

ORDER NO. 73011

IN THE MATTER OF THE INQUIRY	*	BEFORE THE
INTO ALTERNATIVE FORMS OF	*	PUBLIC SERVICE
COMMISSION		
REGULATING TELEPHONE COMPANIES.	*	OF MARYLAND
	*	
	*	
	*	CASE NO. 8715
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**By the Commission:**

**I. SUMMARY**

During the 1995 legislative session, the General Assembly enacted Chapters 140 and 141 which added Section 69(e) to The Public Service Commission Law.<sup>1</sup> This new subsection, which grants the Commission authority to regulate telephone companies by means other than traditional rate base/rate of return regulation, reads as follows:

(e) Notwithstanding the provisions of subsection (a) of this section or any other provision of law to the contrary, the Commission may regulate a telephone company by means of alternative forms of regulation, which may include, but are not limited to, the use of price regulation, revenue regulation, ranges of authorized return, rate of return, categories of services, or price indexing, if it finds, after notice and hearing, that the alternative form of regulation protects consumers by, at a minimum, producing affordable and reasonably priced local exchange service, as defined by the

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<sup>1</sup> Article 78, Annotated Code of Maryland ("The PSC Law").

Commission, and by ensuring the quality, avail-ability, and reliability of telecommunications services throughout the State; encourages the development of competition, and is in the public interest.

Accordingly, any alternative form of regulation that could be adopted by the Commission would have to provide price and service quality protection for customers, encourage the development of competition, and be in the public interest.

We instituted this proceeding in order to examine the alternative regulation proposals filed by several parties, as well as review Bell Atlantic-Maryland, Inc.'s ("BA-MD" or "Company") rates as necessary to meet the requirements of Section 69(e).<sup>2</sup>

As discussed in detail below, we find that replacing traditional rate base/rate of return regulation with an alternative form of regulation, commonly referred to as price cap regulation, is in the public interest. The plan we adopt today includes the following basic elements:

- 1) Replacement of traditional rate base/rate of return regulation by price regulation which includes price

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<sup>2</sup> Alternative regulatory proposals were filed by MCI Telecommunications Corporation ("MCI"), the Office of People's Counsel ("OPC" or "People's Counsel"), Commission Staff and BA-MD. Several intervenors also suggested alternative price cap proposals through their direct testimony. People's Counsel and Staff also filed petitions to reduce BA-MD's rates.

caps and price adjustment formulas;

2) Start-up rate reductions in access charges;

3) Aside from the reduction in access charges, the starting point for BA-MD's regulated prices will be existing rates;

4) A three-year rate freeze on basic residential services, basic business services, and reduced access services;

5) Pricing flexibility for discretionary and competitive services; and

6) Mechanisms to protect captive customers from unfair price increases after the expiration of the three-year freeze, and from subsidies in support of competitive services.

We expect this plan to protect consumers, improve efficiency, encourage modernization of services and equipment, and enable BA-MD to respond to the

emergence of competition and rapid technological advancement in the telecommunications industry. Therefore, we conclude that the plan we adopt today satisfies the statutory requirements of Section 69(e).

## **II. INTRODUCTION**

Over the past 15 years, the telecommunications industry has undergone significant changes. Traditional monopoly service providers have been joined by a variety of new, competitive entrants. New technologies, supporting new services, have been widely deployed throughout the State. Maryland's telecommunications providers, government leaders and utility regulators have responded to and at times anticipated these changes through a series of statutory and regulatory initiatives.

Prior to the 1983 divestiture of the Regional Bell Operating Companies ("RBOCs") from the former American Telephone and Telegraph Company,<sup>3</sup> the Commission used a traditional rate base/rate of return method to regulate rates and charges for telecommunications services. Divestiture, however, coupled with effective toll call competition, led the Commission to adopt

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The divestiture was accomplished in the Modification of Final Judgment by the United States District Court for the District of Columbia in Civil Action No. 82-0192, United States v. Amer. Teleph. & Teleg. Co., 552 F. Supp. 131, 48 PUR 4th 227 (DC Cir. 1982).

regulatory methods for interexchange telephone companies ("IXCs") more appropriate than traditional rate base/rate of return regulation. Typically, in these decisions the Commission determined that sufficient competition existed to permit variations from the traditional rate base/rate of return method. In each proceeding, the key to our decision was a satisfactory showing of effective market dynamics.

The Commission's first decision authorizing a flexible approach to rate regulation was issued in 1983.

In Order No. 66319, the Commission authorized the resale of Wide Area Telephone Service ("WATS") and Message Toll Service ("MTS")<sup>4</sup>, and established a liberal entry policy for resale carriers. We stated that we would presume, due to the effect of competitive forces, that proposed tariffs of resellers are just and reasonable.

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In Re Commission's Policy on the Resale of Telephone Service, Order No. 66319, August 10, 1983.

