

Decision 00-05-020 May 4, 2000

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Pacific Bell (U 1001 C), a Corporation, for Authority to Categorize Centrex as a Category III Service.

Application 98-07-020
(July 8, 1998)

In the Matter of the Application of Pacific Bell (U 1001 C), a Corporation, for Authority to Categorize Toll-Free (8XX) and Business MTS IntraLATA Toll Services as Category III Services.

Application 98-07-029
(July 10, 1998)

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TABLE OF CONTENTS

| Title | Page |
|--|------|
| OPINION..... | 2 |
| I. Summary..... | 2 |
| II. Jurisdiction | 2 |
| III. Background..... | 3 |
| IV. Price Flexibility..... | 3 |
| V. Proceeding Type | 5 |
| VI. Prehearing Conferences..... | 5 |
| VII. Presiding Officer and Scope of Proceeding..... | 5 |
| VIII. Customer Notice..... | 6 |
| IX. Public Correspondence..... | 6 |
| X. Evidentiary Hearing..... | 7 |
| XI. Market Power Standard..... | 8 |
| A. Pacific Bell's Position | 9 |
| B. ORA's Position | 10 |
| C. Discussion | 11 |
| D. Conclusion..... | 12 |
| XII. Centrex Service..... | 13 |
| A. Centrex Proposal | 14 |
| B. Pacific Bell's Position | 14 |
| 1. Relevant Market..... | 15 |
| 2. Entry & Exit..... | 15 |
| 3. Demand Elasticity | 16 |
| 4. Supply Elasticity | 17 |
| 5. Cost Support and Ceiling Rate | 17 |
| C. AT&T, MCI WorldCom, & CCTA's Joint Position | 19 |
| D. ORA's Position | 20 |
| E. Market Power Discussion | 24 |
| F. Price Discussion | 26 |
| G. Above the Line Discussion | 27 |
| H. Conclusion..... | 28 |

**TABLE OF CONTENTS
(Continued)**

| Title | Page |
|---|-------------|
| XIII. Toll-Free (8XX) and Business Toll Service..... | 28 |
| A. Toll-Free and Business Local Toll Service Proposal | 30 |
| B. Pacific Bell's Position | 31 |
| 1. Relevant Market | 31 |
| 2. Entry and Exit | 31 |
| 3. Demand Elasticity | 32 |
| 4. Supply Elasticity | 33 |
| 5. Cost Support and Ceiling Rate | 34 |
| C. Interested Parties Position | 34 |
| D. ORA's Position | 35 |
| E. Market Power Discussion | 36 |
| F. Price Discussion | 40 |
| G. Above-the-Line Discussion..... | 40 |
| H. Reporting Requirements..... | 40 |
| I. Conclusion..... | 42 |
| XIV. Draft Decision Comments..... | 42 |
| Findings of Fact..... | 43 |
| Conclusions of Law..... | 46 |
| ORDER | 47 |

O P I N I O N

I. Summary

By this decision Pacific Bell is authorized to move its Category II Basic Centrex Line, Centrex Basic Features, Centrex Optional Station Features, Centrex Optional System Features, Toll-Free, and Business MTS IntraLATA Toll Services (Business Local Toll) services to Category III. The ceiling rate for Basic Centrex Line, Centrex Basic Features, Centrex Optional Station Features, and Centrex Optional System Features may be increased up to ten percent of the currently effective ceiling rate. All services being moved from Category II to Category III shall continue to be accounted for as above-the-line services for ratemaking purposes.

II. Jurisdiction

Pacific Bell is a public utility telephone corporation, as defined in Pub. Util. Code § 234, subject to the jurisdiction of this Commission. Pacific Bell filed applications for authority to re-categorize certain Centrex, Toll-Free (8XX), and Business Local Toll services from Category II to Category III services, pursuant to Commission D.89-10-031¹ and Rule 42 of the Commission's Rules of Practice and Procedure (Commission's Rules).

The Centrex services which Pacific Bell seeks to re-categorize are Basic Centrex Line, Basic Features, Optional Station Features, Optional System Features, and other associated Centrex features and services including Station Message Detail Recording, Call Center Manager, Uniform Call Distribution, and Integrated Services Digital Network.

¹ 33 CPUC2d 43, 235.

III. Background

Telecommunication services are classified into three distinct categories: Category I, Category II, and Category III. Services deemed to be basic monopoly services are classified as Category I. Services deemed to be discretionary or partially competitive services for which the Local Exchange Carriers (LECs) retain significant, though perhaps a declining, market power are classified as Category II. Services deemed to be fully competitive are classified as Category III, with upward and downward price flexibility.

The rates and charges for services classified as Category I and II can only be set or changed upon Commission approval. Category III provides Pacific Bell with upward and downward price flexibility provided that it meets certain notice requirements. These notice requirements are addressed in our price flexibility discussion.

IV. Price Flexibility

Rate changes for Category II services must occur by advice letter and price reductions at or above the price floor² become effective on five days' notice, while price increases up to the approved ceiling rate are effective on 30 days' notice.³ The currently effective prices for Category II services were capped as

² The price floor standard was the lower of the long run incremental cost (LRIC) or direct embedded costs (DEC) for a specific rate element (56 CPUC2d 117, 263). However, subsequent to the submittal of this proceeding, the price floor standard was modified to the volume sensitive portion of TSLRIC for the service plus the contribution from any monopoly building block necessary for the service. See *Rulemaking to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks*, Decision (D.) 99-11-050, *mimeo.*, at 271-272, (1999).

³ *Id.* at 264 and 65 CPUC2d, 156.

price ceilings for calendar years 1996, 1997, and 1998 with the exception of Z-factor adjustments and Commission approved applications for increases above the rate caps.⁴ With the phasing out of Z-factor adjustments,⁵ the Z-factor exception is less likely applicable.

Conversely, rate changes set below the ceiling rate for Category III services are not subject to protests and may be changed upon one-day's notice.⁶ Subsequent changes to the ceiling rate of a Category III service which decrease the ceiling rate or increase the ceiling rate less than 5 percent (%) become temporarily effective on one-day's notice and five days' notice, respectively, and are made permanent on the twentieth day after filing, if not protested. A 5% or greater increase in the ceiling rate becomes temporarily effective on 30 days' notice and permanent on the thirtieth day after filing, if not protested. Protested changes in the ceiling rate remain temporary until the protest is withdrawn or resolved by Commission action. If the protest is not withdrawn or resolved, the ceiling rate reverts to its previously authorized level.

A Category III classification reduces the number of advice letters that need to be filed, shortens the time period for advice letters, to become effective extends the time allowance for promotions and lessens contract approval requirements. Hence, Pacific Bell can obtain additional price flexibility for its Centrex, Toll-Free, and Business MTS services by re-classifying these services from Category II to Category III.

⁴ 63 CPUC2d 377, 406.

⁵ OIR into Third Triennial Review of the Regulatory Framework, D.98-10-026, *mimeo.*, at 93.

⁶ Resolution T-15139, dated March 24, 1993.

V. Proceeding Type

Pursuant to Rule 6(a)(1), Pacific Bell requested that these applications be classified as ratesetting proceedings and that hearings not be held. This Commission preliminarily found in Administrative Law Judge (ALJ) Resolution 176-2997, dated July 23, 1998, that these proceedings are ratesetting proceedings and that hearings may be held.

VI. Prehearing Conferences

A Prehearing Conference (PHC) was held on Pacific Bell's applications before assigned Commissioner Henry M. Duque and ALJ Galvin in San Francisco on December 1, 1998. Appearances were received from Pacific Bell (Applicant), MCI Telecommunications (MCI WorldCom), AT&T Communication (AT&T-C), the California Cable Television Association (CCTA), and the Office of Ratepayer Advocates (ORA).

Pursuant to the Assigned Commissioner's November 4, 1998 Ruling Setting a Prehearing Conference and Establishing Procedures, all parties addressed the merits of consolidating Pacific Bell's applications at the PHC. These applications were consolidated at the PHC by the assigned ALJ pursuant to Rule 55 of the Commission's Rules, which provides for proceedings involving related questions of law or fact to be consolidated.

VII. Presiding Officer and Scope of Proceeding

A December 10, 1998 Scoping Memo and Ruling was issued by the assigned Commissioner that affirmed the preliminary ratesetting classification of this application as defined in Rule 5(c) of the Commission's Rules. That ruling also designated ALJ Galvin as the principal hearing officer, confirmed the need for evidentiary hearings, and determined the scope of the proceeding. The issues to be addressed in this proceeding were market power, above and below the line

treatment, and impact of the Universal Service Fund on intra Local Access and Transport Area (intraLATA)⁷ Toll.

