mechanism would provide sufficient additional funding for non-rural carriers, including Roseville, to maintain affordable rates. The new high-cost support mechanism is based on a model which determines the costs that should be incurred to provide universal service, assuming that service is provided in an efficient manner. The new FCC model showed that an efficiently managed Roseville could maintain affordable rates with no additional funding from outside support sources. Accordingly, states Peters, the FCC is reviewing a proposal to discontinue the universal service support funding currently provided to Roseville from federal sources. (Id. at 18.)

6.4. Discussion

In Roseville's GRC decision in 1996, we found that the EAS payment from Pacific made up a significant portion of Roseville's revenues needed to provide utility service. Roseville is correct that a regulated utility is entitled to earn a reasonable rate of return. Simply eliminating the $11.5 million from Roseville's revenue stream without any reanalysis of Roseville's revenue requirement would not be reasonable at this time.

ORA and Pacific are opposed to the Commission's granting any replacement revenues for Roseville. ORA cites recent data for RCC regarding operating revenues and net income and concludes that, because of the substantial growth shown in the data, Roseville does not need replacement revenues. ORA describes Roseville as a "financially healthy company."

Similarly, Pacific makes the argument that Roseville should be able to make up the revenues through "efficiencies" based on studies which Pacific prepared using two different sets of FCC data. We find the comparison data which Pacific's witness Peters compiled on Roseville's corporate operations expenses and plant expenses as indicators that there could be problems with Roseville's expenses, but Pacific has provided no specific tie between that data and the specific revenue requirement for $11.5 million. Without quantifiable analysis of specific expense levels, we cannot determine which expenses are unreasonable, and should be used to offset the $11.5 million.

We conclude that we must either order some sort of revenue recovery, or conduct a further analysis of Roseville's revenue requirement, to determine whether the $11.5 million is still a necessary component of Roseville's revenue requirement. We do not have an adequate record before us at this time to support ORA and Pacific's contentions that Roseville does not need any sort of revenue recovery.

7. Overview of Proposals for Alternative Funding Source

The parties presented three major proposals for an alternative funding source: CHCF-A, CHCF-B, and some sort of rate increases for Roseville's ratepayers. The three proposals are discussed below.

7.1. Use of the CHCF-A as an Alternative Funding Source

7.1.1. Background

The CHCF-A was originally adopted by the Commission in D.85-06-115 as a means of keeping reasonable and affordable basic exchange rates for customers of smaller LECs that concurred in Pacific's statewide average toll, private line, and access rates. The small LECs are typically higher cost than Pacific so rates set at Pacific's levels are insufficient to generate the small LECs' revenue requirement. The rationale provided for the introduction of the CHCF-A was to provide customers of smaller independent LECs with the systemwide rate averaging benefits afforded to Pacific's rural customers by virtue of Pacific having the same rates throughout its territory.

The CHCF-A rules currently in effect require the small LECs to comply with a means test and waterfall provision if they request funding from the CHCF-A. The means test ensures that draws from the fund do not result in intrastate rates of return in excess of those authorized by the Commission. The waterfall provision provides LECs with the incentive to file a GRC while funding levels are still high. Appendix A to D.91-09-042 describes the waterfall as follows:

> The issuance of a Commission decision in a general rate proceeding of an independent company will have the effect of a "fresh start" for that company under the HCF [High Cost Fund] plan. Specifically, the phase-down of funding shall be reinitiated effective January 1 following the utility's first subsequent annual October advice letter filing after resolution or decision is rendered in the utility's general rate review proceeding. The phase-down cycle under this reinitiation will be six years: three years at 100% funding level following by three succeeding years at 80%, 50% and 0% respectively, if a local exchange company has not initiated a general rate review proceeding by December 31st of the previous year.

7.1.2. Roseville's Position

Roseville states it has already established that the Commission can authorize CHCF-A recovery of the $11.5 million payment. (<u>See</u> Brief By Roseville Telephone Company (U 1015 C) On Use of CHCF-A and CHCF-B, filed March 21, 2000.) However, to implement recovery from the CHCF-A, the Commission must make several administrative modifications as applied to Roseville. First, the CHCF-A has a waterfall feature whereby draws issued to rate base regulated companies are automatically reduced depending upon the time since a company's last GRC. Pursuant to NRF, Roseville no longer undergoes GRCs. Accordingly, the waterfall should not apply to Roseville. Second, the CHCF-A applies a means test to rate base regulated companies to ensure that they are not earning in excess of their authorized rates of return when they draw from the CHCF-A. As applied to a NRF company, however, a means test would frustrate the earnings incentive that is the centerpiece of NRF regulation. The $11.5 million payment was an essential aspect of Roseville's start-up revenue requirement. From 1996 to present, those funds have not been subject to a waterfall or means test. When recovered from the CHCF-A going forward, it would therefore be inappropriate to apply such tests, developed for rate-of-return regulated companies, to a NRF company.

Roseville asserts that the purpose of the CHCF-A is to assure that small company exchange rates remain within a reasonable range of Pacific's exchange rates in comparable neighboring exchanges. According to the rules governing the CHCF-A, each rural and small metropolitan company shall file with the Commission an advice letter incorporating the net settlement effects upon such company of regulatory changes ordered by the Commission and the FCC. Among other things, states Roseville, the rules specify that the CHCF-A filings should include the effects of EAS settlement revenue changes.

Roseville reports that it ceased submitting CHCF-A filings upon implementation of the interim opinion in its GRC. In Roseville's rate case order, the Commission found that the rates and charges adopted allowed Roseville a reasonable opportunity to earn its authorized rate of return and eliminated the need for Roseville to receive any further funds from the CHCF-A after February 1, 1997 (the date the rates went into effect). In the rate case order, the Commission also included the $11.5 million in annual revenues received from Pacific pursuant to the STA in the adopted rate design. The elimination or modification of these payments, says Roseville, will necessarily re-open the need for Roseville to receive further funds from the CHCF-A to account for the changes in EAS settlements between Pacific and Roseville, one of the original purposes of the CHCF-A.

According to Roseville, nothing in the Commission's order in its universal service proceeding decision (D.96-10-066) expressly prohibits future CHCF-A draws by Roseville. The order speaks only to Roseville's draws from the CHCF-B, but nowhere in the order does it state that Roseville may never draw again from the CHCF-A. The fact that D.96-10-066 does not expressly terminate Roseville's right to draw from the CHCF-A obviates the need to modify D.96-10-066 to reinstate that ability.

Roseville believes that no other order would need to be modified for Roseville to draw from the CHCF-A. All that would be required would be an order in this proceeding authorizing Roseville to draw replacement revenues from the CHCF-A. As noted earlier, Roseville is now regulated under NRF and therefore will have no further GRC proceedings. The Commission should acknowledge this fact in this proceeding and find that the waterfall provision of the CHCF-A which provides for a phase-down in CHCF-A funding based on the time since the recipient's last GRC does not apply to Roseville. Similarly, the Commission should find that the "means test" is similarly inapplicable to Roseville.

According to Roseville, recovery from the CHCF-A has several advantages over other possible replacement revenue funding sources.

First, this revenue recovery mechanism is analogous to Pacific's intracompany cross-subsidization of different cost exchanges. This would treat Roseville's ratepayers in a manner consistent with Pacific's and GTEC's ratepayers who have their costs spread over a large billing base. For example, Pacific keeps its rates in higher cost areas around the state lower by subsidizing operations in those areas with revenues from its lower cost exchanges. A draw from the CHCF-A would mimic this form of cross-subsidization.

Second, Roseville asserts that spreading the burden across a large billing base instead of simply Roseville subscribers comports with Public Utilities Code Section 739.3. Section 739.3 requires the Commission to establish fair and equitable rate structures for telephone companies operating in rural and small metropolitan areas. The Commission may use transfer payments to ensure that rates are fair and equitable. The CHCF-A is the tool the Commission has created to satisfy the requirements of Section 739.3, and it should be used to ensure that Roseville's rates do not increase substantially to recover the $11.5 million payment.

Third, recovery from the CHCF-A is consistent with the Commission's universal service goals. Roseville's access line rates are already higher than comparable areas in the state. Requiring Roseville to recover the $11.5 million payment through rates would drive basic service rates even higher. As rates increase, subscribership declines, contrary to the Commission's universal service goals.

According to Roseville, the impact on statewide rates would be nominal if Roseville's revenue requirement were recovered through the CHCF-A. For example, assuming the surcharge necessary to recoup Roseville's $11.5 million draw were placed on all LEC subscribers, the increase in monthly rates would be approximately four cents per access line. (Exh. 2 at p. 25, Rebuttal Testimony of Gierczak for Roseville.) Four cents per access line is insignificant given that Roseville's subscribers currently subsidize Pacific's operations in the amount of $1.58 per access line per month. (Ibid.) This is because the majority of all the CHCF-B distributions, approximately 86%, flow to Pacific. (See Resolution T-16365.) It is unusual, Roseville believes, for the company with the lowest costs and lowest rates in the state to receive the majority of support, while Roseville receives minimal support to serve its customers yet has higher costs and higher rates.

Roseville states that its proposal to recover the $11.5 million payment from the CHCF-A is consistent with the static payment established under the STA. Under the STA, Roseville's payment was fixed at $11.5 million. The per-access-line revenue attributable to the $11.5 million payment decreases as the number of Roseville's access lines increases. Accordingly, from 1992 until now, the per-access-line revenue attributable to the $11.5 million payment has decreased 37% while the EAS payment has remained fixed at $11.5 million. An increase in access lines leads to higher overall company costs, without any corresponding increase in the EAS payment. Roseville is therefore required to become more efficient as the payment covers fewer of Roseville's costs on a per access line basis as the company continues to grow. Freezing the CHCF-A draw at $11.5 million would more closely resemble the existing payment from Pacific than would any of the other revenue recovery options offered in this proceeding.