In 1984, the Commission issued a key decision involving the regulatory policies and practices which would be applied to non-dominant IXCs.<sup>5</sup> The Commission concluded that the level of competition in the interexchange market and the absence of market power of such companies justified the presumption that the forces of competition would operate to ensure that the non-dominant IXCs' rates would be just and reasonable.<sup>6</sup> Accordingly, the Commission stated that it would waive on request the thirty-day notice requirement for establishing new rates or changes in existing rates, and that the new or changed rates could be accepted for filing without suspension or formal evidentiary proceedings at the Commission's Administrative Meeting within 14 days after the filing was made.<sup>7</sup> The MCI decision was followed in other cases involving non-dominant IXCs.<sup>8</sup>

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Non-dominant IXCs are those long distance telephone companies, other than AT&T Communications of Maryland, Inc. ("AT&T"), which handle a relatively small portion of the total volume of intrastate long-distance telephone service.

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Re MCI Telecommunications Corp., 75 Md. PSC 331 (1984).

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However, we retained full jurisdiction over MCI Telecommunications Corporation's ("MCI's") intrastate rates and could at any time subject the filing to suspension and investigation. Id. at 334.

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See, e.g. Re U.S. Telephone, Inc., 76 Md. PSC 548 (1985); Re U.S. Transmission Systems, Inc., 77 Md. PSC 205 (1986); Re GTE Sprint Communications Corp.; 77 Md. PSC 437 (1986); Re Western Union Teleg. Co., 77 Md. PSC 444 (1986).

The Commission also established a new regulatory treatment for AT&T, the dominant provider of long distance telecommunications services between Maryland's local access and transport areas ("LATAs"). Following a complete review of competitive conditions in the interexchange market, we determined that it was premature to provide absolute parity between the treatment of dominant and non-dominant carriers. Nevertheless, in light of existing competitive conditions, we authorized AT&T to flexibly price its rates within a band approximately five percent above and below the simulated test year revenue requirement.<sup>9</sup>

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Re AT&T Communications of Maryland, Inc., 75 Md. PSC 495 (1984).

In 1986, we found that competitive conditions had changed sufficiently to permit further flexibility in the regulation of AT&T. We determined that it was no longer necessary for AT&T to file for expedited rate changes within the five percent band. However, we continued to impose upon AT&T certain regular reporting requirements.<sup>10</sup>

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Re AT&T Communications of Maryland, Inc., 77 Md. PSC 208 (1986), adhered to on rehearing, 78 Md. PSC 202 (1987).

Our first alteration of the regulatory scheme under which BA-MD<sup>11</sup> operated occurred in 1985. In Case No. 7851, a C&P rate proceeding, we authorized C&P to implement a flexible pricing plan for its message toll services. C&P was authorized to change its toll rates anywhere within a specified range upon 14 days notice to the Commission.<sup>12</sup>

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BA-MD was known, prior to 1993, as the Chesapeake and Potomac Telephone Company of Maryland, or "C&P".

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9Re Chesapeake & Potomac Telephone Co. of Maryland, 76 Md. PSC 238, 294-295 (1985).

Other changes occurred in 1986 and 1987, when the Commission authorized the provision of customer-owned coin-operated telephone service<sup>13</sup> and shared tenant service.<sup>14</sup> These services compete with certain services provided by C&P. Also in 1987, we concluded that the radio common carrier industry was sufficiently competitive so that the protection of the public interest no longer required any form of Commission regulation and supervision. Accordingly, we recommended to the Governor and the General Assembly that Section 55A, establishing the Commission's jurisdiction over the radio common carrier industry, be repealed.<sup>15</sup> At the next session of the General Assembly, a bill was enacted fully deregulating the radio common carrier industry.<sup>16</sup>

Thus, by the mid-1980s, and within the parameters established by Article 78, the Commission modified various regulatory policies and practices in order to reflect changes in the telecommunications industry occurring at that time. As noted above, our decisions established regulatory flexibility for

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<sup>13</sup>

Re Customer Owner Telephone Coin Equipment in the Public Telephone Market, 77 Md. PSC 579 (1986).

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Re Chesapeake and Potomac Telephone Co. of Maryland, 78 Md. PSC 352 (1987).

<sup>15</sup>

Need for Regulation of the Radio Common Carrier Industry, 78 Md. PSC 440 (1987).

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interexchange carriers, resellers of interexchange service, customer-owned coin-operated telephones, and radio common carriers. These decisions pertained to services where the extent of competition was easily measurable and the telecommunications companies involved were providing a narrow range of services. Thus, it was not difficult for the Commission to assess the degree of competition and the capability of any one telecommunications company to unfairly price its services or engage in anti-competitive behavior.

The Commission was faced with a greater challenge toward the end of 1987. On September 30, 1987, C&P filed with the Commission a proposal for a four-year trial of a new method of regulation. In part, the proposal provided that during the four-year trial, basic telephone services<sup>17</sup> would be protected from price increases except under specific conditions. In addition, C&P proposed to have the flexibility to price, in response to market conditions, other telecommunications services which it characterized as competitive or discretionary. As an added protection, C&P offered to place caps on the amount of rate increases for certain

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Basic telephone services included residential and business dial tone lines, residential usage and service charges and foreign exchange service. According to C&P, these services represented approximately 49 percent of its tariffed revenues.

specified services.<sup>18</sup> On January 18, 1988, the Commission instituted an evidentiary proceeding for the purposes of evaluating C&P's modified proposal and determining whether the Commission should change its regulatory oversight of C&P on an experimental or trial basis.<sup>19</sup>

In filing its proposal, C&P argued that rapid technological advances and increasing competitiveness in telecommunications markets had created an environment in which traditional regulation was ill-equipped to respond.