VIII. Customer Notice

Upon consideration of the parties' positions at the PHC, the ALJ ruled at the PHC that Pacific Bell should provide its customers with notice of its Centrex request. Consistent with this ruling, Pacific Bell sent a bill insert notice to its customers between February 10, 1999 and April 5, 1999. This bill insert notice informed customers of Pacific Bell's request to establish maximum prices for its Centrex services and to obtain flexibility to increase its current prices up to the maximum price or decrease them to meet competition with one day's notice to the Commission. The customer notice was in conformance with Rule 24 of the Commission's Rules.

IX. Public Correspondence

The Commission's Public Advisor's Office received approximately twenty comments on this application by the way of letters and electronic mail from the general public. Each of these customers opposed Pacific Bell's request to raise the rates of its Centrex services up to a maximum of 100%. Several of these customers also opposed any re-categorization of Centrex services from Category II to Category III. These complaint letters and copies of electronic mail messages were placed in the correspondence file of this consolidated proceeding.

⁷ California is divided into ten Local Access and Transport Areas (LATAs) of various sizes, each containing numerous local telephone exchanges. "IntraLATA" describes services, revenues, and functions that relate to telecommunications originating and terminating within a single LATA.

X. Evidentiary Hearing

Evidentiary hearings were held on May 24, 25, and 28, 1999. Pacific Bell, AT&T-C joined by MCI WorldCom, CCTA, and ORA participated in the Centrex issues identified in the Assigned Commissioner's Scoping Memo. Pacific Bell, AT&T-C joined by MCI WorldCom, and ORA participated in the Toll Free and MTS IntraLATA toll issues.

Eleven witnesses testified in this consolidated proceeding and sixty exhibits were received into evidence, seventeen of which were placed under seal. The data placed under seal should remain under seal for a period of one year from the date of this order. The sealed data should not be made accessible or disclosed to anyone other than Commission staff during the one year time period. However, the sealed data may be disclosed on the execution of a mutually acceptable nondisclosure agreement or on further order or ruling of the Commission or the designated ALJ serving as the Law and Motion Judge.

Consultant Jerry A. Hausman, SBC Telecommunications, Inc. Director of Business Systems District Jim M. Murphy, Director of Business Usage Carol Norem, Cost Manager Robin C. Taylor, and Cost Manager Judith A. Timmermans testified for Pacific Bell.

Consultant Marvin H. Kahn testified for CCTA. Consultant Nicholas Economides and AT&T's Law and Government Affairs Division Manager Robert E. Kargoll testified for AT&T. Regulatory Analyst Simin Litkouhi, Public Utilities Financial Examiner IV Danilo E. Sanchez, and Public Utilities Regulatory Analyst Michael J. Sukhov testified for ORA.

Opening and reply briefs were filed by Pacific Bell, CCTA, ORA, and jointly by AT&T and MCI WorldCom. This consolidated proceeding was submitted upon receipt of the August 5, 1999 reply briefs.

Altogether, the Commission held one PHC and three days of evidentiary hearings in this proceeding. The assigned Commissioner and ALJ attended the PHC. The assigned ALJ presided over the three days of evidentiary hearings. A final decision in this matter is being issued beyond the 18-month statutory time period set forth in SB 960 (Stats. 1996, Ch. 856, § 1).

XI. Market Power Standard

Market power is the primary issue in this consolidated proceeding because it is the only criteria that Pacific Bell must satisfy to justify re-classifying its Centrex, Toll-Free, and Business MTS services from Category II to Category III. By definition, a service is placed in Category III if it has satisfied one of two conditions. These conditions are that the service has been detariffed due to statutory requirements or federal preemption, or that the local exchange carrier is able to show that “it has or is expected to have insignificant market power in the provision of the service in each market it intends to service.”⁸ Because the services identified in this consolidated proceeding were neither detariffed nor preempted by the Federal Communications Commission, the burden of proof is on Pacific Bell to substantiate that it has or is expected to have “insignificant market power” for the services it wants re-classified to Category III.

The critical test for determining whether Pacific Bell has insignificant market power is whether Pacific Bell could retain its market share in the wake of any attempt to raise its prices above-competitive levels.⁹ The primary

⁸ D.89-10-031 (33 CPUC2d 43 at 127).

⁹ Re Authority to Categorize Business Inside Wire Repair, Interexchange Carrier Directory Assistance, Operator Assistance Service and Inmate Call Control Service as Category III (D.99-09-036, *mimeo.*, pp. 7-8).

determinants of market power are ease of entry and exit, demand elasticity, supply elasticity, and market share.¹⁰ A consideration of market share may prove helpful in determining market power, although this remains less critical than considerations of market entry and exit and the elasticities of supply and demand. This is because courts have often found firms with greater than a 50% share not to have market power.¹¹

A. Pacific Bell's Position

To meet the burden of proof that it has insignificant market power in the Centrex, Toll-Free, and Business MTS IntraLATA Toll services, Pacific Bell utilized the "1992 Horizontal Merger Guidelines of the U.S. Department of Justice and the Federal Trade Commission" (Merger Guidelines). The same Merger Guidelines were previously used by Pacific Bell to substantiate a need to re-categorize, among other services, its Business and Residential Inside Wire services from Category II to Category III.¹²

The Merger Guidelines framework requires an assessment to determine whether Pacific Bell has the ability to exercise unilateral market power. That is, whether Pacific Bell has the ability to increase the price for a service above the competitive level for a significant amount of time. Pacific Bell utilized four steps to make this assessment: it defined the relevant markets, assessed the ease of entry into and exit from the markets at issue, assessed the demand elasticity¹³ of

¹⁰ *Id.*

¹¹ *Id.*

¹² D.99-06-053, *mimeo.*, pp. 14-15.

¹³ Demand elasticity is demonstrated when customers switch to competing suppliers as prices change.

substitutes for its services, and assessed the supply elasticity¹⁴ of substitutes for its services.

B. ORA's Position

ORA opposed any reliance upon the Merger Guidelines to evaluate the extent of Pacific Bell's market power because ORA believes that the Commission is not bound by the Merger Guidelines. In addition, ORA believes that Pacific Bell applied the Merger Guidelines in a selective and inconsistent manner and failed to undertake the detailed analysis required by the Merger Guidelines to assess whether Pacific Bell can exercise market power.

ORA recommended, instead, that we utilize the nine market power criteria¹⁵ that it proposed in this proceeding to assess whether Pacific Bell has insignificant market power for the requested services in this and all future requests for Category III treatment or similar request for regulatory flexibility. ORA's recommendation is based on the market power criteria addressed in D.89-0-031¹⁶ and D.90-04-031. ORA believes that its proposed market power criteria are general enough to allow for flexibility in the evaluation of service-

¹⁴ Supply elasticity demonstrates the willingness of suppliers to enter the market or expand their service or product offering in a response to price changes for the service.

¹⁵ The criteria consisted of: relevant market; market share; earnings and return; competitor's ownership of facilities; ease of market entry and exit; competitors' size and growth potential; availability of alternative services; consumer perceptions and views; and, utility affiliate offering a comparable service.

¹⁶ 33 CPUC2d 43 at 127.

specific data. ORA also recommended that each of the nine criteria be evaluated with six service-specific factors.¹⁷

C. Discussion

The Commission decisions relied on by ORA did address the market power criteria. However, we concluded in D.89-10-031 that any reliance on such criteria would be very service-specific. Hence, we specifically chose not to establish definitive criteria to determine insignificant market power, and we left the responsibility of proposing criteria for assessing market power up to Pacific Bell through the application process at the time it seeks to re-categorize a service to Category III.¹⁸

In response to applications for rehearing of D.89-10-031, a process in which the Division of Ratepayer Advocates¹⁹ participated, D.90-04-031 affirmed that assessment of market power would likely continue to be a very service-specific undertaking. Hence, the market power criteria addressed in D.89-10-031 and D.90-04-031 were not required to be addressed in each and every request to place a service in Category III. However, each such request for re-categorization

¹⁷ Factors are: specific characteristics of each service; ways in which service is provisioned to end-users; nature of markets; extent to which competitors depend on independent local exchange companies' bottleneck facilities to provision a similar service; existing technological capabilities or limitations of the service; and, other service-specific characteristics not captured in these factors.

¹⁸ 33 CPUC2d at 127.

¹⁹ ORA's predecessor.

should address whether each of the criteria²⁰ is applicable and, if so, include the relevant information.

The burden of proof in this proceeding lies with Pacific Bell. This is not the proceeding to litigate or fine-tune the market power criteria. To now require a submission of extensive data on every single criterion as proposed by ORA would result in cumbersome and lengthy proceedings. Such an outcome would defeat one of the very goals our policies on re-categorization of services seek to meet – permitting carriers the ability to timely change prices of services offered in competitive markets in response to market conditions.