As further support for a draw from the CHCF-A, Roseville reminds the Commission it is the only designated Carrier of Last Resort (COLR) in its entire service area. See D.96-10-066 (October 25, 1996). As a COLR, Roseville is obligated and must be ready to serve each potential subscriber in its service area in furtherance of the Commission's universal service goals. Therefore, Roseville does not have the choice of whether to offer services to customers as its competitors do. Accordingly, replacing the $11.5 million payment with a draw from the CHCF-A is consistent with Roseville's COLR obligations.

Roseville states that Pacific opposes Roseville's recovery of the $11.5 million from the CHCF-A, while Pacific receives approximately $368 million from the CHCF-B to subsidize its operations. (Exh. 2, p. 35, Rebuttal Testimony of Gierczak for Roseville.) Pacific's CHCF-B fund draw represents approximately 4% of Pacific's total revenues. Roseville currently receives less than one-half of one percent of its revenues from the CHCF-B. If anything, Roseville claims, replacing the $11.5 million payment with a draw from the CHCF-A will treat Roseville and Pacific in a consistent manner.

7.1.3. ORA’s Position

ORA opposes any modification to or use of CHCF-A as a source of replacement funding.[5] First, CHCF-A was established for the very specific purpose of assisting small LECs, which are still under traditional rate-of-return regulation. Roseville is under NRF regulation and is no longer required to undergo regular rate reviews. Second, both the means and waterfall tests are essential components of CHCF-A. The means test ensures that the utility’s earnings do not exceed the rate of return authorized by the Commission. The purpose of the waterfall is to encourage the utility to file a GRC application.

[5] See ORA’s brief on the use of CHCF-A or B, dated March 21, 2000, filed in this proceeding.

Roseville, however, seeks to modify the CHCF-A so that it is exempt from both of these tests. Third, the amount a company draws from CHCF-A is not fixed. In other words, the amount of draw depends on the company's rates of growth, expense and investment. In D.91-05-016, the Commission held that:

> The funding in one year should not be automatically flowed through to future years. Although rates are not adjusted between formal rate reviews, CHCF-A support should be. That support should not be used to keep utility's earnings at levels which exceed those authorized by the Commission.[6]

Roseville, however, wants to receive $11.5 million from CHCF-A annually in perpetuity. ORA believes this is inconsistent with the goals of universal service. Fourth, CHCF-A is recovered from California customers statewide. If Roseville is permitted to recover $11.5 million from CHCF-A, ORA says, all California ratepayers would essentially be paying for Roseville's operations even though Roseville is financially healthy. All California ratepayers who contribute to the CHCF-A should not have to subsidize Roseville's operations without any assurance that Roseville is not over-earning.

For these reasons, ORA recommends that the Commission not use CHCF-A as a replacement revenue source. Allowing Roseville to replace its EAS revenues through CHCF-A would only encourage Roseville to continue to run its operations inefficiently to the detriment of ratepayers and harm competition in Roseville's territory.

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[6] D.91-05-016 [40 CPUC 2d 40, 43].

ORA rebuts Roseville's argument that the only viable replacement funding option is the CHCF-A. Roseville asserts that the fund is available to both small and mid-size LECs. ORA disagrees. According to D. 96-10-066, it is only available to small LECs, not to mid-sized LECs. More importantly, it is a universal service mechanism; it was never intended to subsidize EAS payments.

ORA disputes Roseville's assertion that recovery of the $11.5 million EAS payment from the CHCF-A is appropriate because it comports with Public Utilities Code Section 739.3. To the contrary, says ORA, Roseville's proposed use of CHCF-A is not permissible under § 739.3. First, § 739.3 is clearly intended for small telephone corporations as follows:

> The Commission shall develop, implement, and maintain a suitable program to establish a fair and equitable local rate structure aided by transfer payments to small independent telephone corporations serving rural and small metropolitan areas. (PU Code Section 739.3(a).)

According to ORA, the Commission does not consider Roseville a "small telephone corporation." Roseville is a mid-size LEC which has enjoyed the regulatory flexibility of NRF. Second, § 739.3 is intended for small telephone companies providing services in rural and small metropolitan areas. The Commission has also held that Roseville is not a "rural telephone company" because its service area does not have the attributes of a traditional rural company. The Commission concluded that "it is reasonable…to treat Roseville as a non-rural carrier for all purposes, including universal service funding." (See CPUC's FCC filing <u>Opposition by California to Petition for Reconsideration</u>, filed February 3, 2000 in CC Docket, Nos. 96-45 and 97-160, p. 5.)

Third, states ORA, Section 739.3 concerns universal service, not EAS. According to the Commission's Universal Service handbook, the main goals of universal service include:

- Providing consumer choice among competitive telephone companies.

- Providing for addition of new services to basic service as new services become more widely used, to avoid some people having inferior access to information than others; ..." (Universal Service Handbook issued by the Telecommunications Division, December 17, 1998.)

The Commission's universal service handbook also states that the purpose of CHCF-A is to provide a source of supplemental revenues to 17 small LECs whose basic exchange access line service rates would otherwise be increased to levels that would threaten universal service. (Id. at p. 114.)

ORA opposes modifying the CHCF-A to allow Roseville to continue receiving $11.5 million to subsidize its services. Notwithstanding the existing purpose and objectives of CHCF-A, if the Commission still believes Roseville should be able to recover any or all of the $11.5 million from this fund, the fund must be modified. In order to do so, the Commission must provide an opportunity for all contributors to the fund to participate in the modification process. CHCF-A is funded through a surcharge imposed on all intrastate services. Since any change to the fund would impact all contributors to the fund, it would be a violation of due process if the contributors were not afforded an opportunity to participate in the modification process. ORA recommends that the Commission consider whether CHCF-A should be used as replacement funding for EAS in the universal service triennial review.

7.1.4. Pacific's Position

Pacific opposes Roseville's proposal to transfer the entire $11.5 million to the CHCF-A and exempt Roseville from the CHCF-A's waterfall and means tests. Competitors would not have access to these amounts as they would not be portable[7] under the CHCF-A. Competitors would, therefore, have unequal funding in Roseville's territory. Unequal funding, Pacific argues, would allow Roseville to more effectively and unfairly compete against all current and potential competitors while continuing an inefficient cost structure. Such a result is completely inconsistent with Roseville's NRF status.

Pacific states that the Commission is already on record as being opposed to such a result in a similar situation. The Commission stated in its July 22, 1999 comments to the FCC in CC Docket No. 96-45 and 96-262 that unequal federal funding would harm a competitor's ability to provide service at competitive rates, with the result that the Incumbent Local Exchange Carrier (ILEC) would not only receive a windfall, but also a competitive advantage that could squeeze out competitors. According to Pacific, this outcome would be counter to the goals of the 1996 Telecommunications Act, and would harm competition in Roseville's territory.

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[7] Under the rules set for the CHCF-B, the subsidy is portable to any carrier, which is an authorized COLR in that area. If Roseville loses a residential customer in a high-cost census block group (CBG) to another carrier, which has been designated as a COLR, the subsidy moves from Roseville to that carrier. There is no similar portability provision governing the CHCF-A.

7.1.5. Discussion

Roseville points to the Commission's universal service goals in support of its proposal to utilize CHCF-A funding to replace the revenue which Roseville has been receiving from Pacific. We have stated our support that telephone service be ubiquitously available throughout California, with the highest household penetration rate possible. We recognize that subscribership may fall as rates increase, and we want to avoid that outcome in Roseville's territory. We are well aware that Roseville's customers currently pay one of the highest residential access line rates in California.

Roseville is correct that, since the CHCF-A is funded from a statewide surcharge on all intrastate telecommunications services, it would amount to only a few cents per customer per month to make up Roseville's revenue shortfall. Roseville analogizes this amount to the $1.58 per month that its customers pay to subsidize Pacific's operations under the CHCF-B distributions. But Roseville is mixing apples and oranges when it attempts to compare the two. The CHCF-B has a specified purpose, separate and apart from the purpose of the CHCF-A. (The CHCF-B will be discussed in detail in the following section.)

While the payment may be merely a few cents from customers throughout California to fund Roseville's revenue requirement, the amount charged on California customers' bills is not the issue. The bottom line is that Roseville requests a static draw from the CHCF-A, without adhering to two of the major tenets of the fund, that payments be subject to a waterfall provision and means test. Roseville recognizes that the Commission will have to make several administrative modifications as applied to Roseville. According to Roseville, the waterfall provision should not apply to Roseville, since Roseville is no longer subject to GRCs. We established the waterfall provision to encourage small LECs to file GRCs, if they want to maintain 100% funding from the CHCF-A. Second, the means test is applied to rate-base regulated companies to ensure that they are not earning in excess of their authorized rates of return when they draw from the CHCF-A.

The question we have before us is whether or not it is appropriate to make the alterations Roseville proposes so that Roseville can receive the replacement funding, in perpetuity, without further scrutiny. We created the rules governing the CHCF-A over the past few decades of experience with the fund, and have developed a workable system to maintain reasonable basic exchange rates for customers of small rural telephone companies to further our goal of universal service in rural areas. However, the requirements for the waterfall and the means test assure us that the companies that draw from the fund are submitting themselves periodically to Commission scrutiny of their operations, and are not over-earning. In other words, all California ratepayers should not be funding inefficiencies and excessive earnings.

Also, we agree with ORA and Pacific's conclusion that use of the CHCF-A subsidy by Roseville is anti-competitive, since it allows Roseville to receive an outside subsidy that is not portable to other carriers, and therefore is not available to its competitors. This represents a significant competitive advantage for Roseville as other carriers attempt to compete in its territory.

We are not willing to change the administrative rules to the CHCF-A to allow Roseville to draw on the fund as a permanent part of its revenue requirement. We have not used the fund in that manner for any other LEC and it is not appropriate that Roseville be allowed to have California's telephone ratepayers fund its operations, without any mechanism for determining whether Roseville needs the revenue on an ongoing basis.