Accordingly, C&P argued that its proposal offered a different form of regulation that would protect customers of basic telephone service from price increases and at the same time provide C&P with flexibility to respond quickly and innovatively to market conditions.

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"Capped" services were switched access, special access, private line, business message units, business service charges and Touch-Tone. According to C&P, these capped services provided 31.5 percent of C&P's tariffed revenues.

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Due to the unique nature of C&P's proposal, the Commission initially established a Telecommunications Task Force to serve as a forum for informal analysis and discussion. After several meetings, C&P filed a modified proposal on December 8, 1987 which was intended to address some of the concerns raised during the meetings. However, in its written report, the Task Force indicated that no consensus could be reached regarding the proposal.

Because of the limits imposed by Section 69(a) of The PSC Law, the Commission's ability to consider regulatory reforms which addressed the changing telecommunications marketplace was limited. The Commission concluded that it lacked the necessary legal authority to accept certain key aspects of C&P's proposal.<sup>20</sup> The evidence proffered by C&P on potential competition for certain services did not persuade the Commission that competition could be relied upon as a mechanism to assure just and reasonable rates during the trial period.<sup>21</sup> Since C&P had emphasized that it would withdraw its proposal were the Commission to reject or modify any significant portion of it, the Commission denied C&P's request to implement the proposal.

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Re Chesapeake and Potomac Telephone Company of Maryland, et al. 79 Md. PSC 169, 193-199 (June 30, 1988).

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Specifically, the Commission found that the evidence did not support a finding that the flexibility to increase the business message unit rate, special access rate or private line rate would satisfy the just and reasonable standard even though the proposal incorporated constraints on C&P's freedom to increase those rates. Id. at 195.

However, the Commission found that certain aspects of C&P's proposal had merit. The evidence established that certain services were subject to active competition or indirect competition from viable and closely substitutable services and alternative providers.

Thus, market pricing of these services would result in just and reasonable rates. The Commission authorized market pricing of: Centrex intercom and related services;<sup>22</sup> billing and collections service; intra-LATA WATS and 800 services; high capacity private line service; speed dialing; and the custom calling features of call waiting, call forwarding and three-party calling for multi-line business customers. Both audiotex service and preferred telephone number service were found to be discretionary and thus also could be market priced. Additionally, the Commission determined that tariffs for new services could be filed under its market pricing requirements so long as there was an adequate description of the new service and cost support was provided to Staff. As a final matter, the Commission recommended that the General Assembly consider amending The PSC Law to provide the Commission with authority to engage in

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The Commission approved market pricing of these services to allow C&P to compete with the various competitors offering private branch exchanges ("PBXs") or other similar customer premises equipment. However, the Commission retained regulatory authority over the charges for PBX trunks and Centrex access lines. Id. at 203.

trials of regulatory methods which might involve the acceptance of rates which otherwise could not be shown to clearly satisfy the just and reasonable standard of Section 69(a).

In 1990, this flexible regulatory regime was expanded. On May 1, 1990, C&P, OPC and Staff filed a Joint Petition for Approval of Agreement ("Tripartite Agreement"). The Tripartite Agreement proposed an open-ended flexible regulatory structure for C&P that capped certain basic rates, continued market pricing for competitive services, provided for sharing of earnings above a specified range and directed the development of a cost allocation manual. On September 24, 1990, the Commission granted the Joint Petition.<sup>23</sup> This approval created a bifurcated incentive-based flexible regulatory structure for C&P that expanded the existing policy of separating C&P's services into those that could be market-priced ("competitive services") and those that could not be market-priced ("other-than-competitive" or "OTC" services), provided for the sharing of earnings between the Company and its OTC customers if the return on equity earned on OTC services exceeded 13.6 percent, and allowed C&P to retain all earnings on its competitive services. Additionally, C&P was directed to file

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Re Chesapeake and Potomac Telephone Company of Maryland, 81 Md. PSC 395 (1990).

evidence and testimony addressing the operation of the Tripartite Agreement and the reasonableness of its OTC rates by March 31, 1992.

In 1993, the Commission again considered the issue of the appropriate regulatory framework for C&P. In Case No. 8462, C&P presented evidence concerning the Company's operations under the Tripartite Agreement and proposed changes to the existing regulatory structure. In its Order, the Commission determined that the current bifurcated incentive-based regulatory plan had worked well and should be continued.<sup>24</sup> Further, the Commission concluded that it would not preclude C&P or other parties from petitioning for recognition of exogenous cost changes. The Commission's expressed intention was to continue its progressive policies in regulating the rates and services of C&P.