Pacific Bell addressed the D.89-10-031 and D.90-04-031 market power criteria it deemed applicable in its testimony and brief, including aspects of the Merger Guidelines. Pacific Bell also used the Merger Guidelines with market power criteria it deemed relevant to obtain Category III status for its Business and Residential Inside Wire services.²¹ To the extent that Pacific Bell concluded that certain criteria were relevant in this proceeding, it provided additional information.

D. Conclusion

Pacific Bell has complied with prior Commission decisions in regard to addressing the market power criteria it deemed relevant. To the extent that the evidence presented in this proceeding convinces us that Pacific Bell has insignificant market power as set forth in our prior discussion of the market

²⁰ The criteria consisted of: market share; ease of entry and exit; facilities ownership; size and growth capability of competitors; local exchange carrier return on equity; competitors' earnings; substitutable services; rates, terms, and conditions of substitutable services; and whether a utility affiliate offers a competitive service.

²¹ D.99-06-053, *mimeo.*, at 15.

power standard, Pacific Bell's re-categorization request should be granted. Conversely, to the extent that the evidence does not convince us that Pacific Bell has insignificant market power, its request should be denied.

XII. Centrex Service

Centrex is a central office based business telecommunications system that permits customers to identify and select a variety of features to be deployed on stations. A Centrex business system consists of an access line, or loop, for each station on the system and both ordinary and special functions provided by Pacific Bell's central-office switch. A Centrex business system allows feature selection to be customized at the customer's option for any business with two or more lines. Ongoing customer requirements for Centrex are met through technology upgrades deployed at the central office. Both analog and digital formats are available. Analog Centrex is offered as Basic Centrex²² and Centrex DMS-100 Electronic Business Sets. Digital Centrex is offered through Centrex ISDN and provides customers with Basic Rate ISDN capabilities-integrated voice and data communication.

The Basic Centrex Line was classified as a Category I service in 1989, pursuant to D.89-10-031.²³ By that same order, the Commission found that Centrex features were discretionary or partially competitive. Hence, Centrex features were placed in Category II. Subsequently, the Basic Centrex Line was re-categorized from Category I to Category II in 1994 because it was found to be a close substitute and discretionary alternative to Private Branch Exchanges

²² Basic Centrex is also referred to as Basic Centrex Line.

²³ 33 CPUC2d at 126.

(PBX).²⁴ Centrex and PBX services require access to the public switched network through a loop or trunk line. Basic Centrex Line and Centrex features are currently classified as Category II services.

A. Centrex Proposal

Pacific Bell seeks authority to re-categorize its Centrex service from Category II to Category III and to continue treating these services as above-the-line services for ratemaking purposes. The details of Pacific Bell’s proposed tariff changes were attached to the application as Exhibit A, as amended by a September 30, 1998 filing. Because of the voluminous changes to its tariffs consisting of more than 300 individual features, Pacific Bell’s proposed changes were not identified in detail. However, to put Pacific Bell’s request in perspective, the following tabulation compares the maximum price of Pacific Bell’s four primary components of Centrex service in its current Category II classification and the proposed Category III classification.

| <u>Service</u> | <u>Current price</u> | <u>Proposed maximum</u> | <u>Percent increase</u> |
|---------------------------|----------------------|-------------------------|-------------------------|
| Basic Centrex Line | \$8.35 | \$16.70 | 100% |
| Basic Features | 2.07 | 4.14 | 100 |
| Optional Station Features | Price Varies | Price Varies | 100 |
| Optional System Features | Price Varies | Price Varies | 100 |

B. Pacific Bell’s Position

Pacific Bell represented that the relevant market, ability of competitors to enter and exit the Centrex market, demand elasticity, and supply elasticity

²⁴ 56 CPUC2d 117 at 221-222, 286.

substantiate that its Centrex service should be re-classified from Category II to Category III. Pacific Bell concluded that it maintains an insignificant market power for its Centrex service and does not have the ability to price its Centrex service above a competitive level for a period of time.

1. Relevant Market

Pacific Bell identified the relevant market to its Centrex service to include business systems such as facilities-based Competitive Local Exchange Carriers' (CLECs) alternative services, PBX, and Key Set Systems. Facilities-based CLECs have either their own switches and outside plant facilities or purchase Pacific Bell's unbundled elements and repackage them to their customers.

A PBX system is a customer-owned premise-based system that literally allows customers to perform and use the same functions as Centrex. PBX owners are responsible for upgrading, maintaining, and programming of their premise-based system. PBX owners also use telephone sets similar to Centrex.

A Key Set System (Key System) is comprised of telephone sets, business access lines, and subscriber features. A Key System has much of the same feature functions as PBX and Centrex, but is not connected to a "system" that allows a dialing plan or "network" features.

2. Entry & Exit

Pacific Bell testified that it has experienced a significant increase in direct competition within its Centrex market since 1994 due to the ease of entry and exit in the relevant Centrex market. This is because the smaller customers typically opt for less expensive Key System due to the minimal up-front capital investment and the larger customers typically opt for PBX business systems.

Hence, customers have a choice of purchasing the type of their business system. These alternatives make it very difficult for a Centrex monopolist to raise its Centrex price by a significant non-transitory amount without customers switching to PBX and Key Systems. As shown by the following tabulation, Pacific Bell's cost comparison between Centrex, PBX, and the Key Systems demonstrate that the cost for each business system is comparable.²⁵

| <u>Line Size</u> | <u>Centrex</u> | <u>PBX</u> | <u>Key System</u> |
|-------------------------|-----------------------|-------------------|--------------------------|
| 2- 20 | \$ 2,440-\$22,800 | - | \$4,833-\$10,041 |
| 21- 100 | 23,920-112,400 | \$82,318-91,219 | 9,666-25,571 |
| 101-400 | 113,520-448,400 | 83,878-347,065 | - |
| 401-1000 | 344,044-1,120,400 | 344,044-836,316 | - |

3. Demand Elasticity

Based on marketing studies, Pacific Bell found that its Centrex market has remained at a static 15% market share since the fourth quarter of 1997.²⁶ At the same time, competitive PBXs hold a 41% market share and Key Systems a 43% market share.

Pacific Bell began providing Centrex service in 1962. Although Pacific Bell also provided PBX and Key Systems service to its customers, it has not provided these services since 1982, pursuant to the terms of the AT&T antitrust consent decree. Pacific Bell found similar insignificant market share

²⁵ Excludes trunking charges, customer premises equipment, and back-up battery costs.

²⁶ Business system stations were equated to a representative number of stations served by a line or trunk to access an outside line simultaneously; Centrex stations are on a 1:1 ratio, Key Systems are on a 1:1.33 ratio and PBX trunks on a 1:7.48 ratio.

results within any grouping by size of the users as shown in the following tabulation. Thus, Pacific Bell concluded that it does not have the ability to raise its price above competitive levels for Centrex service.

| Number of Equivalent Stations | Pacific Bell's Share |
|--------------------------------------|-----------------------------|
| 2 – 20 | 22.5% |
| 21 – 100 | 24.5 |
| 101 – 400 | 19.3 |
| 401 – 1,000 | 19.0 |

4. Supply Elasticity

Pacific Bell identified six major competitors that offer Centrex service, seven that provide PBX, and nine that provide Key Systems. The Centrex competitors are GTE of California, Brooks Fiber, "MFG", Teleport Communications Group (TCG), "ELI", and "GST". The PBX competitors are Siemens and Rolm, Mitel, Ericsson, Fujitsu, and Hitachi. Key System competitors are Toshiba, NEC, Panasonic, Nitsuko, Executone Info Sys, Comdial, and Inter-Tel. In addition, Lucent and Nortel compete in the Centrex, PBX and Key System markets. Pacific Bell utilizes both Lucent and Nortel for its Centrex systems.

Pacific Bell found that PBX and Key System manufacturers face no significant barriers to expansion. This is because most manufacturers operate in national and international markets. That enables them to increase their product supply to California in a relatively short period of time and at a comparable price.

5. Cost Support and Ceiling Rate

Cost support for the rate elements Pacific Bell seeks to move from Category II to Category III were submitted as part of its application and

testimony. Upon Pacific Bell's request and without any opposition from interested parties, the cost data was placed under seal pursuant to Pub. Util. Code § 583 and General Order 66-C. The sealed cost data included the results of Pacific Bell's Total Service Long Run Incremental Cost (TSLRIC) to support its Centrex Line, Centrex Basic Features, and Centrex Optional Features cost and price floors. The cost data for these services were identified at the rate element level by long-run incremental volume sensitive cost, non-volume sensitive cost,

and non-recurring cost. Such cost data was also based on previously filed Open Access and Network Architecture Development (OANAD) Phase II cost studies for the provision of products approved by the Commission pursuant to D.96-08-021. However, Pacific Bell offered no support to substantiate its request to raise the ceiling rate for each of its Centrex services by 100%.