Also, we dispute Roseville's conclusion that mid-sized LECs are entitled to draw from the CHCF-A. Roseville states that D.96-10-066 does not preclude a mid-sized LEC from drawing from the CHCF-A. Roseville is correct that the decision does not include an explicit prohibition against mid-sized LECs drawing from the CHCF-A. However, in our discussion in that decision regarding the use of the CHCF-A and CHCF-B, we made it clear which carriers we expected to draw from each of the funds:

> For the above reasons, we will include GTEC, Pacific, CTCC [Citizens], Contel, and Roseville in the CHCF-B fund for determining universal service subsidy support in their high cost areas.
>
> As for the seventeen smaller LECs, we shall exclude them from the CHCF-B for the purpose of estimating their costs of service. Instead, we shall continue to allow them to draw from the CHCF-A fund under our existing procedures. (D.96-10-066) [68 CPUC 2d 524, 584].

While Roseville is correct that our decision contains no specific prohibition on a large or mid-size LEC drawing from the CHCF-A, we clearly expressed our intent that the larger companies would draw from the CHCF-B, and that the seventeen smaller companies would draw from the CHCF-A. In addition, there are inherent contradictions in a NRF LEC drawing from a fund intended for use by rate-of-return LECs.

In its Comments on the Proposed Decision (PD), Roseville disputes the PD's conclusion that Roseville is not covered by the provisions of PU Code Section 739.3. After the adoption of Section 739.3 in 1987, the

Commission established the rules for the California High Cost Fund (subsequently referred to as CHCF-A). Roseville was authorized and eligible to draw from the CHCF-A under the Commission's implementation of Section 739.3. According to Roseville, the Commission has historically treated Roseville as eligible for the benefits under Section 739.3, and nothing in D.96-10-066 changed the Commission's decision that Roseville is eligible for those benefits.

We support our original contention but wish to clarify our reference to Section 739.3. Section 739.3(a), which was adopted in 1987, did apply to Roseville, but only until 1996 when subsection (c) was added to Section 739.3. Section 739.3(c) provided the basis for the creation of the CHCF-B. As stated above, while our Universal Service decision (D.96-10-066) did not explicitly state that mid-sized LECs were not covered by the provisions of the CHCF-A, we made it clear that that was, indeed, the case. As ORA mentions in its Reply Comments to the PD, the Commission's Universal Service Handbook specifies that the CHCF-A is intended for 17 small, rural telephone companies operating under rate-of-return regulation and CHCF-B is intended for 5 ILECs. (ORA, Reply Comments at 2.) As ORA asserts, the purpose of creating the CHCF-A and CHCF-B was to distinguish between the small rural telephone companies and the large and mid-sized LECs, of which Roseville is one. (Ibid.)

Therefore, we concur with ORA's conclusion that Roseville is not a small LEC and therefore not covered by the provisions of PU Code § 739.3(a), since that section applies only to "small independent telephone corporations." We consider Roseville a mid-sized LEC, not a small LEC, and regulate the company accordingly.

For all the foregoing reasons we deny Roseville's request that the $11.5 million in replacement funding come from the CHCF-A.

7.2. Use of the CHCF-B as an Alternative Funding Source

7.2.1. Background

The CHCF-B was created in D.96-10-066 in the Commission's universal service proceeding. The Commission made a commitment to ensure that residential basic telephone service be made available throughout California and that the rates for such service remain affordable. The decision adopted rules pertaining to how universal service was to be carried out in California as the local exchange telephone markets were opened to competing carriers. As California entered a more competitive telecommunications environment, the Commission found that yesterday's policies supporting universal service were no longer sustainable.

The Commission included the five large and mid-size LECs in the proxy cost model calculation for determining universal service support. They, and other COLRs who serve high cost areas in these service territories, are eligible for subsidy support through the CHCF-B. Using the Cost Proxy Model, a statewide average cost of $20.30 was derived. That statewide average cost serves as the cut-off point for determining which CBGs are high cost. CBGs whose costs exceed the statewide average cost of $20.30 are deemed high cost areas and eligible for support from the CHCF-B.

The decision states that the 17 smaller LECs will not be subject to the rules applicable to the CHCF-B fund, but will continue to be eligible for universal service support under the existing CHCF-A.

In order to avoid a windfall for the five large and mid-size LECs, any subsidy support received from the CHCF-B shall be reduced by the same amount through an equal percentage reduction for all services except for basic service rates. The ILEC and any other designated COLR, shall be entitled to subsidy support for those high-cost CBGs in accordance with the adopted rules. The calculation is made on an access line basis, and is portable to other COLRs who serve residential customers in the high cost CBGs.

7.2.2. Roseville's Position

According to Roseville, the CHCF-B, established in D.96-10-066, provides an alternative to the CHCF-A as an external funding source for replacement revenues to account for changes to the payments made by Pacific. In Roseville's view, however, it is an inferior choice and would require more dramatic changes, including modification of D. 96-10-066 itself, with notice to all parties in the universal service proceeding, either as part of this proceeding or the universal service case (Rulemaking 95-01-020).

Roseville states it currently draws a modest amount (approximately $500,000) of high-cost fund support from the CHCF-B. Roseville's CHCF-B draw is based on the Cost Proxy Model adopted by the Commission in D.96-10-066. Despite the CHCF-B's reliance on the Cost Proxy Model, Roseville believes it may be possible for the Commission to authorize a fixed draw of $11.5 million from the CHCF-B. However, Roseville acknowledges there would need to be a greater number of adjustments made to the CHCF-B process to achieve this result than the changes identified for the CHCF-A. As a consequence, says Roseville, recovery form the CHCF-B is less attractive than recovery from the CHCF-A.

First, CHCF-B draws today are based on a Cost Proxy Model calculation. The CHCF-B rules currently make no provision for fixed draws. The

Commission would need to modify its rules to allow for a draw from the CHCF-B, which is not based on the Commission's Cost Proxy Model.

Second, says Roseville, the $11.5 million annual recovery should not be portable. If the $11.5 million were to become portable, under the CHCF-B rules, it would be portable only for residential customers. In addition, if the amount is portable, it would have to be priced on a per-access-line amount which would then grow as the number of residential access lines grows. In effect, it would no longer be a fixed $11.5 million amount. Accordingly, if Roseville's residential access lines were to grow 5% annually, Roseville's draw from the CHCF-B would increase at a corresponding amount, or in this example, Roseville's draw would increase to approximately $12.1 million. Roseville states that it is willing to accept a fixed amount of $11.5 million that was included in its GRC rate design, if the draw amount is not portable. If the Commission decides that any draw should be portable, the amount of the draw should grow as access lines grow.

Third, the CHCF-B process requires recipients to reduce other rates as an offset to any CHCF-B support they receive because that support is considered "new" money in excess of what just and reasonable rates would otherwise produce. This is not the case with respect to the $11.5 million annual payments received by Roseville. Thus, the CHCF-B would need to be modified to eliminate the requirement that rate offsets be implemented for that portion of the CHCF-B funds received in lieu of the $11.5 million annual payments from Pacific.

7.2.3. ORA's Position

ORA states the CHCF-B is specifically designed to provide a subsidy to large and mid-size LECs for residential basic exchange service in high-cost areas. ORA is opposed to modifying the CHCF-B in order to allow Roseville to recover its $11.5 million in EAS revenues from the fund. Furthermore, asserts ORA, since all contributors to the fund would be impacted, any modification to the fund should be considered, if at all, in the universal service triennial review.

7.2.4. Discussion

Roseville's proposal to use the CHCF-B as a source of revenue recovery suffers from some of the same defects as its proposal to use the CHCF-A. First, since the CHCF-B is funded from a statewide surcharge on all telephone ratepayers in California, Roseville is asking to have its operations subsidized by other California ratepayers. Under Roseville's proposal, the subsidy would be permanent, and not subject to any further scrutiny.

Also, the CHCF-B as formulated in 1996 does not provide any new money to carriers. Any carrier, including Roseville, which receives a draw from the CHCF-B must reduce its rates by the same amount. Further, ORA is correct in noting that the Commission specifically limited the scope of the CHCF-B to carriers providing residential local exchange service in high-cost areas. (See D.96-10-066, Ordering Paragraphs 7 and 8.)

Roseville acknowledges that significant changes would have to be made to the CHCF-B in order for it to be used for permanent draws of a fixed amount. In fact, Roseville's proposal would completely change the character of the CHCF-B from a system of support for CBGs in high cost areas. Roseville would turn the fund on its head and make it the source of a subsidy to Roseville, which we clearly never intended and will not entertain at this time.

We deny Roseville's request to use the CHCF-B as a permanent source of funding to replace the $11.5 million payment from Pacific.

7.3. Use of Funding Sources, Other than CHCF-A and CHCF-B

7.3.1. Roseville's Position

In Roseville's last GRC decision, the Commission identified various means by which reductions in EAS revenues could be replaced. Several possible alternatives were suggested without any conclusive statement made as to which alternative should be followed:

> EAS resolution might be accomplished by a universal services funding mechanism, a rate realignment, or some other approach. (D.96-12-074 at 151.)

The Commission also discussed the possibility of future Z-factor recovery of a revenue shortfall caused by a change in the EAS payments, once again without committing to this particular approach:

> [W]e decline to end Pacific's Extended Area Service (EAS) payment to Roseville. Nonetheless, we may authorize Z factor treatment if and when the EAS payment changes or ends. The EAS payment is a revenue flow to Roseville based on freezing payments at the 1991 level until the Commission renders a decision on how local intercompany traffic should be compensated. If Pacific or Roseville apply for consideration, or the Commission on its own considers the issue, and the EAS flow of funds changes or ends, Roseville may apply for Z-factor treatment. (Id. at 141.)