The next step in opening Maryland's local telephone service markets to competition began on July 26, 1993, with the filing by MFS Intelenet of Maryland, Inc. ("MFSI-MD") of an application for authority to provide and resell local exchange and intrastate exchange telecommunications services in the areas of Maryland served by BA-MD. In addition, MFSI-MD petitioned the Commission to establish specific policies and

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Re Chesapeake and Potomac Telephone Company of Maryland, 84 Md. PSC 4 (1993).

requirements for the interconnection of competing local exchange networks. In setting the application for hearing, the Commission concluded that the proceeding should serve to establish generic policies, procedures and requirements for telecommunications carriers seeking to provide competitive local exchange telephone service in Maryland.

In the first phase of the MFSI-MD proceeding,<sup>25</sup> the Commission approved, in principle, the unbundling of local exchange links and ports.<sup>26</sup> We granted MFSI-MD authority to provide telephone services on facility and resale bases in Maryland. BA-MD was required to provide for interconnection with MFSI-MD at tandem and central office switches. An interim interconnection rate also was established for local call termination on BA-MD's network. In addition, MFSI-MD was permitted to file a tariff, with cost support, to establish a charge for the termination of calls on its own network.

The Commission revisited the issue of the appropriate method of regulating BA-MD in Case No. 8584.

BA-MD argued that the Commission should institute price

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Re MFS Intelenet of Maryland, Inc., Case No. 8584, 85 Md PSC 38 (April 25, 1994). The second phase of the MFSI-MD proceeding, Re MFS Intelenet of Maryland, Inc., 86 Md. PSC 467 (December 28, 1995), resulted in decisions concerning the rates for and terms and conditions of services offered by competing local exchange companies.

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The policy requires unbundling by BA-MD to the extent that the purchase of unbundled elements is requested by a co-carrier, reseller or interconnector and is reasonable and technically feasible without causing damage to network integrity.

cap regulation of the Company as a response to the local market entry of competing local exchange companies ("CLECs") such as MFSI-MD.

The Commission determined that it would be inappropriate to implement Company-related regulatory changes in Case No. 8584, and further found that BA-MD's proposed price cap model was not consistent with statutory requirements. As it did in 1988, however, the Commission emphasized that it should have the option to consider alternative forms of rate determination. Accordingly, the Commission concluded that the Public Service Commission Law should be amended to clarify the Commission's authority to consider new approaches to rate setting. The Commission invited parties to proffer draft legislation for its review in Case No. 8587.<sup>27</sup> The purpose of this proffer was to provide an additional opportunity for all parties to offer analysis, comments or alternative legislation. After examining the submissions of the parties, the Commission reaffirmed its conclusion that the Commission should have broad

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In Re Regulation of Firms, Including Carrier Telecommunications Providers, and Cable Television Firms, Which May Provide Local Exchange and Exchange Access Services in Maryland in the Future, Case No. 8587, 85 Md. PSC 69 (May 5, 1994, the Commission determined that it had jurisdiction over two-way telecommunications services offered by cable television companies. In a later order in the same proceeding, the Commission considered generic issues in regard to the provision of local exchange service by competing entities. 85 Md. PSC 187 (October 5, 1994).

authority to consider new forms of rate setting and stated that it favored a simple legislative amendment to Article 78.

During the 1995 legislative session, the General Assembly passed bills codifying Section 69(e). The bills were signed into law by the Governor on May 9, 1995.<sup>28</sup> The law went into effect on June 1, 1995. This proceeding is a direct result of this enactment.

Maryland's experience with competition-oriented regulation demonstrates the viability of alternatives to traditional rate base/rate of return regulation. In general, Maryland has been well served by the incentives and protections created through past initiatives. Building on that experience, adoption of a price cap regulation plan will create additional incentives for BA-MD to implement cost-cutting and revenue enhancing measures. It also will ensure that customers benefit from BA-MD's and CLEC's deployments of modern technology.

However, the adoption of a price cap plan for BA-MD does not alter the Company's position as a monopoly or near monopoly provider of many telecommunications services in Maryland. Although we recognize the emergence of competition in Maryland, BA-MD does not yet face competition for many of its services. Adequate

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Laws of Maryland, Chapters 140 and 141 (1995).

safeguards remain necessary to protect the interests of the public where elements of monopoly continue to exist.

### **III. PROCEDURAL HISTORY**

On November 20, 1995, MCI filed a "Petition for Implementation of Competition Plus: A True Price Cap Plan for Maryland." This petition proposed an alternative method of regulating the rates of BA-MD. In written comments addressing this petition, Staff recommended that we docket a proceeding to consider MCI's proposal as well as any other alternative regulation proposals. Staff also included a list of issues and a proposed schedule.

Then, on December 4, 1995, OPC filed a "Petition for a Reduction in the Rates of Bell Atlantic-Maryland, Inc." In this petition, OPC requested that we institute a proceeding to investigate the justness and reasonableness of BA-MD's rates and that we order a reduction in those rates of at least \$40.4 million.