Centrex Station and System Features costs and price floors were based on non-recurring cost previously filed in Pacific Bell's OANAD Phase II cost studies and re-occurring cost based on the Implementation Rate Design (IRD) methodology set forth in D.94-09-065. The price floors for these Centrex Optional Features were also filed in the 1998 Implementation Monitoring Report.

All data placed under seal should remain sealed for a period of one year from the date of this order. The sealed cost data should not be accessible or disclosed to anyone other than Commission staff during the one year time period. However, such sealed data may be accessible or disclosed upon the execution of a mutually acceptable nondisclosure agreement or on further order or ruling of the Commission or the ALJ then designated as the Law and Motion Judge, the assigned ALJ, or the assigned Commissioner.

C. AT&T, MCI WorldCom, & CCTA's Joint Position

AT&T, MCI WorldCom, and CCTA opposed Pacific Bell's request for Category III treatment of its Centrex service on the basis that Pacific Bell retains a substantial degree of market power over Centrex service. Protestants do not dispute that Centrex and PBX services are similar services. For example, Centrex and PBX services offer customers similar features such as intercom calling and call forwarding. However, these protestants assert that the level of competition that exists in the market for telecommunications equipment has no bearing on whether Centrex should receive Category III status. The opposition is based on

the fact that Centrex and other telecommunications equipment, such as PBX, are dependent on the use of Pacific Bell's access lines through a Centrex loop or a PBX trunk, and both require the use of Pacific Bell's local switching capability²⁷.

These protestants assert that Pacific Bell's share of the business access line market is virtually unchanged from where it stood two years ago. For example, Pacific Bell retains an over 95% share of the business access line market, and an over 98% share of the residential access line market. In regards to the local switching market, Pacific Bell has over 780 local switches within its service territory, while its competitors have only 50 local switches throughout the entire state.

The protestants conclude that Pacific Bell retains a virtual monopoly over access lines and local switching within its service territory and customers do not have a choice of providers for the access lines and local switching they need to make their telecommunications equipment work. The protestants also conclude that Pacific Bell's virtual monopoly over access lines and local switching allows Pacific Bell to engage in vertical price squeezes, cross-subsidies, and non-price discrimination against competitors for its Centrex service.

D. ORA's Position

ORA concurred with Pacific Bell that its Centrex service competes with vendors of PBX and Key Set Systems, and CLECs. However, ORA opposed Pacific Bell's Category III and increased ceiling rate request for the Basic Centrex Line on the basis that Pacific Bell failed to substantiate most of its market power

²⁷ Centrex service requires local switching capability for all calls placed through a Centrex service and PBX service requires local switching capability for only off premise calls.

allegations with relevant data, failed to consider relevant sub-markets, and that Pacific Bell retains monopoly control over the Basic Centrex Line.

ORA's sub-market position was based on its interpretation of the D.89-10-031 requirement that a market power test must be performed in each market a LEC serves. ORA contends that its sub-market position is further supported by D.87-07-017, which looks to relevant sub-markets, market segments, and the overall market for a service, to determine the degree of regulatory flexibility that should be granted to a particular service provider. Consistent with its interpretation, ORA identified two primary sub-markets that Pacific Bell should have considered in its market power analysis. They are Basic Centrex Access and geographically identified markets.

Based on ORA's independent market power analysis of Pacific Bell's Basic Centrex Access sub-market, ORA concluded that Pacific Bell controls over 98% of this sub-market, a substantial share of the access line sub-market. ORA also concluded that Pacific Bell's dominance over the Centrex Access sub-market would preclude a finding that Pacific Bell's Centrex service is fully competitive.

ORA did not dispute that Centrex service is provisioned on a bundled basis. However, it concluded that Centrex service should continue to be evaluated by each component of Centrex service so long as Centrex service contains access lines, a monopoly building block. ORA is concerned that Pacific Bell's control of this building block would allow it to potentially limit, delay or deny its competitors access to the Basic Centrex Access components. ORA is also concerned that Pacific Bell could price-squeeze its competitors by lowering the overall price it charges for bundled Centrex service, while maintaining the existing discount rate provided to resellers, and the Unbundled Network Elements (UNE) wholesale prices to its competitors for the Centrex local loop and PBX trunk access components.

ORA considered the importance of geographical sub-markets because facilities-based competitors in rural areas may have a minimal presence, if any. To the extent that facilities-based competitors may exist in the rural areas, ORA was concerned that competition may only exist over scattered pockets of the rural area and PBX and Key System providers have no alternative but to purchase their business lines from Pacific Bell.

ORA concluded that Centrex service does not merit Category III treatment because the end-users of PBX, Key System, and CLECs' Centrex equivalent services are dependent on Pacific Bell's access line facilities to provide their respective services.

Alternatively, if Pacific Bell is granted Category III status for its Centrex service, ORA recommends that the Commission's D.89-10-031 and D.94-09-065 imputation requirement continue to apply for Pacific Bell's Centrex service. That is, Pacific Bell should continue to impute the tariff rate of any function deemed to be a monopoly building block in rates for Centrex or Centrex-equivalent services.²⁸

ORA recommended that upon the issuance of a final OANAD decision, Pacific Bell submit an advice letter to revise the Basic Centrex Line price floor to comply with the OANAD adopted imputation and price floor requirements. ORA also recommended that the Centrex optional station and system features price floors be equivalent to their adopted Implementation Rate Design (IRD), Long Run Incremental Cost (LRIC) or TSLRIC. This is because ORA considered the optional station and system features to be competitive elements of Pacific Bell's Centrex offerings that exclude monopoly building blocks. With the

²⁸ 33 CPUC2d at 232.

issuance of the recent OANAD decision, D.99-11-050, these recommendations need not be acted on in this proceeding. That decision addressed and required Pacific Bell to comply with specific monopoly building block and price floor requirements.

ORA also recommended the establishment of safeguards to prevent Pacific Bell from engaging in anti-competitive behavior. ORA proposed that Pacific Bell continue to demonstrate that its Basic Centrex Access prices are equal to or above the respective price floor, and that Pacific Bell submit specific information²⁹ as part of its Centrex contract advice letters. Again, the recent OANAD decision has resolved ORA's anti-competitive contract reporting requirement concern. Hence, the anti-competitive contract concern need not be addressed further.

Although ORA did not object to Pacific Bell's proposal to raise the price of its Centrex Features by 100%, it did object to Pacific Bell's proposal to raise its Basic Centrex Line by the same percentage. ORA recommended that the Basic Centrex Line ceiling rate be set no higher than 10% above the present \$8.35 tariff rate.

Finally, ORA concurred with Pacific Bell that any Centrex service components that are moved to Category III should be given above-the-line treatment for ratemaking purposes.

²⁹ ORA proposes that the following information be provided: 1) The types of services provided under contract; 2) the contract price for each service element; 3) the price floor for each service element; and 4) the calculations for customer-specific contracts to verify that the contract price for Basic Centrex Access meets the imputation tests.

E. Market Power Discussion

There is no dispute among the parties that the relevant market for Centrex service consists of PBX Systems, Key Systems, and facilities-based CLECs. Hence, the measurement of Pacific Bell's market power should be based on the relationship between its Centrex service and the identified relevant market.

As identified in the prior entry and exit discussion, the PBX and Key Systems are a two business systems that perform similar Centrex functions, and which are comparably priced to the Centrex systems utilized by Pacific Bell. The comparably priced equipment, coupled with the availability of such equipment by numerous large established suppliers, demonstrate that competitive entities are willing to enter and remain in the relevant market for providing equipment features. This availability of relevant market competitors demonstrates the supply elasticity of the overall relevant market.

Because Pacific Bell has not provided or offered any PBX or Key System services since 1982, Pacific Bell's overall relevant market share of approximately 15% is based solely on its Centrex service. This insignificant market share does not provide Pacific Bell with the ability to retain or improve its overall relevant market share if it attempts to raise its prices above competitive levels. Hence, Pacific Bell has insignificant market power in the overall Centrex relevant market. However, this insignificant market power finding is not necessarily valid for each of the Centrex service sub-markets or components for which Pacific Bell seeks Category III status.

In its application, Pacific Bell requested that its Centrex service be moved from Category II to Category III based on a market power analysis of its packaged Centrex service consisting of four components. The four components,

which were identified in the “Centrex Proposal” section, are Basic Centrex Line, Basic Features, Optional Station Features, and Optional System Features.

Although ORA asserted the need to address geographical sub markets, D.87-07-017 determined that the scope of the relevant market may change depending on the type of regulatory changes under consideration. For example, where competitive conditions may exist for pricing flexibility by geographic areas, a sub-market analysis may be appropriate. However, in D.99-11-050, the Commission concluded that geographical sub-market pricing flexibility was not appropriate at this time.