Roseville states that nowhere in the Roseville rate case decision does the Commission state that changes in the $11.5 million payment from Pacific must be recovered through any particular method. The Commission can choose from the full range of options to replace the $11.5 million payment.

Roseville opposes Pacific's proposal that Roseville recover replacement revenues through a Z-factor surcharge applied to Roseville's subscribers. An increase in rates through a Z-factor surcharge would substantially increase the rates and charges paid by Roseville's subscribers. For example, if the modifications to the EAS payments are treated as a Z-factor and recovered through a surcharge, Roseville's subscribers would pay a surcharge rate ranging between 16% and 22%, depending on the billing base. According to Roseville, Pacific's proposal is self-serving as Pacific's CLEC competes in Roseville's service area for business customers and the use of a surcharge will increase Roseville's business customers' rates which will allow Pacific's CLEC to compete more easily against Roseville. Roseville believes reliance upon the use of a generic surcharge for rate rebalancing would inordinately spread the replacement of this revenue on customers and services that are already paying rates in excess of their respective costs.

7.3.2. ORA's Position

ORA asserts that if the Commission finds that replacement funding is warranted, it should come from Roseville's ratepayers. According to ORA, Roseville's operations will not be jeopardized by the discontinuance of the EAS revenues. Based on Roseville's current financial status, it should not have to raise any rates even if it no longer receives the $11.5 million subsidy from Pacific. In view of Roseville's income statements and reported earnings for the last three years and future earnings, there is no reason why Roseville would not be able to offer its services at current rates, even without the $11.5 million subsidy.

However, if the Commission determines that Roseville is entitled to recover the $11.5 million from another source of funding, ORA asserts that Roseville should recover the revenues from its own ratepayers through rate increases of local exchange services. ORA recommends the following rate design to effectuate this revenue recovery mechanism:

a. Reduce the $11.5 million by the amount that Roseville currently receives from CHCF-B;

b. Increase the rates of local exchange services to cost except for the basic access line services which are currently priced below cost;

c. Increase the rates of local exchange services, except for the basic access line service, by 100 percent;

d. Increase the rates of basic access line services by 15 percent; and

e. Recover any remaining amount by a billing surcharge applied to local exchange services.[8]

This rate design would effectuate the true cost of providing service while at the same time encouraging competition in Roseville's service territory.

ORA states that its proposal would also have a minimal impact on Roseville's local exchange rates. The proposal would not result in rate shock to Roseville's customers. In its GRC, Roseville proposed a higher rate increase than what ORA is proposing in the above rate design, and in its GRC Roseville stated that its rate increase proposal was reasonable. Roseville

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[8] During the hearings, counsel for Roseville asked whether ORA had performed any bill analysis of its rate design. ORA responded that it could not perform a bill analysis because it was not able to obtain the necessary cost information from Roseville. Roseville has not performed a cost study since 1991 alleging that it is too costly, but Roseville also alleges in this proceeding that except for residential access lines, all other services are priced at cost or above cost. (1 R.T. 69-70, Gierczak for Roseville.)

recommended a 40% rate increase to its residential service rates. Here, ORA is merely proposing a 15% rate increase to the residential rates which were adopted in Roseville's GRC. ORA states its rate design is reasonable and would not have an adverse impact on Roseville's customers.

If the Commission finds that the replacement funding should come from an external source and not from Roseville's ratepayers, the funding should be temporary and competitively neutral. As stated in ORA's direct testimony, this can be accomplished by increasing the rates for all existing activated access lines and providing a billing surcredit by an equal amount. The billing surcredit would be portable with each customer regardless of the service provider so that the external funding is competitively neutral. ORA's witness Jarjoura provided an example in his testimony and further clarified his example during the evidentiary hearings. The proposal would work as follows:

Assume that Roseville has 12,000 existing activated access lines and assume that the Commission authorizes $1.44 million to be recovered from an external source. Roseville would increase the rate by $10 per month and provide a billing surcredit equal to $10 per month. If the customer leaves Roseville and switches to another service provider, the customer would take the $10 per month surcredit to the new service provider, thus rendering the surcredit portable with each customer. This proposal would ensure that any replacement funding is competitively neutral. (Exh. 19, p. 6, Jarjoura for ORA; 2 Tr. 209-10.)

According to ORA, if the Commission authorizes permanent external funding, Roseville's NRF status should be suspended and Roseville should be ordered to file for a GRC immediately.

7.3.3. Pacific's Position

Pacific asserts that Z-Factor treatment should be used for any replacement revenues for Roseville. In D.96-12-074, the Commission ordered:

> Roseville is authorized to request exogenous ("Z") factor treatment of the $11.5 million per year extended area service payment from Pacific Bell (Pacific) if that payment changes or ends as a result of a Commission decision, with Commission review of the request before it is authorized. (D.96-12-074 at 166, O.P. 7.)

In its application, Roseville stated that Z-factor treatment would cause a 23% surcharge to be added to its local rates. This would result in its local residential rate increasing from the present rate of $18.90 to $23.25. This new rate level would still be less than the $23.60 that Roseville requested in its last rate case four years ago. (Id. at 146.) Since Roseville did not appear to have any concern about raising its residential rate level to $23.60, the lesser level of $23.25 is not unreasonable, says Pacific.

7.3.4. Discussion

ORA's proposal calls for no replacement funding for Roseville. However, if the Commission finds that replacement funding is warranted, ORA asserts the revenue should be recovered from Roseville's own ratepayers. ORA's rate design includes five separate components. ORA proposes reducing the $11.5 million by the amount that Roseville currently receives from the CHCF-B, which is about $500,000. However, under the rules governing the CHCF-B, Roseville is already required to reduce its rates by the amount it draws from the CHCF-B so no new revenue is generated to reduce the $11.5 million.

ORA's second proposal is to increase to cost the rates of local exchange services that are currently below cost, except for basic access line services. However, according to Roseville, only Roseville's residential rates are priced below cost. (Roseville's Opening Brief at 2.) Therefore, there are no other below-cost services whose rates can be increased. ORA also proposes increasing any rates for local exchange services, except for the basic access line service, by 100 percent, and increasing basic access line services by 15%. ORA would recover any remaining amount by a billing surcharge applied to local exchange services. The net result would be a 15% increase in basic access line services, 100% increase in other local exchange services, and the remainder recovered through a billing surcharge.

Pacific proposes Z-factor treatment for recovering the $11.5 million in revenues which Roseville currently receives from Pacific. According to Pacific, Z-factor treatment would cause a 23% surcharge to be added to Roseville's local rates so that the local residential rate would increase from the present rate of $18.90 to $23.25.

In other words, both ORA and Pacific's rate design proposals would result in rate increases for Roseville's ratepayers. During the two Public Participation Hearings held on June 27, 2000, and in the hundreds of letters received from Roseville's ratepayers, Roseville's customers were almost unanimously opposed to any sort of rate increase. Roseville's customers are well aware that they pay much higher rates than Pacific customers in neighboring exchanges, and they complained about the disparity in rates.[9]

Both ORA and Pacific indicate that no replacement funding is warranted. Pacific bases its recommendation on two major factors. The Commission had expressed concern about Roseville's efficiencies in its GRC decision, D.96-12-074. The Commission disallowed various costs while declining to disallow other costs due to lack of information. Pacific cites paragraph 5.2.3.3 from the decision, where the Commission stated:

> We remain concerned with Roseville's total number of employees devoted to regulated operations, but make no further adjustment. As a measure of productivity, Roseville's number of access lines per employee was 195 in 1993 and fell to 189 in 1994. Over the same period, of 15 California telephone utilities excluding Roseville, nine experienced an increase or no change, and six suffered a decline. Based on this scant information, the trend is for California companies to become more, not less, efficient. Ranked by most access lines per employee, Roseville placed seventh out of the 16 California utilities in both 1993 and 1994. While not the most efficient by this measure with clear room for improvement for a mid-size telephone company, Roseville is also not the least efficient. Thus, we find no basis to further adjust Roseville's number of regulated employees. (D.96-12-074 at 121.)

[9] To protect the privacy of Roseville's customers, we will not include customers' names. However, in the transcript of the two public participation hearings, similar comments were made by customers at several points during the Public Participation Hearings, including 3 R.T. 283, 3 R.T. 286, 3 R.T. 291, 3 R.T. 328, 3 R.T. 330, to name a few.

And in paragraph 5.5.1.3, the Commission stated:

> ORA correctly observes, however, that Roseville's growth in plant per access line is higher than all other telephone companies in California, except for Sierra. Similarly, its growth is second highest out of the 17 firms nationally. We do not have comprehensive data, however, which may reveal factors explaining the higher growth for Roseville, such as the customer mix, change in customer mix, service mix, change in service mix, growth in other services, growth in minutes of use, types of technology deployed, and region-specific cost effects. Because other factors may justify the higher growth for Roseville, we decline to find Roseville's investment unreasonable simply due to the rate of increase. (Id. at 131.)

Pacific points out that as far back as 1996, Roseville's efficiency, or lack thereof, started to come into serious question. Sufficient data, however, was not then available to make a determination. (Exh. 10 at 16, Peters for Pacific.)

The FCC also found indications of inefficiencies in Roseville's operations. We are aware that the FCC's universal service model is currently being reviewed by the U.S. Supreme Court, but the model itself is not the issue here, nor is the specific amount of any disallowance made by the FCC. What is the issue is that the FCC found the model pointed to inefficiencies on the part of Roseville. We find it significant that the FCC has disallowed some of Roseville's interstate costs due to inefficiencies and have determined that this Commission needs to examine Roseville's intrastate operations to see if similar inefficiencies exist.