In written comments, Staff recommended that we grant OPC's request to institute an investigation into the rates charged by BA-MD, and suggested that this investigation should be conducted simultaneously with our consideration of alternative regulation proposals. Responses to Staff's comments were filed by BA-MD, OPC, MCI and the Cable Television Association of Maryland,

Delaware and the District of Columbia ("CATV").

We considered both MCI's and OPC's filings at our December 20, 1995 Administrative Meeting. MCI, OPC, Staff, BA-MD and AT&T presented oral argument in support of their positions.

By Order No. 72339, dated December 22, 1995, we instituted an evidentiary proceeding to examine all alternative regulatory proposals filed by January 4, 1996, as well as to review BA-MD's rates. Furthermore, we adopted a procedural schedule and ordered the parties to develop a list of issues to be filed by January 4, 1996. Notice of these proceedings was published in regional newspapers.

On December 22, 1995, BA-MD filed a Petition for Adoption of a Price Cap Form of Alternative Regulation. Also on that date, OPC filed a request for waiver of the January 4, 1996 deadline for filing alternative regulation proposals. Staff also filed a similar request for waiver on December 27, 1995. We granted both requests.

On January 17, 1996, we held a prehearing conference at which Staff and OPC entered their appearances. Petitions to intervene were granted for the following: BA-MD, AT&T, MFSI-MD, MCI, Teleport Communications Group, Inc. ("TCG"), Sprint Communications Company, L.P. ("Sprint"), Baltimore Gas

and Electric Company ("BGE"), CATV, and the U.S. Department of Defense and All Other Federal Executive Agencies ("FEA"). At the prehearing conference, we adopted a procedural schedule and took under advisement the issues that the parties should be required to address during the proceeding.

On January 19, 1996, Staff filed its price cap proposal. OPC filed a price cap proposal on January 23, 1996. On February 1, 1996, we issued a Notice of Procedural Schedule, Service List and List of Issues. This notice confirmed the procedural schedule adopted at the prehearing conference. After reviewing the issue lists submitted by Staff, BA-MD and OPC, we adopted a list of issues to be addressed by the parties during the proceeding.<sup>29</sup>

Direct testimony was filed on February 15, 1996.

BA-MD proffered the testimony of Daniel J. Whelan, Mary R. Vaden, Richard G. Petzold, Edward M. Wylonis and Alfred E. Kahn. The Commission Staff presented the testimony of Steve Molnar, Geoffrey J. Waldau, Anthony Myers, and Wayne L. Lash.

Filing testimony on behalf of OPC were Kenneth F. Gallagher, Ben Johnson, Michael J. Majoros, Basil L. Copeland, Jr. and Trevor Roycroft. MCI sponsored

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See Appendix 1 for the list of these issues.

witnesses Joseph Dunbar and Dr. Nina W. Cornell. Also filing testimony were John W. Mayo on behalf of AT&T, Harry Gildea on behalf of FEA, Dan Vanderpool for Sprint and Dr. A. Daniel Kelley for CATV.

On March 14, 1996, rebuttal testimony was filed by the parties. Daniel J. Whelan, Mary R. Vaden, Edward M. Wylonis, William M. English, Richard G. Petzold, James H. Vander Weide, William E. Taylor and Alfred E. Kahn filed on behalf of BA-MD. AT&T proffered the testimony of G. Blaine Darrah III, Don J. Wood, John W. Mayo, and James Dionne. Dr. Nina W. Cornell and Dr. Robert A. Mercer filed testimony on behalf of MCI. Also filing testimony were Dan Vanderpool for Sprint, Dr. A. Daniel Kelley for CATV, Kenneth F. Gallagher and Ben Johnson for OPC, and Geoffrey J. Waldau for Staff.

A final round of testimony was filed on April 1, 1996. Surrebuttal testimony was filed by Daniel J. Whelen, Mary R. Vaden, Edward W. Wylonis, William M. English, Richard G. Petzold, William E. Taylor and Alfred E. Kahn on behalf of BA-MD. MCI proffered the surrebuttal testimony of Dr. Nina W. Cornell and Terry L. Murray. The same witnesses who filed rebuttal testimony for AT&T also filed surrebuttal testimony. Similarly, the same witnesses who filed direct testimony on behalf of Staff and OPC also filed surrebuttal testimony on behalf of those respective parties.

Evidentiary hearings were held from April 15, 1996 through April 19, 1996, and completed on April 22, 1996. During these hearings, witnesses for the various parties were cross-examined on their prefiled testimony.

In addition to the hearings conducted at the Commission's offices, several evening hearings were advertised and held at various locations throughout the State for the purpose of receiving public comment.

Initial briefs were filed on May 14, 1996. Reply briefs were submitted on May 24, 1996.

We have carefully considered all evidence and arguments presented by the parties to this proceeding in arriving at our findings in this case.

#### **IV. THE PARTIES' PROPOSED PLANS**

Four parties formally submitted price cap proposals. BA-MD, Staff and OPC propose forms of "traditional" price cap regulation, while MCI proposes what it considers to be a streamlined price cap plan.