ORA also raised the issue of Pacific Bell’s ability to engage in a price squeeze with competitors if its Basic Centrex Line is moved to Category III. ORA is concerned because Pacific Bell controls over 98% of the access lines within its service territory. Even though Centrex relevant market services require the use of some type of access facilities, the evidence does not substantiate ORA’s claim. Pacific Bell is not seeking to reclassify all of its access lines to Category III. It is only seeking to reclassify its retail Centrex service.

Irrespective of Pacific Bell’s share of access lines, there are Commission established safeguards in place to prevent Pacific Bell from attempting a price squeeze on its competitors. For example, access to unbundled loops is fully regulated as a Category I service. Alternative PBX service requires the use of PBX trunks, a Category II service subject to price floors and price caps regulated by the Commission. The Basic Centrex Line, by definition, if moved to Category III must be priced at or above cost. Hence, there is no risk of a price squeeze.

In regards to the market power analysis of the Centrex services, we have been convinced that Pacific Bell has insignificant market power in the Basic Centrex Line, Centrex Basic Features, Optional Station Features, and Optional System Features. This is because of the availability of numerous large

established suppliers with the ability to offer competitive equipment features through Centrex, PBX, or Key Systems. In addition, Pacific Bell's participation in the Centrex relevant market is limited to only Centrex services. Furthermore, Pacific Bell is unable to price its Centrex features above a competitive level for a period of time, and to keep or increase its market share within the identified relevant market. For example, customers have the ability to change to an alternative Centrex provider or to a competitor's PBX or Key System Service should Pacific Bell attempt to increase the price for these services. The evidence also shows that other providers have the ability to defeat any attempted price increase for these services and that customers would find these competitive alternatives to be acceptable substitutes. Hence, Pacific Bell should be authorized to move its Basic Centrex Line, Centrex Basic Features, Optional Station Features, and Optional System Features from Category II to Category III.

F. Price Discussion

The ceiling rate rules established in Resolution T-15139, dated March 24, 1993, provided utilities with the flexibility to change a Category III service rate upon one-day's notice without protest if the new rate is below the service's ceiling rate. Hence, the higher the ceiling rate, the more pricing flexibility Pacific Bell will have. Consistent with its desire for more price flexibility, Pacific Bell proposed a 100% increase in its ceiling rate for each component of its Centrex service.

Only ORA provided evidence on what a reasonable ceiling rate should be if Pacific Bell's Category III requests are approved. ORA's evidence was limited to the Basic Centrex Line. Pacific Bell provided no evidence to substantiate its request for a 100% price increase. Upon questioning by ORA, Pacific Bell told ORA that although it requested a 100% increase in the ceiling

rates for its Centrex service, it does not intend to ever price its Centrex service that high.³⁰

ORA recommended that if the Basic Centrex Line was moved to Category III that the ceiling rate should be raised no higher than 10% above the present \$8.35 tariff rate. ORA arrived at its 10% figure by calculating the cumulative change in the inflation index from 1995 to 1998. A 100% increase in the Centrex ceiling rate is not supported by any evidence and should be rejected. The 10% increase is a realistic increase given the evidence in the record and should be adopted for all components of Centrex.

G. Above the Line Discussion

Pacific Bell requested that all components of its Centrex services that are moved to Category III should be given above-the-line treatment for ratemaking purposes. No party objected to the above-the-line treatment. ORA concurred on the basis that Centrex service does not face a high-risk of having plant potentially rendered not useful because of competition. Also, Centrex service has provided a contribution above its costs to keep the rates for basic exchange service lower than they would otherwise be for the past ten years.

We concur. The components of Centrex being moved to Category III by this order should continue to be given above-the-line treatment for ratemaking purposes.

³⁰ 2 R.T. 167.

H. Conclusion

Pacific Bell should be authorized to reclassify its Basic Centrex Line, Centrex Basic Features, Centrex Optional Station Features, and Centrex Optional System Features from Category II to Category III.

The ceiling rate for Centrex components should be limited to 10% above the currently effective ceiling rates. The limiting of ceiling rates by this order does not preclude Pacific Bell from seeking approval to further increase its Category III ceiling rates through the process set forth in Resolution T-15139, dated March 24, 1993. The re-categorized components of Centrex service should continue to be treated as above-the-line items for ratemaking purposes.

XIII. Toll-Free (8XX) and Business Toll Service

Pacific Bell provides inbound IntraLATA service to subscribers who establish a Toll-Free (8XX) number on a dedicated line, local business line, or local residential line. Calls are routed via the public switched network to the terminating access line(s) associated with the Toll-Free number at no charge to the calling party. For interLATA or interstate calls, a participating long distance carrier must provide inbound calls from outside the subscriber's intraLATA service area. Pacific Bell's subscriber pay for the incoming calls associated with that number.

In setting up the service, the subscriber selects a Toll-Free number using 800, 888, or 877 area codes, which are portable numbers. Optional features include a listing in AT&T's Directory Assistance 1-800-555-1212, priced at \$5.50 a month for statewide service and \$14.00 a month for nationwide service. Additionally, Pacific Bell offers Call Handling and Destination for a one time fee of \$150.00 to route calls by time of day, day of week, location and call volume distribution.

To set up the area of service, subscribers can choose to receive calls from a single LATA, multiple LATA's, statewide or nationwide. Pacific Bell notifies those subscribers wanting to receive interLATA calls that its Toll-Free service cannot extend beyond the LATA boundary. Pacific Bell also notifies those subscribers that an IEC or CLEC can provide the long distance portion of their service, and that Pacific Bell will work with the customer's chosen carrier to coordinate the local and long distance service. If the customer wants two different carriers, Pacific Bell will offer to contact the selected IEC or CLEC with the customer on a three-way call to obtain their rates and coordinate the service. If the IEC or CLEC does not work with Pacific Bell and/or if they offer lower rates to the customer while on the three-way call, the subscriber may then elect to establish their intraLATA and interLATA Toll-Free service with the IEC and/or CLEC.

The business and residential Toll-Free products being offered by Pacific Bell include Custom 8 Business, Custom 8 Residential, Easy 8 Business, Easy 8 Residential, Interexchange Receiving Service via operator assisted or direct dialed, and, 800 service for the Full State, Half State, Metro Area, or Universal 800. The details of these products are listed in its Tariff Schedule Cal. P.U.C. No.A7, attached to the application.

Toll-Free (8XX) service was classified as a Category I service in 1989 and re-classified to Category II in 1994. Toll-Free service is currently classified as a Category II service.

Business Local Toll service consists of calls completed between two stations in different local service areas within a LATA. In Zone Usage Measurement (ZUM) areas these are calls exceeding 16 miles, and in non-ZUM areas these are calls exceeding 12 miles. Local toll is classified and rated as one of six types: Dial Station Service (direct dialed), Dial Calling Card Station Service

(Calling Card), Coin Station Service, Coin Person Service, Operator Station Service, or Operator Person Service. Dial Station Service calls are generally completed without the assistance of an operator and are rated based on a mileage-band and time-of-day sensitive rate table. The other five types of calls are rated based on mileage-band and time-of-day sensitive rate tables along with service charges associated with each type of call. Calls are rated on a first minute and additional minute basis and are all rounded up to a full minute. Only the underlying usage rate tables are being addressed in this proceeding. The service charges associated with these products are being addressed in a separate application.

Pacific Bell also offers several optional calling plans as set forth in its Tariff Schedule Cal. P.U.C. No.A.6.5, attached to the application. These optional calling plans include Value Promise Direct Discounts, Value Promise Advantage 25, Value Promise Advantage 50, Value Promise Advantage 1000, Value Promise Plus Simplicity, and Value Promise Plus.

Business Local Toll service was classified as a Category I service in 1989, pursuant to D.89-10-031 and subsequently re-classified to Category II in 1994. Business Local Toll service is currently classified as a Category II service.

A. Toll-Free and Business Local Toll Service Proposal

Pacific Bell seeks authority to re-categorize its Toll-Free and Business Local Toll service from Category II to Category III and to continue treating these services as above-the-line services for ratemaking purposes. The details of Pacific Bell's proposed tariff changes were attached to the application as Exhibit A.

B. Pacific Bell's Position

Pacific Bell contends that its analysis of the relevant market, the ability of competitors to enter and exit the Toll-Free and Business Local Toll service markets, demand elasticity, and supply elasticity substantiate its request that Toll-Free and Business Local Toll service markets should be re-classified from Category II to Category III. Pacific Bell asserts that these services are offered in fully competitive markets in which it has insignificant market power because it does not have the ability to price these services above a competitive level for a period of time.

1. Relevant Market

Pacific Bell identified the relevant market for its Toll-Free and Business Local Toll services to include all IECs and CLECs that offer both intraLATA and interLATA toll service that enables the IECs and CLECs to offer a one-stop solution. Examples of Toll-Free competition include AT&T's Megacom 800, Readyline 800, Advanced 800 and 800 Starter; MCI's Business Line 800, 800 VIP, 800 Guardian; Sprint's FONLine 800, Ultra 800 and Interactive 800. Secondary services to Pacific Bell's Toll-Free service included collect calls, calling card calls, remote call forwarding calls and Internet telephony calls. Alternatives to Pacific Bell's Business Local Toll service include 10XXX dialing, autodialers, wireless, dedicated lines services, and direct connections between locations.