ORA cites the results of the audit performed by Overland Consulting of Roseville's operations from 1997 through June of 1999. According to ORA, the audit revealed a severe cost misallocation problem. Roseville moved to strike ORA's portions of ORA's Reply Brief which reference Roseville's NRF review proceeding. Roseville takes exception to ORA's discussion of the heavily litigated proceedings in Roseville's NRF review application. Roseville asserts that neither Roseville's NRF review application nor the resulting evidentiary record from the hearings on the application are within the record of this proceeding. Second, even if the Commission considers the evidentiary record in A.99-03-025 in this proceeding, ORA inaccurately characterizes Roseville's positions in that proceeding.

ORA filed its Opposition to Roseville's motion to strike portions of ORA's Reply Brief. ORA asks the Commission to take official notice of the audit report submitted by Overland Consulting in Roseville's NRF proceeding pursuant to Rules 72 and 73 of the Commission's Rules of Practice and Procedure. ORA asserts the audit report is an official record of the Commission as it was marked for identification and moved into evidence in the NRF proceeding. (Exhibit ORA-22 in A.99-03-025.)

Roseville is correct that the audit report and findings are not within the scope of this proceeding. ORA has presented as "fact" issues which were litigated by the parties in the NRF proceeding. While the audit report was moved into evidence in the NRF Review proceeding, it was not introduced in this proceeding, and we decline to take official notice of an exhibit in an ongoing Commission proceeding. We have not yet ruled on that case, and the record of that proceeding is separate and apart from the record of this proceeding. The specific audit results which ORA cites will not be given any weight in this proceeding.

We also question ORA's reliance on Rules 72 and 73 in our Rules of Practice and Procedure. A portion of Rule 72 states as follows:

> If testimony in proceedings other than the one being heard is offered in evidence, a copy thereof shall be presented as an exhibit, unless otherwise ordered by the presiding officer.

ORA did not present the Overland Consulting audit as an exhibit in this proceeding, nor did ORA ask the presiding officer to order that it was not necessary to present the audit report as an exhibit. It is too late to make the request at the briefing stage of the proceeding.

Rule 73 is entitled "Official Notice of Facts." This is intended to deal with published documents such as orders of the FCC which present factual conclusions and orders from that federal agency. The Overland Consulting audit presents purportedly factual material, which has not been authenticated, since we have not yet ruled on the various aspects of the audit report. Therefore, ORA's reliance on Rule 73 in this instance is problematic. We decline to take official notice of the Overland Consulting audit report in A.99-03-025.

We granted Roseville NRF status in D.96-12-074, and have no intention of returning Roseville to rate-of-return regulation. We have long stated our preference that local exchange companies be regulated under NRF. NRF regulation puts a direct profit incentive on the companies which tends to generate efficiency-producing programs. One of our key goals for NRF companies is economic efficiency, both productive efficiency and pricing efficiency.

We approved Roseville's NRF status with the explicit recognition that the $11.5 million payment from Pacific was a significant portion of Roseville's revenues. (D.96-12-074 at 151.) And, at that time, we recognized that the EAS payment from Pacific would be eliminated at some point in the future. In hindsight, it would have been best to eliminate the payment as part of the GRC/NRF proceeding, but as we stated then:

> This EAS payment ($11.5 million) is a significant portion of Roseville's revenues ($11.5 million out of Roseville's $98.3 million estimated test year 1996 total company revenues, $77.0 million intrastate revenues, at present rates). The flow of funds from alternative treatment of intercompany traffic must be carefully considered before reaching a decision, including careful attention to collecting this revenue from Roseville's ratepayers. The parties have not presented sufficient assessment of this topic to authorize changes at this time, nor has a reasonable alternative been presented for recovering these costs should we eliminate the EAS payment. (Id.)

In other words, at the time of Roseville's GRC, we did not have an adequate record before us to determine the best method for recovering the revenues. We mentioned the possibility of using a Z-factor and also the possibility of universal service funding, but declined to set a specific method of revenue recovery at that time.

Now four years later we find ourselves entertaining a request from Roseville for replacement revenues for the $11.5 million payment from Pacific. This is complicated by the fact that both Pacific and ORA point to

Roseville as a financially healthy company with exceptionally high corporate expenses in some areas. As Peters cited, the FCC even found cause to disallow some of Roseville's interstate expenses. None of these studies provide us with enough information to conclude that Roseville does not need the $11.5 million payment as part of its revenue requirement. There is no direct cause and effect analysis presented by either Pacific or ORA, which link the specific amount of $11.5 million to increases in revenues or high expense levels. However, we cannot in conscience adopt a rate increase for Roseville's ratepayers to provide the additional revenues without first reexamining Roseville's expense levels and revenue requirement.

In its Comments on the Proposed Decision (PD), Roseville took exception to the PD's statement that the Commission had never before been in the position of having to deal with replacing a sizable outside subsidy to a NRF company several years after granting NRF status. According to Roseville, the Commission faced precisely the same situation with another NRF LEC, GTE California (GTEC).

Roseville states that in 1989 GTEC exited the revenue pooling arrangement that it had entered into with Pacific, which had resulted in a flow of revenues from Pacific to GTEC. To facilitate the termination of pooling between GTEC and Pacific, Pacific agreed to make transitional payments to GTEC. In 1990, GTEC received approximately $195.3 million from Pacific. In setting GTEC's rate design under the original NRF decision, the Commission factored in the significant payments GTEC was receiving from Pacific. <u>See</u> 41 CPUC2d 1, 11 (D.91-07-044). This is precisely the same treatment the Commission afforded to Pacific's EAS payments to Roseville when the Commission established Roseville's original NRF in D.96-12-074.

In its Implementation Rate Design decision (D.94-09-065), the Commission did not consider reviewing GTEC's revenue requirement, but instead focused on replacing the revenues which the Commission had incorporated into GTEC's rate design in the original NRF decision, although five years had passed since that decision. The replacement revenues were considered a rate design issue, and the Commission created a rate design for GTEC that replaced the payments from Pacific on a dollar-for-dollar basis. According to Roseville, it occupies precisely the same position that GTEC occupied when the Commission addressed the replacement of payments from Pacific to GTEC. Roseville asserts there is no basis in the record which supports discriminatory treatment between GTEC and Roseville.

We do not agree that the situation is the same with Roseville, as it was for GTEC. On the contrary, the situation with Roseville is unique and our treatment of it must also be unique. This instant proceeding raised issues of inefficiencies on the part of Roseville which we have determined we must examine further; there were no such allegations surrounding the payment to GTEC.

Furthermore, in the decision which approved Roseville's entry into NRF, we left the door open that we could at some point in the future choose to impose some elements of rate of return regulation on Roseville, for then unspecified reasons:

> We decline to satisfy Roseville's request that we affirm rate of return regulation is no longer applicable to Roseville and no traditional ratemaking issues will henceforth be heard. The 'clean break' Roseville believes we need to make is made with our decision to convert Roseville to NRF regulation. That is not to say, however, that rate of

> return issues may never arise nor be considered. (D.96-12-074 at 144.)

We find it appropriate at this point in time to order further examination of Roseville's revenue requirement and expenses in light of Roseville's request for the Commission to find an alternate source of funding to replace the $11.5 million EAS payment currently received from Pacific. Without resorting to traditional rate of return data, we are unable to analyze Roseville's revenue needs and the continued need for the $11.5 million as part of its revenue requirement.

NRF is the cornerstone of our regulation of all large and mid-sized LECs in California, and we do not intend to change that. However, in the case of Roseville, we need to recalibrate Roseville's revenue requirement to determine whether Roseville is able to absorb some or all of the $11.5 million or whether the revenue must come from Roseville's ratepayers. Our ultimate goal is to have Roseville dependent on its own resources for its revenue requirement. In today's competitive environment, a competitor in the telecommunications market should not have the advantage of an outside subsidy to fund its operations.

We do not propose to rescind Roseville's NRF status, and Roseville will continue to operate as a NRF company during the pendency of our investigation. It is not our intention to conduct a full-blown GRC for Roseville. We do not intend to perform a rate design (except to the extent necessary if we determine some of the revenues must come from Roseville's ratepayers). Also, we do not intend to review the rate of return adopted for Roseville in D.96-12-074. Rather, we will focus our attention on Roseville's current revenue requirement and expense levels.

Therefore, we order the assigned Administrative Law Judge to prepare an OII within 45 days of the effective date of this order for our consideration. The focus of the OII will be to investigate Roseville's expense levels and revenue requirement. We are aware that Overland Consulting recently conducted an extensive audit of Roseville's operations, but that audit focused on allocation between Roseville's regulated and nonregulated operations. The audit was too tightly focused to provide us with all the information we need to investigate Roseville's revenue requirement. However, the results of that audit and our findings in Roseville's NRF review could point to expenses which should be disallowed, which could make up some of the $11.5 million. Therefore, we will incorporate the record of proceeding A.99-03-025 and its outcome into the record of the OII so that we can take advantage of information gleaned in that audit.

We find it difficult to consider any sort of rate increase for Roseville's ratepayers until we can assure ourselves that Roseville is an efficiently run company. The OII we are ordering will allow us to address that issue and determine a method and amount of revenue recovery that is fair to Roseville and to its ratepayers.

7.4. Temporary Replacement Revenues for Roseville

We have expressed the view that continuation of the payment from Pacific to Roseville is anti-competitive, so we will terminate that obligation 60 days from the effective date of this order. However, Roseville is entitled to recovery of the $11.5 million on an interim basis while we reconsider Roseville's revenue requirement, since we established in Roseville's GRC four years ago that the $11.5 million made up a significant portion of Roseville's revenue requirement.

We have considered two options for temporary revenue recovery, during the period while we are conducting our investigation into Roseville's operations. First, we considered establishment of an All End User Surcharge (AEUS) such as Roseville proposed in its previous GRC, to make up the $11.5 million of its revenue requirement. (Id. at 156-157.) In that scenario, all telecommunications carriers in the state would be ordered to bill their end-user customers and remit the surcharge revenue collected. The billing base would be the same as for the public program surcharges collected by the Commission, such as for the CHCF-B.