All the proposals involve alternative regulatory plans that would regulate the Company's prices rather than its earnings. Under BA-MD's plan, services would be divided into six categories: Access; Basic-Residential; Basic-Other; Discretionary; Competitive; and Co-Carrier services. The rates for Basic-Residential services would be capped for a period of two years, and prices for many

businesses services for one year. After that, rates for these services could be increased or decreased annually using a formula based on changes in the Gross Domestic Product-Price Index ("GDP-PI") and a productivity offset of 1.5 percent. Rates for discretionary services could be increased up to 25 percent annually or reduced at any time, provided rates are not reduced below costs. Competitive services would be subject to full pricing flexibility.

Staff's proposal divides services into five categories: Basic-Competitor Inputs; Core Services; Basic-Other; Other-than-Competitive-Discretionary; and Competitive. Prices for Core Services, Basic-Competitor Inputs and Basic-Other would be frozen for five years. Price changes for Discretionary services would be subject to the price cap index formula. Staff's proposed formula differs from BA-MD's in that Staff recommends a productivity offset of 5.3 percent and also recommends a service quality index ("SQI") offset. The SQI offset would be used to reduce the Company's price cap index if BA-MD fails to meet the service quality requirements proposed by Staff. Under Staff's plan, other-than-competitive basic services could only increase 10 percent annually, while other-than-competitive discretionary services could increase up to 25 percent annually. Like the BA-MD proposal, Staff's proposal recommends full

pricing flexibility for competitive services. Staff's plan also differs from BA-MD's plan in that Staff recommends a review of the plan after five years. Finally, Staff recommends reducing switched access charges, as well as rates for some other BA-MD services, to establish the initial rates under price cap regulation.

MCI proffered a "Competition Plus" price plan. The MCI plan would essentially realign access or interconnection rates with direct economic costs, cap rates for BA-MD's OTC services at existing rates, develop a universal service support mechanism, and eliminate earnings reviews, price regulation of competitive services, and cost studies for BA-MD. The MCI plan eschews automatic price adjustments. Finally, in lieu of competitive safeguards, MCI's plan would rely on strict enforcement of antitrust law to police anti-competitive behavior by BA-MD.

OPC's plan creates six categories of services: Residence-Basic; Business-Basic; Discretionary; Competitive; Toll-Switched Access; and Other-Wholesale. Under OPC's proposal, prices for Residence-Basic and Business-Basic are frozen for three years. The prices for Discretionary Services, Other-Wholesale Services, and Toll-Switched Access Services would be subject to the PCI formula. OPC recommends a productivity offset of 5

percent and, like Staff, also recommends a service quality adjustment. As a further limitation, OPC's plan would limit the price increases for individual rate elements. OPC's plan requires the price for each service used by BA-MD to exceed total long run incremental cost, and the price for each rate element to exceed its long run marginal cost. Finally, as noted earlier, OPC requests that we reduce BA-MD's rates to establish the initial rates under price cap regulation.

## **V. POSITIONS OF THE PARTIES**

As noted earlier, we asked the parties to address the issues listed in Appendix 1 during the course of these proceedings. The following is a summary of the parties' positions concerning these issues.

### **A. Section 69(e) Criteria**

This section addresses two of the issues contained in the list. Parties addressed how their proposed framework would further the legislative objectives contained in Section 69(e), as well as how the new regulatory framework would improve performance beyond that of the current regulatory structure.

According to BA-MD, the record evidence confirms that its plan meets each of the requirements of Section

69(e). BA-MD asserts that its plan ensures that basic rates will remain affordable and reasonably priced. It bases this conclusion on several factors, including the assertion that it has not earned in excess of the rate of return authorized in 1993.<sup>30</sup> BA-MD also notes that the Commission specifically found in 1994 that local exchange rates were affordable, based in part on Maryland's telephone penetration rate of 96 percent. This penetration rate has since increased to 97.3 percent which, BA-MD claims, demonstrates that rates have become more affordable and reasonably priced.

The Company asserts that its plan also preserves the Commission's existing authority to oversee the quality and reliability of BA-MD's services. According to BA-MD, the plan ensures that the development of competition will be both fast and fair, and that the plan will be in the public interest because it will protect and benefit consumers.

OPC contends that Section 69(e) preserves the Commission's authority to regulate a telephone company using the present rate base/rate of return method if that method best meets the legislatively-mandated goals. According to OPC, the Commission could comply fully with Section 69(e) by continuing existing regulatory methods

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As noted previously, the Commission set BA-MD's current rates in 1993 and also established a mechanism requiring earnings above an authorized level to be shared. BA-MD has never had excess earnings during this period.

and reducing BA-MD's rates by \$218 million, a figure which reflects the results of OPC's examination of BA-MD's rates subsequent to the filing of its December 4, 1995 rate reduction petition.

OPC contends, however, that if the Commission determines that a price cap is the proper method of regulation, earnings information still is essential for a proper determination of rates. OPC says that the Commission is free to set prices based on any appropriate criteria.