2. Entry and Exit

Pacific Bell does not believe that there are barriers to enter or exit the Toll-Free or Business Local Toll relevant market because of the ease in which competitors can obtain certification as an IEC in California. Pacific Bell explained that a visit to the Commission's web site supports the ease of entry and exit with a 27-page list of IECs qualified to provide the relevant market services. Pacific

Bell contends that many of these competitors can offer low, flat-rate intrastate service in California because the IECs can simply resell the services of any facilities-based carrier, whether from Pacific Bell or from another CLC. These IEC carriers do not need to build their own network to offer a competitive Toll-Free or Business Local Toll service.

3. Demand Elasticity

Based on a 1998 marketing study, Pacific Bell found that customer demand for its Toll-Free and Business Local Toll service decreased from the second quarter of 1995 to the fourth quarter of 1997, and that it has eroded even further by the first quarter of 1999. A 1998 marketing study for the same time period found an even larger decline in demand for Pacific Bell's combined inter- and intraLATA relevant market services.

Pacific Bell concluded that the usage decrease in its Toll-Free and Business Local Toll services and high elasticity of demand in the relevant market demonstrates that it does not have the ability to raise its price above competitive levels for its relevant market services. The following tabulation summarizes the results of both Pacific Bell's intraLATA and combined inter- and intraLATA usage studies it relied on to conclude that it has an insignificant share of market demand for its relevant market services.

| | IntraLATA Toll | | Inter & IntraLATA Toll | |
|--------------|-------------------------------|-------------------------------|-----------------------------------|-------------------------------|
| | 2nd Quarter | 4th Quarter | 2nd Quarter | 4th Quarter |
| Service | <u>1995</u> | <u>1997</u> | <u>1995</u> | <u>1997</u> |
| 800 | 23.8% | 12.5% | 6.3% | 2.2% |
| Calling Card | 32.4 | 21.8 | 7.3 | 5.8 |
| Outbound | 63.9 | 48.7 | 15.6 | 9.8 |
| Overall | 56.5 | 43.6 | 13.9 | 8.8 |

4. Supply Elasticity

Pacific Bell explained that IECs have been active in the relevant market since they were permitted to offer intraLATA Toll-Free service beginning in 1996. The number of IECs offering relevant market services is large because of their ability to combine intraLATA and interLATA services, thereby offering a bundled product in the relevant market while Pacific Bell is precluded from providing any interLATA service. Other sources of Toll-Free and Business Local Toll relevant market services are PBX and Key Telephone Systems programmed to route local toll calls to an IEC.

Pacific Bell identified three major Toll-Free and Business Local Toll service competitors, in addition to the 27 pages of certified IECs listed on the Commission's web site, to substantiate its argument that the supply elasticity of the relevant market is high. AT&T, MCI, and Sprint, its major competitors, enjoy the largest share of the relevant market based on a 1998 market study. The following tabulation summarizes the results of this market study.

| Service | Pacific Bell | AT&T | MCI | Sprint | Other |
|----------------|---------------------|-----------------|------------|---------------|--------------|
| | | | | | |
| 800 | 12.5% | 42.8% | 22.2% | 14.1% | 8.4% |
| Calling Card | 21.8 | 34.1 | 21.3 | 8.7 | 14.1 |
| Outbound | 48.7 | 22.4 | 15.6 | 6.4 | 6.9 |
| Overall | 43.6 | 24.6 | 16.4 | 7.1 | 8.3 |

Pacific Bell concluded that the high elasticity of supply in the relevant market demonstrates that it has an insignificant share of the Toll-Free and Business Local Toll service relevant market, and that it does not have the ability to raise its price above competitive levels for its relevant market services.

5. Cost Support and Ceiling Rate

Cost support for the rate elements Pacific Bell seeks to move from Category II to Category III were submitted as part of its application and in its testimony. Upon Pacific Bell's request and without any opposition from interested parties, the cost data was placed under seal pursuant to Pub. Util. Code § 453 and General Order 66-C.

Toll-Free and Business Local Toll service costs were based on Pacific Bell's OANAD Phase II cost studies, as approved in D.96-08-021. Because approval of the proposed OANAD price floor methodology was pending in the OANAD proceeding at the time these consolidated proceedings were being addressed, Pacific Bell used the IRD methodology set forth in D.94-09-065 to identify the Business Local Toll price floors for its re-categorization request.

Pacific Bell had originally requested that its Toll-Free and Business Local Toll service ceiling rates remain at the maximum price being charged at the time its application was filed. However, because some of its ceiling rates were lowered in a recent universal service re-balancing decision, Pacific Bell modified its ceiling rate request to set its Toll-Free and Business Local Toll services to its currently effective rates once these services were moved to Category III.

C. Interested Parties' Position

AT&T, MCI WorldCom, and CCTA opposed Pacific Bell's Category III request for Toll-Free and Business Local Toll services on the basis that Pacific Bell maintains a monopoly over access lines and local switching. That is, Pacific Bell has the only network with loops connecting every customer to switches that can direct calls anywhere on the public switched network. AT&T, MCI WorldCom, and CCTA recognized that Pacific Bell may have only a 12.5% market share of intraLATA toll service. However, they contend that Pacific Bell has the ability to use its almost 100% market share over the switched access service to harm both

customers and the competitive process in California by pricing its switched access above cost to produce subsidies to hold down the price of local service. In addition, they contend that Pacific Bell receives a return regardless of whether it is successful in competing for toll free customers because it is compensated for lost toll free business through access rates that are priced above cost.

AT&T, MCI WorldCom, and CCTA concluded that even though Pacific Bell's Toll-Free and Business Local Toll market shares have fallen dramatically, Pacific Bell has failed to recognize that it continues to enjoy competitive advantages. These competitive advantages include incomplete intraLATA pre-subscription, uncertainty over the CLECs' ability to avoid Pacific Bell's access charges, ability to be made whole for certain Toll-Free and Business Local Toll price reductions, maintaining current margins on switched access rates which raise competitors' costs, and non-use of Category II pricing flexibility.

D. ORA's Position

ORA took no position on Pacific Bell's request to re-categorize Toll-Free intraLATA service. However, ORA opposed re-categorization of Business Local Toll service on the basis that intraLATA toll competition has not evolved to a level where Pacific Bell's Business Local Toll service can be found to be fully competitive. ORA's opposition was based on its belief that Pacific Bell failed to demonstrate that it has insignificant market power, and failed to verify the market share data used in the marketing study which showed Pacific Bell losing its overall Business Local Toll service market share.

If Pacific Bell's re-categorization request is approved, ORA recommend that Pacific Bell should be required to separately show the tariff pricing and price floor support for Business Local Toll contracts. Pacific Bell should also continue to comply with the Commission's imputation rules to set price floors for Business

Local Toll service, and to continue classifying such service above-the-line for ratemaking purposes.

E. Market Power Discussion

Pacific Bell is precluded from providing interLATA Toll and Toll-Free services until Pacific Bell has met the Section 271 checklist and related requirements. To demonstrate its insignificant market power in the broader market, Pacific Bell provided testimony which compared its market share of intraLATA toll calls to the broader overall market that included interLATA services offered by IECs and CLECs.

Defining the relevant market is crucial to a reasonable market power analysis of buyers and sellers whose purchase and production decisions establish the price at which the product or service is sold. Including services that Pacific Bell is precluded from offering tends to bias the market power analysis toward a finding of insignificant market power. Because Pacific Bell is precluded from offering interLATA services, its analysis of a broader market is not a factor in assessing the degree of Pacific Bell's market power in this proceeding, and therefore, should not be accorded any weight in this proceeding.

The relevant market for Pacific Bell's Toll-Free and Business Local Toll service encompasses those types of calls, or services, placed between two stations within a local service area. There is no dispute that these relevant market services are offered by Pacific Bell, IECs and CLECs. Hence, the degree of Pacific Bell's market power should be based on the relationship of its Toll-Free and Business Local Toll service market to the total Pacific Bell, IEC, and CLEC Toll-Free and Business Local Toll market.

A standard for the placement of services into Category III was established in 1989. That standard is for the LEC to establish that it has or is

expected to have insignificant market power in providing the service in each market it intends to serve.³¹ Consistent with this standard, an analysis of ease of entry and exit should be based on the services being considered for reclassification to Category III.