The AEUS would be an interim expedient, lasting only two years or so until we complete our OII on Roseville's revenue requirement. However, with the proliferation of surcharges on customers' bills, it is not a preferred option to add another surcharge line item to customers' bills. Also, we recognize that carriers expend substantial resources updating billing programs to implement Commission-mandated changes, and do not want to require carriers to update their billing programs to accommodate a temporary surcharge which will continue for only a few years. Also, carriers need 6-8 months lead time to update their billing programs to add a new surcharge line item, and we prefer not to delay termination of the current payment from Pacific to Roseville.

Second, we considered use of CHCF-B funds on a temporary basis, even though here we have rejected use of CHCF-B funds as a permanent replacement for the EAS payments. We are aware that the CHCF-B currently has a substantial reserve. The reserve is projected to be about $160 million at the end of year 2000.[10] The CHCF-B has the same billing base that we would use for an AEUS so the same end-user customers would be paying for an AEUS as contribute on an ongoing basis to the CHCF-B. Rather than set up a new surcharge, we will make use of the reserve in the CHCF-B. Because of the sizable balance in the CHCF-B, we would not be collecting surcharges from customers to fund the payments to Roseville on a prospective basis. If two years of payments to Roseville are taken from the CHCF-B, that would amount to $23 million, which would not have a negative impact on the operation of the CHCF-B.

As Roseville acknowledges, use of CHCF-B funding to replace the $11.5 million in EAS revenues would require that the Commission deviate from the rules governing the CHCF-B established in D.96-10-066. We disagree, however, that deviating from those rules on an interim basis pending resolution of the OII we order in this decision would necessitate wholesale modifications to the universal service program.

Section 276 of the Public Utilities Code codified the CHCF-B and its administrative committee. Section 276(a) specifies that the purpose of the program is to "provide for transfer payments to telephone corporations providing local exchange services in high-cost areas in the state to create fair and equitable local rate structures...." The statute authorizes the Commission to establish a program for the stated purpose, and the Commission did so in D.96-10-066.

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10 Resolution T-16409, June 8, 2000, p. 5.

The Commission created the universal service fund in order to ensure that customers in high-cost areas would be able to obtain local telephone service at affordable rates. The mechanics of the program specifically authorize use of CHCF-B funds to compensate eligible carriers for costs that otherwise would be passed along to ratepayers in the form of higher rates. In this proceeding, we have determined that the $11.5 million EAS payments constitute a significant percentage of Roseville's annual revenue requirement. As we stated earlier in this decision, without a further analysis of Roseville's revenue requirement we cannot determine whether the $11.5 million remains a necessary component of that revenue requirement. Should we decide here, without an adequate record, that Roseville can get by without the $11.5 million dollars, we run the risk that Roseville will be harmed financially and its customers may suffer. In the alternative, allowing Roseville interim recovery of the $11.5 million EAS payments affords protection of Roseville's customers as we evaluate the company's status in the OII we order here.

Finally, as the purpose of the CHCF-B is to maintain affordable rates for local exchange customers in high-cost areas, the risk that Roseville would need to raise its rates to recoup the $11.5 million justifies the transfer of payments contemplated by Public Utilities Code Section 276.

Parties to this proceeding have been on notice from the filing of Roseville's application that the Commission was considering use of funds from either the CHCF-A or the CHCF-B to cover the loss to Roseville of the $11.5 million EAS payments once the agreement between Roseville and Pacific is terminated. Parties have commented on the proposals, and on the specific elements of the proposals which deviate from the universal service rules adopted in D.96-10-066. Based on this record we authorize a narrow, limited deviation from the universal service rules in order to allow Roseville to receive the transfer from the CHCF-B of $11.5 million to replace the EAS payments. We authorize this arrangement on an interim basis, pending a determination in the OII we issue here as to whether the $11.5 million continues to comprise a necessary component of Roseville's annual revenue requirement.

We must stress that this use of the CHCF-B reserves is simply a temporary expedient and should not be deemed to be precedent-setting in any way. The monthly payments Roseville receives pursuant to this order should not be subject to the rules governing the CHCF-B and shall be separate and apart from any draws Roseville receives under the CHCF-B for providing service in high-cost CBGs. The payment to Roseville is not portable to other carriers.

Therefore, beginning the 75th day from the effective date of this decision, we will order the California High Cost Fund – B Administrative Committee to make monthly payments to Roseville in the amount of $958, 333. Those temporary monthly payments to Roseville, which total $11.5 million per year, will be made on the same day each month and will continue until we approve a final decision in Roseville's OII and order an end to the payments.

However, Roseville should not view this monthly subsidy as without any strings attached. In return, we expect Roseville to cooperate fully in our OII, and do all in its power to maintain the schedule in the scoping memo issued by the Assigned Commissioner in the upcoming OII. If Roseville does not cooperate fully with the assigned ALJ, Commission staff and parties to the proceeding to move the case forward in an expeditious manner, we direct the assigned ALJ to prepare a decision for our consideration, recommending elimination of a portion of the subsidy payment. We are serious about moving this OII forward so that we can eliminate the California ratepayer subsidy of Roseville's operations, and we will commit the necessary Commission resources to completing the OII as quickly as possible.

8. Should Pacific Refund the $11.5 Million to its Ratepayers?

8.1. ORA's Position

ORA asserts that if the Commission terminates the EAS payments and thereby ends Pacific's financial obligation to Roseville, Pacific should be ordered to refund the $11.5 million to its ratepayers. According to ORA, the $11.5 million must be returned to ratepayers because Pacific is currently collecting this amount through its rates. This implies that there is a cost to Pacific, and Pacific is authorized to recover its cost. Thus, if Pacific is no longer obligated to make EAS payments to Roseville, it should not be allowed to collect the $11.5 million annually through rates. Otherwise, there would be a windfall of $11.5 million to Pacific on an annual basis.

ORA states that refunding the EAS revenues to ratepayers is proper and consistent with the Commission's actions in the past. According to ORA, Pacific also had EAS agreements with Citizens and GTEC, (now Verizon), whereby Pacific provided a subsidy for EAS traffic. Recognizing that EAS agreements were only intended to be temporary and intended to be eliminated by 1997, the EAS agreements between Pacific and Citizens and between Pacific and GTEC were eliminated in 1997. The elimination of those EAS payments to the two LECs was reflected in Pacific's rates through a Z factor adjustment in its price cap filing.

Even though Pacific adjusted its rates to reflect the elimination of its EAS payments to Citizens and GTEC, Pacific asserts that it should not be required to adjust its rates in this proceeding. According to ORA, Pacific asserts that an adjustment cannot be done because an EAS cost change does not qualify for limited exogenous (LE) treatment.

ORA references D.98-10-026 in which the Commission streamlined Z-factor treatment by eliminating new Z factor adjustments and adopting a limited exogenous framework.[11] According to ORA, the Commission held that only two types of cost decreases or increases qualify for LE adjustments: (1) matters mandated by the Commission and (2) changes between federal and state jurisdictions. Pacific's witness Borsodi states that EAS does not qualify as an LE-factor because "the termination of Pacific's obligation to pay the EAS payments to Roseville is not a Commission mandated cost change." (Exh. 16 at 5, Borsodi for Pacific.) Furthermore, Borsodi states "the Commission does not need to issue a decision ordering Pacific to end the payments." (Ibid.) ORA states that Borsodi's characterization of the STA and his interpretation of the Commission's LE framework are flawed and plainly incorrect.

First, says ORA, the STA states that Pacific and Roseville agree to use their best efforts to negotiate a permanent EAS arrangement. However, if they fail to reach a new EAS arrangement by 1997, either party or the parties may jointly request the Commission to establish a permanent EAS arrangement. ORA

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[11] D.98-10-026, Rulemaking on the Commission's Own Motion into Third Triennial Review of the Regulatory Framework Adopted in Decision 89-10-031 for GTE California Incorporated and Pacific Bell, mimeo. at 61 (October 9, 1998).

does not dispute that the STA allows Pacific and Roseville to end the EAS payments, without the Commission's approval or intervention. However, in this case, the parties have been unable to reach a new agreement on their own. Hence, says ORA, Pacific's EAS obligation to Roseville still exists and this issue is now before the Commission for a resolution. Thus, concludes ORA, it would qualify as an LE factor.

ORA states there are other available options, in addition to the LE-factor option, that the Commission can use to order Pacific to make the EAS cost adjustment. D.98-10-026 allows the Commission to address new rate adjustments such as EAS outside of the LE realm. The decision states as follows:

> [N]ot every Commission-mandated cost change will necessarily be reflected in rates, unless considered by the Commission at the time the program or event causing the cost change is authorized, and the change is therein approved for LE factor recovery. Moreover, in considering whether the cost will be allowed, we will consider whether the cost is unique to Pacific…or is a cost generally borne uniformly by all carriers in the industry. (D.98-10-026 at 61-62.)

According to ORA, by this statement the Commission correctly recognized that there may arise circumstances where a cost adjustment will be necessary. The $11.5 million EAS cost is clearly unique to Pacific because only Pacific's ratepayers are assessed the cost of EAS payments to Roseville. The potential of double recovery should be avoided, says ORA. ORA concludes that even if the Commission finds that the EAS cost change does not meet the LE criteria, the Commission could still order revenue adjustments resulting from the EAS arrangement pursuant to D.98-10-026.