OPC argues that to the extent the Commission determines that the adoption of a price cap plan is in the public interest, it should adopt OPC's plan without modification. OPC believes BA-MD's plan provides too much relief from oversight and regulation, while impeding the emergence of full and fair competition. Similarly, according to OPC, MCI has presented a price cap plan that primarily protects its corporate interests.

Staff contends that its plan is designed to protect consumers by controlling prices where consumers lack competitive alternatives, insulating captive customers from risks of competitive losses, and establishing service quality standards that will ensure high quality service by both BA-MD and its competitors. In addition, Staff asserts that its plan removes barriers to competitive entry, while providing BA-MD with the

pricing flexibility necessary to respond to competition, increase productivity, and offer new and innovative services while maintaining financial stability.

Furthermore, with regard to the Section 69(e) requirements, Staff argues that the term "reasonably priced basic local exchange service" means a service which is priced close to cost. According to Staff, the proposal by a number of parties to reduce switched access charges to cost, coupled with the Commission's authority to see to it that IXCs flow the reductions through to customers, directly responds to the legislative mandate to encourage the development of competition. Finally, Staff's plan proposes service quality measures and a service quality index.

Both Staff and OPC object to BA-MD's contention that Maryland's high telephone penetration rate means that basic rates are affordable. According to Staff, the concept of affordability as a regulatory standard is new and the Commission should be careful in crafting its interpretation.

MCI contends that its plan best meets the legislative standard because it protects consumers by capping rates for basic local exchange service while allowing downward pricing flexibility and preventing automatic increases in basic rates. Further, MCI claims that its plan protects captive ratepayers because they

will see real price decreases, at least equivalent to inflation, even before those services become competitive.

According to MCI, the plan guarantees that BA-MD cannot raise basic service rates through annual automatic price increases resulting from a price formula. Also, the plan guarantees that BA-MD cannot raise basic service rates through revenue neutral rate rebalancing, thus preventing captive ratepayers from having to ensure BA-MD against competitive risks. Finally, MCI argues that only its plan assures the development of full and fair competition by immediately setting essential monopoly input functions at incremental cost.

CATV is the only party opposing the adoption of a price cap plan. CATV contends that the proponents of price cap regulation have failed to demonstrate that price caps are in the public interest, and that absent cost filings by BA-MD, the record does not support the immediate implementation of a price cap plan.

#### **B. Inflation Offset/Productivity Factor**

All parties presenting a price cap proposal, except for MCI, agree that the GDP-PI is the appropriate index for inflation, but disagree on the appropriate inflation offset to be incorporated into the formula. BA-MD argues that the Commission should adopt a 1.5 percent inflation offset, contending that it is the only

one that is fair to both consumers and the Company.

According to BA-MD, the record indicates that the Company will have competitive losses of approximately \$140 million annually, or 12 percent of its existing revenue over a five-year planning period. Further, BA-MD contends that its achievable productivity gains will be modest, because any significant breakthroughs in network efficiency have already been realized and additional progress will be incremental. The Company claims that increased network efficiency will be partially offset by the need to incur greater expense for marketing, advertising, and depreciation, and BA-MD will have to share any growth with competitors targeting customers of high-margin, value-added services.

MCI contends that PCI formulas fail to produce competitive market results. MCI asserts that BA-MD's 1.5 percent offset will result in residential ratepayers not sharing in the cost benefits engendered by improvements to BA-MD's network, and guarantees annual price increases for residential ratepayers.

OPC also objects to BA-MD's 1.5 percent offset on the ground that BA-MD failed to present any evidence supporting it. Instead, OPC contends that its proposed 5 percent productivity factor ensures that increases in productivity associated with a more competitive BA-MD and the rapid technological innovations in the

telecommunications field will benefit residential customers with lower prices, similar to those occurring in truly competitive markets. Finally, OPC asserts that telecommunications is a declining cost industry and that BA-MD is experiencing explosive growth.

Staff proposed a productivity factor of 5.3 percent based upon factors developed by the Federal Communications Commission ("FCC"). Staff argues that its formula reflects growth in output and efficiency, as well as capturing the savings from declining costs in the telecommunications industry. Staff contends that it conducted a complete Total Factor Productivity ("TFP") and Input Price Differential ("IPD") analysis taking into account all outputs and inputs to determine that the telecommunications costs are declining, while BA-MD did only a partial analysis.

FEA contends there is a need for a substantial productivity offset. However, according to FEA, the PCI should be designed to more accurately reflect differences between the overall rate of inflation in the nation's economy (measured by the GDP-PI) and conditions pertinent to the costs that BA-MD incurs to provide services to end users and other carriers.

According to BA-MD, Staff and OPC erroneously conclude that: competition will not adversely affect BA-MD's revenues and productivity; that competition will be

slow to develop and will have minimal effect on the Company; and that competition will promote the introduction of new services and major cost reductions that will enhance BA-MD's productivity.