Although Pacific Bell believes that the ease of entry and exit criteria has been met, the interested parties do not. Pacific Bell based its belief on the Commission's IEC streamlined certification process, the Commission's 27-page web site list of certificated IECs, and the low start-up cost needed for IECs to offer resold relevant market services from any facilities-based carrier, whether it be Pacific Bell or any other CLEC. The interested parties contend that Pacific Bell retains a monopoly over access lines and local switching which limits entry and exit.

Pacific Bell may have substantial control over access lines and local switching, as alleged by the interested parties, and addressed in our Centrex market power discussion. However, access lines and local switching are not the relevant services, nor are they the components of the relevant services being considered for Category III treatment in this proceeding. Acceptance of the interested parties' argument would stifle telecommunications competition and preclude the establishment and continuance of fully competitive Category III services because most, if not all, telecommunications services require a connection to either access lines or local switching.

Given that Pacific Bell's access lines and local switching are not components of, and are not in direct competition with, the proposed Category III Toll-Free or Business Local Toll services, they should not be a factor in deciding

³¹ 33 CPUC2d at 127.

whether Toll-Free and Business Local Toll services should be moved to Category III. The interested parties' arguments regarding access lines and local switching are rejected.

We agree with Pacific Bell that its analysis of the streamlined certification process, the number of IECs, and the low start-up cost, all demonstrate the ease of entry and exit for Toll-Free and Business Local Toll services.

We now turn to whether the market for these services is competitive.

Concerning the demand and supply elasticity of Toll-Free and Business Local Toll services, Pacific Bell has demonstrated through the results of its market studies, as acknowledged by some of its major competitors, that competitors have been successful in entering the relevant market and that it has been losing market share since 1995. Although ORA was not able to validate the results of these market share studies, AT&T's witness confirmed that the market study results were reasonable. Hence, we conclude that Pacific Bell's market share in each of these businesses has declined since 1995, when intraLATA toll competition was introduced.

The issue now turns to whether this decline in market share provides Pacific Bell with the ability to unilaterally raise prices for these services above a competitive level for a period of time.

AT&T, MCI WorldCom, and CCTA contend that Pacific Bell continues to enjoy an unearned competitive advantage from the days when Pacific Bell was the only supplier of Toll-Free and Business Local Toll services. The arguments regarding the competitive advantages applicable to access charges and rates have already been addressed and need not be addressed further. The interested parties also contend that a competitive advantage exists because of the lack of intraLATA pre-subscription and the ability to be made whole for Toll-Free and

Business Local Toll price reductions. At the same time it should be noted that although Pacific Bell is subject to price floors and ceilings, AT&T, MCI, Sprint and other competitors are not.

With the issuance of D.99-04-071 on April 22, 1999, Pacific Bell implemented intraLATA pre-subscription and began providing its customers the ability to use alternative IECs for intraLATA toll without dialing extra digits. Even prior to pre-subscription, business customers had the ability to program their PBX's and key systems to route Business Local Toll calls to IECs automatically. Hence, this perceived benefit is no longer a valid argument.

Interested parties believe that Pacific Bell has the ability to be made whole for Toll-Free and Business Local Toll price reductions. Previously, Pacific Bell was insulated from the negative financial impacts that other carriers experience when reducing intraLATA toll prices through rate re-balancing. However, that was not always the case and it is not expected to be the case in the future. Within the last year, Pacific Bell reduced its Flat Rate Plus for Business, Value Promise Plus and Advantage 25 calling plan rates without any offsetting revenues. Pacific Bell has also indicated that additional calling plans will be established with further reduction in its prices without any rate re-balancing. In addition, price floors adopted in D.99-11-050 provide for a forward-looking cost TSLRIC methodology that excludes subsidies.

In summary, the evidence provided in this proceeding leads us to conclude that the market for Toll-Free and Business Local Toll services is easy to enter and exit and that both a high supply and demand elasticity exist in the California market. The evidence also shows that other providers have the ability to defeat any attempted price increase for these services and that customers would find this competitive supply to be an acceptable substitute service.

F. Price Discussion

ORA took exception to the Business Local Toll service price floors calculated by Pacific Bell under the adopted D.94-09-065 IRD price floor methodology because of the then pending OANAD proceeding addressing a new price floor methodology proposed by Pacific Bell. ORA's exception to Pacific Bell's method of calculating price floors was resolved with issuance of the OANAD pricing order, D.99-11-050, which adopted a revised price floor formula. Specifically, that decision grandfathered existing price floors until new price floors could be established pursuant to the price floor formula adopted by that decision.

Pacific Bell has not requested any change in the ceiling rates for its Toll-Free and Business Local Toll services which it seeks to be moved to Category III. Hence, the currently effective ceiling rates for these services should continue in effect.

G. Above-the-Line Discussion

Pacific Bell requested that its Toll-Free and Business Local Toll services being moved to Category III should continue to be given above-the-line treatment for ratemaking purposes. There was no objection to this proposal. Hence, consistent with the above-the-line treatment being authorized for the Category III components of Centrex service, Toll-Free and Business Local Toll services being moved to Category III should continue to receive above-the-line treatment for ratemaking purposes.

H. Reporting Requirements

Although ORA recommended that Pacific Bell should be required to separately identify tariff pricing and price floor supports for its business toll contracts, it did not identify how or to whom such information should be

provided. Pacific Bell confirmed that it would, as in the past, provide tariff pricing and price floor supports for its business toll contract to the Commission upon request. However, it objects to providing such information to its competitors because such information contains confidential price data, and if revealed, would place it at an unfair business disadvantage.

No party has provided any reason to impose new reporting requirements for business toll contracts. Pacific Bell should continue to provide its tariff pricing and price floor support to the Commission upon request. To the extent that Pacific Bell is requested to provide tariff pricing and price floor support for its toll contract by non-Commission staff, Pacific Bell may seek relief under General Order 66-C for confidential treatment, as exercised in this proceeding for pricing data.

ORA also recommended that Pacific Bell be required to comply with the Commission's price floor imputation requirements, as set forth in the Commission's March 24, 1993 Resolution T-15139. ORA contends that Pacific Bell should be required to submit the necessary cost support to show that its rates and charges for Business Local Toll are at or above the authorized price floors. In support of its request, ORA referred to page 4 of that resolution in its brief stating that Pacific Bell's compliance with the imputation requirement may be audited at any time by the Commission's Advisory and Compliance Division (CACD). Subsequent to the issuance of that resolution, CACD was restructured into several new Divisions. Responsibilities for Telecommunication matters were transferred to the new Consumer Services Division and to the Telecommunications Division.

Pacific Bell testified that it would continue to adhere to the Commission's price floor imputation rules for setting prices. Hence, to the extent that the Consumer Services Division or Telecommunications Division wants to

audit Pacific Bell's compliance with the imputation requirement they may do so. ORA has requested that Pacific Bell comply with the imputation resolution and Pacific Bell has confirmed its compliance. There is no proposed change to the imputation requirement before us. Therefore, there is no need to address this matter further.

Pacific Bell should continue to conform to the Commission's current reporting requirements.

I. Conclusion

Pacific Bell should be authorized to reclassify its Toll-Free and Business Local Toll services from Category II to Category III, as requested in its application. The currently effective ceiling rates for Pacific Bell's Toll-Free and Business Local Toll services being reclassified to Category III should continue in effect. Further, the re-categorized Toll-Free and Business Local Toll services should continue to be treated as above-the-line items for ratemaking purposes.

XIV. Draft Decision Comments

The principal hearing officer's proposed decision on this matter was filed and served pursuant to Pub. Util. Code Section 311(g) and Rule 77.1 of the Commission's Rules. Comments to the proposed decision were timely filed by Pacific Bell and ORA. Reply comments to the proposed decision were timely filed by Pacific Bell, ORA, and jointly by AT&T, MCI WorldCom, and CCTA.

Rule 77.3 specifically requires that written comments on the proposed decision focus on factual, legal, or technical errors in the proposed decision, and in citing such errors, requires the party to make specific references to the record. Comments that merely reargue positions taken in briefs will be accorded no weight and are not to be filed. Rule 77.4 requires that comments proposing

specific changes to the proposed decision include supporting findings of fact and conclusions of law.

The comments and reply comments filed by the parties to this proceeding have been carefully reviewed and considered. To the extent that such comments required discussion or changes to the proposed decision, the discussion or changes have been incorporated into the body of this order.

Findings of Fact

1. Pacific Bell is a public utility telephone corporation, as defined in Pub. Util. Code § 234, subject to the jurisdiction of this Commission.

2. Pacific Bell filed its applications for authority to re-categorize certain Centrex, Toll-Free (8XX), and Business Local Toll services from Category II to Category III services, pursuant to D.89-10-031 and Rule 42 of the Commission's Rules.

3. Telecommunication services are classified into three distinct categories: Category I for services deemed to be basic monopoly services; Category II for discretionary or partially competitive services; and, Category III for fully competitive services.