ORA rejects Pacific's allegation that it has refunded more than it received for EAS in the start-up revenue requirement. In January 2000, ORA and Pacific met and at that time Pacific provided an analysis of its rate changes associated with EAS payments. (See Exh. 18.) According to that analysis, Pacific stated that its startup revenue requirement for EAS was $32.8 million. Months later, Pacific revised its startup revenue requirement for EAS downward to $25.155 million. According to ORA, Pacific's witness Borsodi could not provide an explanation of why the start-up revenue amount had changed, but indicated the accounting people who prepared the information had not consulted with him on the development of the startup number.[12] ORA points out that Borsodi was present at the January 2000 meeting and did not dispute the $32.8 million amount at that time.[13] ORA concludes it is questionable whether $25.155 million is the correct startup amount as Pacific alleges or $32.8 million or some other figure.

Pacific's growth in local service revenues also undermines its assertion that it has refunded more than what it has received for EAS. From 1989 to 1999, Pacific's local service revenues increased 61%. Pacific's number of access lines also increased 34.3% over the same period. (Exh. 25.) Thus, even though Pacific alleges that it has refunded more money than it has received, that allegation is questionable at best, states ORA.

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[12] 2 R.T. 167.

[13] Id. at 166-167.

8.2. Pacific's Position

Pacific refutes ORA's position that Pacific should return the $11.5 million to ratepayers. According to Pacific, the adjustments that were made to Pacific's rates in the past, when EAS payments were terminated, were made under the Z-factor mechanism of NRF, before the Commission eliminated Z-factors in D.98-10-026. The Z-factor mechanism was replaced by the LE factor mechanism which allows adjustments for cost increases or decreases resulting from: (1) matters mandated by the Commission; and (2) changes in total intrastate cost recovery resulting from changes between federal and state jurisdictions. Further, states Pacific, in D.98-10-026, the Commission stated that:

> Z-factor recovery shall be continued until fully implemented only for the following adjustments: (1) $200 to $500 capital to expense shift, (2) merger refund authorized in D.97-03-067, (3) gain on sale of land, (4) other billing and collections jurisdictional cost shift, (5) results of Order Instituting Investigation 92-03-052 regarding property taxes, (6) a $99.5 million annual reduction in Pacific's rates for post retirement benefits other than pensions (PBOP) and a $24.025 million annual reduction in GTE's rates for PBOPs, and (7) a $12.656 million reduction in GTE's customer notification and education program costs. (D.98-10-026 at 93.)

Pacific asserts that EAS payments are a subset of intraLATA toll pooling costs. The $19.3 million and $7 million in refunds to which ORA's witness Jarjoura refers were a subset of a total reduction of $36.9 million associated with termination of intraLATA toll pooling payments in Resolution T-15976. In that Resolution, the Commission classified the rate reduction as a Z-factor.

Today, says Pacific, the Commission no longer recognizes changes in intraLATA toll pooling arrangements for Z-factor or LE-factor treatment. The Commission has explicitly discontinued the Z-factor mechanism and has specifically excluded changes in IntraLATA Toll Pooling costs from LE-factor treatment. In D.98-10-026 the Commission stated:

> Our elimination of new Z-factor adjustments means we will no longer authorize recovery for exogenous cost changes, such as Commission-adopted Financial Accounting Standards Board accounting changes, changes in intraLATA toll pooling, or changes in federal or state tax laws. (Id. at 61.)

Furthermore, Pacific states it proved that Pacific refunded more than it received in the start-up revenues established in NRF so a further refund is not warranted. Pacific provided the Commission with the EAS payments made to each company for the period 1989 to 1999 and the costs included in the startup revenue requirement. Simple calculations provide a reasonable demonstration that Pacific has paid substantially more than the costs reflected in the startup revenue requirement. According to Pacific, EAS payments to Roseville were $8.1 million and $8.6 million for 1990 and 1991, respectively, and $11.5 million in 1992 and thereafter. In contrast, a reasonable estimate of the costs in the start-up revenue requirement for EAS payments to Roseville is less than $3.0 million annually.[14] In other words, says Pacific, it has been paying Roseville between $5 million and $8.5 million more annually over the last ten years than was reflected in the startup revenue requirement. Over the 10-year period, EAS payments to

[14] Exh. 17, Rebuttal testimony of Borsodi for Pacific at Exh. EGB-1.

Roseville have been about $80 million more than the EAS costs included in the startup revenue requirement.[15]

Pacific reviewed total EAS payments made by Pacific to all companies that were eligible to receive such payments since 1989 and compared that to total EAS costs in the start-up revenue requirement, net of rate adjustments made by Pacific in annual price cap filings, and found the shortfall is more severe. According to Pacific, its total EAS costs reflected in the startup revenue requirement were $25.155 million annually. Rate reductions that were ordered in ensuing annual price cap resolutions reduced rates by an annual amount of $27.026 million. Therefore, Pacific states it has already refunded approximately $1.9 million more in annual rate reductions than what was included in the start-up revenue requirement. Over the same period of 1990-1999, actual EAS payments significantly exceeded the costs included in the start-up revenue requirement. According to Pacific, the total difference over the 10-year period has been over $131.0 million.[16]

Pacific states that ORA's opinion that Pacific should refund EAS payments even if such payments are not reflected in Pacific's rates should likewise be disregarded. ORA's original position, as stated in its prehearing conference statement, was that Pacific should only be required to refund EAS payments if these payments were reflected in Pacific's rates.[17] Pacific asserts that

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[15] Id. at 6-7.

[16] Id. at Exh. EGB-2.

[17] Prehearing Conference Statement of ORA at 5.

because Pacific has shown that these payments are not in rates, ORA's story has changed. Pacific states that requiring it to refund money it is not collecting in rates amounts to a taking.

In its Reply Brief, Pacific rebuts ORA's argument that since Pacific refunded EAS payments previously, it should do so now. This ignores the fact that D.98-10-026 ordered that these cost charges should no longer be recognized as Z-factor or LE-factor adjustments. The refunds that ORA cites were all prior to the issuance of D. 98-10-026. As Pacific's witness testified, Pacific was not even aware until after the decision was issued that it had refunded more than it had ever collected in the start-up NRF adjustments. Pacific asserts the Commission should follow its directive in D.98-10-026 and find that ORA's request for an LE-factor is unsupportable.

Pacific refutes ORA's position that because Pacific and Roseville could not reach a new agreement on their own, Commission intervention is necessary, and therefore the $11.5 million qualifies as an LE-factor. Pacific states ORA relies on an incorrect fact to come to its conclusion. Recently, Roseville and Pacific reached a new agreement on a permanent EAS arrangement, which has been filed in this proceeding.

Also, states Pacific, ORA's quote from D.98-10-026 means the opposite of what ORA claims. ORA cites the following language from the decision:

> [N]ot every Commission-mandated cost change will necessarily be reflected in rates, unless considered by the Commission at the time the program or event causing the cost change is authorized, and the change is therein approved for LE factor recovery. Moreover, in

> considering whether the cost will be allowed, we will consider whether the cost is unique to Pacific…or is a cost generally borne uniformly by all carriers in the industry. (Id. at 61-62.)

ORA interprets this statement to conclude that the Commission "recognizes that there may arise circumstances wherein a cost adjustment will be necessary…[t]hus…the Commission could still order revenue adjustments resulting from the EAS arrangement pursuant to D.98-10-026. (ORA's Opening Brief at 15.) According to Pacific, ORA's interpretation does not make sense. The plain language of the citation clearly intends to limit LE factors potentially even beyond what the criteria for LE-factor treatment might indicate, not to expand LE-factor opportunities or imply discretion by the Commission. In fact, the paragraph from which ORA's cite was taken explains the Commission's intent when it states "[t]o further streamline the process, we limit rate changes for Commission-mandated cost changes." (D. 98-10-026 at 61.) The Commission also states, "our elimination of the Z-factor mechanism, and replacement with an LE-factor mechanism, is essentially a further narrowing and simplification of the existing process."

8.3. Discussion

The resolution of this issue turns on parties' varying interpretations of D.98-10-026. We will clarify our intent in that decision, but to place our discussion in context, we must first summarize the history of exogenous factors in NRF. When we first adopted the NRF framework for Pacific in D.89-10-031, we included changes in IntraLATA Toll Pooling as one of the initial Z-factors:

> As a starting point, we accept the following factors: changes in federal and state tax laws to the extent they

> affect the local exchange carriers disproportionately, mandated jurisdictional separations, changes to intraLATA toll pooling arrangements or accounting procedures adopted by this Commission, changes in regulatory amortizations such as expensing of station connections, and reflection of tax benefits resulting from premature retirements of high coupon bonds pursuant to D.88-12-094.[18]

In other words, changes in intraLATA toll pooling arrangements, of which EAS is a subset, was clearly delineated as an allowable exogenous factor. And in fact, as ORA points out, when Pacific ended its EAS agreements with Citizens and GTEC in 1997, the elimination of the EAS payments was reflected in Pacific's rates through a Z factor adjustment in Pacific's annual price cap filing.

At the end of 1998, after we approved Z-factor treatment for those EAS adjustments, we issued D.98-10-026. That decision in the Third Triennial Review of our NRF program for Pacific & GTEC made substantial changes in the treatment of exogenous factors. We eliminated consideration of any new Z-factor adjustments. (D.98-10-026 at 60.) We also examined all existing Z-factors, including intraLATA toll pooling, and determined which Z-factors should be phased out over time. We developed a list of seven items which would be allowed continued Z-factor treatment on a limited time basis. IntraLATA toll pooling was not included on that list of allowable Z-factors. To the contrary, we specifically excluded changes in intraLATA toll pooling, as Pacific cited above, as follows:

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[18] D.89-10-031, [33 CPUC2d 43, 137-138].

> Our elimination of new Z-factor adjustments means we will no longer authorize recovery for exogenous cost changes, such as Commission-adopted Financial Accounting Standards Board accounting changes, changes in intraLATA toll pooling, or changes in federal or state tax laws. (Id. at 61.)

In other words, we made it clear that intraLATA toll pooling would no longer be included among allowable Z-factor adjustments.

According to ORA, while we eliminated intraLATA toll pooling as a Z-factor, the EAS adjustment could be treated as an LE factor, under the new criteria adopted in D.98-10-026. In order to clarify our intent in that decision, we need to review the entire relevant portion of the text, including the portion cited above:

> Our elimination of new Z-factor adjustments means we will no longer authorize recovery for exogenous cost changes, such as Commission-adopted Financial Accounting Standards Board accounting changes, changes in intraLATA toll pooling, or changes in federal or state tax laws. We will, however, allow continuation of a streamlined process for requests in two narrow areas: requests for recovery of cost increases or decreases resulting from (1) matters mandated by the Commission and (2) changes in total intrastate cost recovery resulting from changes between federal and state jurisdictions. (Ibid.)

ORA asserts the EAS payment should be included as an LE-factor because it fits the criteria of number (1) "matters mandated by the Commission." We agree that we have the authority to mandate the end of the EAS payment from Pacific to Roseville, and are doing so in this order. However, ORA's interpretation of our intent is not correct. As cited above, we eliminated recovery for exogenous cost changes for intraLATA toll pooling for Pacific and GTEC. Our former Z-factor and the LE-factor we adopted in D.98-10-026 both relate to "exogenous cost changes" so we clearly intended that intraLATA toll pooling would be exempt from either Z-factor *or* LE-factor treatment when we said that we would not authorize recovery for exogenous cost changes for changes in intraLATA toll pooling.

ORA cites a paragraph from D.98-10-026 which ORA interprets as allowing the Commission to order revenue adjustments, other than through an LE-factor. ORA has taken that particular paragraph out of context. Following is that paragraph with the leading two sentences included to give the proper context to our words:

> We allow these two exceptions [the two LE factor exceptions] because they remain potentially significant exogenous events outside utility management control. To further streamline the process, we limit rate changes for Commission-mandated cost changes (either increases or decreases) to only those costs for which an LE factor adjustment is authorized in the underlying Commission decision. That is, not every Commission-mandated cost change will necessarily be reflected in rates, unless considered by the Commission at the time the program or event causing the cost change is authorized, and the change is therein approved for LE factor recovery. Moreover, in considering whether the cost will be allowed, we will consider whether the cost is unique to Pacific and/or GTE, or is a cost generally borne uniformly by all carriers in the industry. (Id. at 61-62.)

The language ORA cited must be reviewed in the context of our adopted rules for the implementation of the LE-factor. That entire paragraph pertains to LE-factors, and ORA's assertion that the second part, taken alone, means that the Commission will address rate changes outside of the LE context is without merit, and is not supported by the plain language of the decision. The entire paragraph deals with treatment of LE factor adjustments.

ORA's proposal that Pacific refund the $11.5 million to its ratepayers is rejected, as it is inconsistent with our directive in D.98-10-026. Therefore, the analysis of whether or not Pacific has paid more than its start-up revenue requirement is moot, and will not be addressed.

9. Comments on Proposed Decision

The Proposed Decision of Administrative Law Judge Karen Jones in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on November 7, 2000 and November 9, 2000 and reply comments were filed on November 14, 2000. We have taken the comments into account in finalizing this order.

Findings of Fact

1. It is not sustainable in a competitive environment for one company to make subsidy payments to its competitor.

2. The Commission found that the $11.5 million EAS payment from Pacific to Roseville made up a significant part of Roseville's start-up revenues in its last GRC decision.

3. A utility whose rates are regulated by a government agency is entitled to the opportunity to earn a reasonable rate of return.

4. The Commission did not have an adequate record in this proceeding to support ORA and Pacific's contentions that Roseville does not need any replacement revenue for the $11.5 million.

5. The requirements for the waterfall and the means test ensure that the companies that draw from the CHCF-A are submitting themselves periodically to Commission scrutiny of their operations, and are not over-earning.

6. In D.96-10-066, the Commission stated its intent that larger LECs draw from the CHCF-B, and smaller LECS draw from the CHCF-A.

7. Significant changes would have to be made to the CHCF-B in order for it to be used for permanent draws of a fixed amount.

8. Both ORA's and Pacific's rate design proposals would result in rate increases for Roseville's ratepayers.

9. The audit report and findings from Roseville's NRF proceeding, A.99-03-025, are not within the scope of this proceeding.

10. The Commission has long stated its preference that local exchange companies be regulated under NRF.

11. NRF regulation puts a direct profit incentive on the companies which tends to generate efficiency-producing programs.

12. One of the key goals for NRF companies is economic efficiency.

13. At the time of Roseville's last GRC, the Commission did not have an adequate record to determine the best method for recovering the $11.5 million in revenues.

14. In D.96-12-074, the Commission mentioned the possibility of using a Z-factor or universal service funding, but did not set a specific method of revenue recovery for the EAS payment from Pacific.

15. The Commission approved Roseville's NRF status with the explicit recognition that the $11.5 million payment from Pacific was a significant portion of Roseville's revenues.

16. Changes in intraLATA toll pooling arrangements, of which EAS is a subset, were clearly delineated as an allowable exogenous factor in D.89-10-031.

17. When Pacific ended its EAS agreements with Citizens and GTEC in 1997, the elimination of the EAS payments was reflected in Pacific's rates through a Z-factor adjustment.

18. In D.98-10-026, intraLATA toll pooling was not included on the list of seven items which would be allowed continued Z-factor treatment.

19. Changes in intraLATA toll pooling were explicitly eliminated as a Z-factor adjustment in D.98-10-026.

20. Z-factors and LE factors both relate to exogenous cost changes.

Conclusions of Law

1. The $11.5 million annual EAS payment from Pacific to Roseville should be discontinued.

2. The terms of the Settlement Transition Agreement require Pacific to make payments to Roseville until a replacement funding source is implemented.

3. The new bill and keep arrangement between Roseville and Pacific should not go into effect until the Commission implements an alternative funding arrangement for the current EAS payment.

4. Eliminating the $11.5 million from Roseville's revenue stream without any reanalysis of Roseville's revenue requirement would constitute a taking.

5. Allowing Roseville to draw from the CHCF-A to recover the $11.5 million is anticompetitive since it allows Roseville to receive an outside subsidy that is not available to its competitors.

6. Roseville is not a small LEC and therefore is not covered by the provisions of Public Utilities Code Section 739.3(a).

7. The administrative rules to the CHCF-A and CHCF-B should not be modified to allow Roseville to draw on the funds as a permanent part of its revenue requirement.

8. The Commission should examine Roseville's intrastate operations to see if inefficiencies exist, similar to those found by the FCC for Roseville's interstate operations.

9. It is appropriate for the Commission to order further examination of Roseville's revenue requirement and expenses, in light of Roseville's request for the Commission to find an alternate source of funding to replace the $11.5 million payment currently received from Pacific.

10. The Commission should recalibrate Roseville's revenue requirement to determine whether Roseville is able to absorb some or all of the $11.5 million or whether the revenue must come from Roseville's ratepayers.

11. A competitor in the telecommunications market should not have the advantage of an outside subsidy to fund its operations.

12. The record of proceeding A.99-03-025 should be incorporated into the OII ordered in this decision so the Commission can take advantage of the information gleaned in the audit associated with the proceeding.

13. Roseville is entitled to recovery of the $11.5 million on an interim basis while we reconsider Roseville's revenue requirement, since the Commission established in Roseville's GRC four years ago that the $11.5 million made up a significant portion of Roseville's revenue requirement.

14. The monthly subsidy payments Roseville receives pursuant to this order should not be subject to the rules governing the CHCF-B and should be separate and apart from any draws Roseville receives under the CHCF-B for providing service in high-cost CBGs.

15. The CHCF-B Administrative Committee should make monthly payments to Roseville in the amount of $958,333. Those temporary payments should continue until further order of the Commission.

16. The monthly payments to Roseville should be contingent on Roseville's cooperating fully with the assigned ALJ, Commission staff and other parties to the proceeding to move the investigation forward in an expeditious manner.

17. For Pacific, changes in intraLATA toll pooling are exempt from either Z-factor or LE-factor treatment.

O R D E R

IT IS ORDERED that:

1. Pacific Bell Telephone Company shall be authorized to discontinue its $11.5 million Extended Area Service payment to Roseville Telephone Company (Roseville). Pacific shall remain obligated to Roseville under the EAS arrangement through the calendar month in which this order is adopted. Pacific shall pay in full all amounts owed to Roseville within 60 days of the effective date of this order.

2. The California High Cost Fund B Administrative Committee is ordered to make monthly payments from the Fund to Roseville in the amount of $958,333 per month. The first calendar month for which the fund shall make payment to Roseville will be the calendar month following the month in which this order is adopted. Payment for a particular calendar month shall be made within 30 days of the end of that month. Those payments shall continue on an interim basis until further order of the commission. Those payments shall continue on an interim basis until further order of the Commission.

3. The assigned Administrative Law Judge (ALJ) shall prepare an Order Instituting Investigation into Roseville's revenue requirement, for our consideration, within 45 days of the effective date of this order.

4. The record in Application 99-03-025, Application of Roseville (U 1015 C) to review its New Regulatory Framework, shall be incorporated into the record of the Order Instituting Investigation ordered in this decision.

5. In the event that Roseville does not cooperate fully with the assigned ALJ, Commission staff and other parties to the proceeding to move the case forward in an expeditious manner, the assigned ALJ shall prepare a decision recommending elimination of a portion of the subsidy payment.

6. Roseville's June 29, 2000, motion to strike portions of the Office of Ratepayer Advocates' Reply Brief is hereby denied.

7. The May 30, 2000, Joint Motion of Roseville and Pacific Bell Telephone Company for Admission of Interconnection Agreement as Late Filed Exhibit, is hereby granted.

8. This proceeding is closed.

This order is effective today.

Dated November 21, 2000, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
JOSIAH L. NEEPER
RICHARD A. BILAS
CARL W. WOOD
Commissioners