4. Pursuant to D.89-10-031, for Category II services to be re-categorized to Category III Pacific Bell must demonstrate that it has or is expected to have insignificant market power for each of the services it seeks to re-categorize.

5. There were approximately twenty comments submitted in opposition to Pacific Bell's Centrex requests by way of letters and electronic mail.

6. This consolidated proceeding was submitted upon receipt of the August 5, 1999 reply briefs.

7. D.89-10-031 directed Pacific Bell to propose criteria for assessing market power at the time it seeks to re-categorize a service to Category III.

8. We did not require that all data regarding the market power criteria addressed in D.89-10-031 and D.90-04-031 be addressed in each and every request to place a service in Category III.

9. Centrex features have been classified as a Category II service since 1989.

10. Basic Centrex Line service was reclassified from Category I to Category II in 1994.

11. Centrex, PBX, and Key Systems services require access to the public switched network through a LEC loop or trunk.

12. Centrex service's relevant market includes alternative CLEC services and business systems such as PBX and Key Set Systems.

13. The costs for Centrex, PBX, and Key Systems are comparable.

14. Pacific Bell began providing Centrex service in 1962.

15. Pacific Bell has not provided PBX or Key System services since 1982.

16. Most PBX and Key System manufacturers operate in national and international markets.

17. Centrex, PBX, and Key System are similar services that perform similar functions.

18. Centrex and other telecommunications equipment, such as PBXs, are dependent on the use of access lines through a Centrex loop or a PBX trunk, and both require the use of local switching capability.

19. Pacific Bell's participation in the Centrex relevant market is limited to only Centrex services.

20. Customers have the ability to change to alternative Centrex services or to competitive PBX and Key System services.

21. Pacific Bell requested that the maximum ceiling rate be set at 100% above the present rates for Centrex service.

22. The cumulative change in the inflation index from 1995 to 1998 was 10%.

23. There was no objection to continue treating those Category II services being moved to Category III on an above-the-line basis for ratemaking purposes.

24. Toll-Free service was classified as a Category I service in 1989 and moved to Category II in 1994.

25. The relevant market for Pacific Bell's Toll-Free and Business Local Toll services includes all IECs and CLECs that offer both intraLATA and interLATA toll service.

26. IEC carriers do not need to build their own network to offer a competitive Toll-Free or Business Local Toll service.

27. IECs were first permitted to offer intraLATA Toll-Free services in 1996.

28. PBX and Key Systems can be programmed to route local toll calls to an IEC.

29. Pacific Bell's Toll-Free and Business Local Toll service costs were based on its OANAD Phase II cost studies.

30. Pacific Bell does not propose any change in its currently authorized ceiling rates for Toll-Free and Business Local Toll services.

31. Pacific Bell is precluded from providing interLATA toll and Toll-Free services until Pacific Bell has met the Section 271 checklist and related requirements.

32. The relevant market for Pacific Bell's Toll-Free and Business Local Toll services encompasses those types of calls, or services, placed between two stations within a local service area.

33. Toll-Free and Business Local Toll services are offered in the relevant market by Pacific Bell, IECs, and CLECs.

34. The Commission has implemented a streamlined process for IEC certification.

35. There are 27 pages of certificated IECs listed on the Commission's web site.

36. AT&T confirmed that Pacific Bell's Toll-Free and Business Local Toll market study results were reasonable.

37. IntraLATA pre-subscription was implemented pursuant to D.99-04-071.

38. Pacific Bell reduced its Flat Rate Plus for Business, Value Promise Plus and Advantage 25 calling plan rates without any offsetting revenues.

39. Pacific Bell does not propose any change in its Toll-Free and Business Local Toll ceiling rates.

40. Upon request, Pacific Bell provides its tariff pricing and price floor supports for its business toll contracts to the Commission.

41. There is no proposed change to the imputation requirement before us.

Conclusions of Law

1. Pacific Bell's applications were consolidated pursuant to Rule 55 of the Commission's Rules, because they involve related issues of law or fact.

2. Pacific Bell's use of the Merger Guidelines and the market power criteria in D.89-10-031 and D.90-04-031 that it deemed relevant, complies with the Commission's market power criteria and may be used to determine whether it has insignificant market power in the services it wants moved to Category III.

3. All data placed under seal should remain under seal.

4. Pacific Bell should be authorized to move its Basic Centrex Line, Centrex Basic Features, Optional Station Features, and Optional System Features from Category II to Category III.

5. The maximum ceiling rate for all Centrex feature components should be limited to 10% above the current tariff price.

6. Those Category II services being moved to Category III should continue to be treated as above-the-line items for ratemaking purposes.

7. The Commission's IEC streamlined certification process, the 27-page list of certificated IECs, and the low start-up cost needed for IECs to offer resold relevant market services from any facilities-based carrier demonstrate the ease of entry and exit for Toll-Free and Business Local Toll services.

8. Toll-Free and Business Local Toll services should be moved from Category II to Category III.

9. The currently effective Toll-Free and Business Local Toll ceiling rates should not be changed at this time.

10. Pacific Bell should continue to provide tariff pricing and price floor support for its business toll contracts to the Commission upon request.

11. Pacific Bell should continue to conform to the Commission's current reporting requirements.

12. The burden of proof is on Pacific Bell to substantiate that it has or is expected to have insignificant market power for the services it wants re-classified to Category III.

13. The critical test for determining whether Pacific Bell has insignificant market power is whether Pacific Bell could retain its market share in the wake of any attempt to raise its prices above-competitive levels.

O R D E R

IT IS ORDERED that:

1. All data placed under seal in the proceeding shall remain sealed for a period of one year from the date of this order. The sealed data shall not be made accessible or disclosed to anyone other than Commission staff during the one

year time period. However, the sealed data may be disclosed upon the execution of a mutually acceptable nondisclosure agreement or on further order or ruling of the Commission or the Administrative Law Judge then designated as the Law and Motion Judge.

2. Pacific Bell is authorized to re-categorize its Basic Centrex Line, Centrex Basic Features, Optional Station Features, and Optional System Features services from Category II to Category III and is authorized to increase its ceiling rate for these Centrex services by 10%. Upon re-categorization of its services to a Category III service, such services shall continue to be treated as above-the-line services for ratemaking purposes.

3. Pacific Bell is authorized to re-categorize its Toll-Free and Business MTS Intra-Local Access and Transport Area (intraLATA) Toll services from Category II to Category III. The ceiling rate for these services shall remain at their

currently effective rate and the services shall continue to be treated as above-the-line services for ratemaking purposes.

4. Pacific Bell is authorized to file revised tariffs with the Commission's Telecommunications Division for the re-categorization of its Basic Centrex Line, Centrex Basic Features, Centrex Optional Station Features, Centrex Optional System Features, Toll-Free, and Business MTS IntraLATA Toll services consistent with this order. The revised tariffs shall become effective when authorized by the Commission's Telecommunications Division, but not less than five days after filing, and shall apply after the effective date of this order.

5. The applications are granted to the extent set forth above.

6. Application (A.) 98-07-020 and A.98-07-029 are closed.

This order is effective today.

Dated May 4, 2000, at San Francisco, California.

HENRY M. DUQUE
JOSIAH L. NEEPER
RICHARD A. BILAS
Commissioners

I dissent.

/s/ LORETTA M. LYNCH
Commissioner

I dissent.

/s/ CARL W. WOOD
Commissioner

APPENDIX A**TABLE OF ACRONYMS AND ABBREVIATIONS**

| | |
|---------------------|--|
| ALJ | Administrative Law Judge |
| Applicant | Pacific Bell |
| AT&T-C | AT&T Communication |
| Business Local Toll | Business MTS IntraLATA Toll |
| CACD | Commission's Advisory and Compliance Division |
| CCTA | California Cable Television Association |
| CLEC | Competitive Local Exchange Carrier |
| Rules | Rules of Practice and Procedure |
| D. | Decision |
| IEC | Interexchange Carrier |
| InterLATA | Inter-Local Access and Transport Area |
| IntraLATA | Intra-Local Access and Transport Area |
| IRD | Implementation Rate Design |
| LATAs | Local Access Transport Areas |
| LECs | Local Exchange Carriers |
| LRIC | Long Run Incremental Cost |
| MCI WorldCom | MCI Telecommunications |
| Merger Guidelines | 1992 Horizontal Merger Guidelines of the U.S. Department of Justice and the Federal Trade Commission |
| MTS | Message Toll Service |
| OANAD | Open Access and Network Architecture Development |
| ORA | Office of Ratepayer Advocates |
| PBX | Private Branch Exchange |
| PHC | Prehearing Conference |
| TSLRIC | Total Service Long Run Incremental Cost |
| UNE | Unbundled Network Elements |
| ZUM | Zone Usage Measurement |

(END OF APPENDIX A)

A.98-07-020, A.98-07-029 ALJ/MFG/tcg