### **C. Service Quality**

With regard to service quality issues, the parties were to address whether the regulatory framework should explain in detail how Section 69(e)'s objectives regarding quality and reliability would be met. Furthermore, the parties also discussed whether a failure to meet quality of service guidelines should influence the prices the Company could charge.

#### **1. Standards**

Staff proposes that BA-MD should be required to meet additional, detailed service quality standards in order to comply with Section 69(e)'s objective of ensuring quality service. Staff believes these additional measures are necessary, because under price cap regulation the incentive for profit maximization may result in deteriorating service quality. Staff also argues that its proposed service quality measures are not burdensome, since BA-MD currently monitors and reports these measures to either this Commission or the FCC.<sup>31</sup>

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<sup>31</sup> According to Staff, the standard requiring BA-MD to meet a 98 percent target of restoring telephone outages within 24 hours is less than the current COMAR standard which requires 100 percent restoration within 24 hours. Furthermore, Staff argues that BA-MD is able to meet enhanced service quality requirements since management voluntarily ~~34~~ raised its service quality standards in connection with its management compensation program.

Staff also proposed several service quality reporting requirements.<sup>32</sup> First, BA-MD should continue to provide all service quality information currently required by the Code of Maryland Regulations ("COMAR"). Second, the Company also should provide the Quality Service Report which is filed with the FCC. Third, Staff recommends that BA-MD be required to file a quarterly service quality report indicating the level of performance in each service category by month and as a rolling average for the current 12-month period.

Staff contends that BA-MD should be required to report all service quality measures on a quantitative basis indicating percentage of compliance. For any quarter in which BA-MD reports that it did not meet the target standards, Staff recommends that the Company prepare a supplemental narrative statement describing the cause, the expected duration and the action being taken to correct the problem. Finally, Staff recommends that BA-MD be required to report service quality performance separately for business and residential customers.

In contrast to Staff's proposal, both the BA-MD and MCI plans would allow competition to regulate service quality. An additional element of BA-MD's plan proposes the continued adherence to current service quality

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CATV supports Staff's reporting requirements.

standards.

AT&T argues that safeguards remain necessary to promote and preserve the nascent competition that is developing in the markets presently served by BA-MD. AT&T proposes that the Commission adopt Staff's recommended service quality standards, with some modifications.

MCI contends that BA-MD should file on a regular basis only the information that the Commission needs to monitor service quality and the development of competition and any information required by the Commission under COMAR. Finally, the OPC plan requires BA-MD to adhere to service quality standards adopted by the Commission but does not suggest specific standards. OPC believes, however, that the standards set forth in Staff's plan are reasonable and appropriate. The OPC plan would require BA-MD to receive Commission approval before discontinuing existing services.

## **2. Service Quality Adjustment/Index**

The OPC and Staff PCI formulas contain provisions designed to financially penalize BA-MD for significant declines in service quality.<sup>33</sup> The OPC plan includes a service quality adjustment ("SQA"), which is a numerical figure used to reduce prices when service

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CATV supports the need for penalties.

quality declines over time. Under this provision, BA-MD can be penalized up to a 2 percent reduction in the PCI if the Commission determines that service quality has deteriorated significantly.

According to OPC, this provision is necessary because BA-MD still has an effective monopoly on residential telephone service. OPC is concerned that BA-MD may try to cut its costs of serving residential consumers to make up for revenue losses it may incur in the more competitive business markets, and that such cost cutting could lead to a decline in service quality.

Staff contends that its price cap plan will ensure quality, availability and reliability of service by linking compliance with higher service quality requirements to the rates BA-MD can charge. Staff asserts that its SQI, which has a maximum reduction of 1 percent, will act as an incentive for BA-MD to maintain appropriate levels of service, since failure to do so will reduce its revenues.<sup>34</sup>

BA-MD objects to the penalty proposals for Company failures to meet service quality standards. According to BA-MD, tying the price cap formula to service quality results is unnecessary in view of the Commission's existing authority, and because customers can go to other companies in competitive markets should a

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<sup>34</sup> Sprint supports Staff's SQI proposal

provider fail to deliver quality service.

#### **D. Service Baskets**

We asked if all of BA-MD's services should be classified into service baskets. Also, the parties were to address what criteria should be used in grouping services together, and in deciding the number of baskets to be utilized. The assignment of services to baskets and the use of bands is intended to replicate the effect of competition. Baskets refer to groups of services with common characteristics; e.g., similar customers, similar degree of necessity, similar levels of competition or similar effects on competition.

Three of the four proposals submitted to the Commission divided BA-MD's services into baskets.<sup>35</sup> Both BA-MD and OPC recommended six service baskets, while Staff's plan utilized five baskets. However, disputes in this area did not center on the number of baskets to be used, but on whether specific services should be considered basic, discretionary or competitive.

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MCI's plan involved capping the rates of all other-than-competitive services, while permitting pricing flexibility for competitive services.

Under BA-MD's plan,<sup>36</sup> services were divided into six baskets: Access; Basic-Residential; Basic-Other; Discretionary; Competitive; and Co-Carrier services. According to the Company, its plan preserves the placement of services in existing categories, with several exceptions. First, Non-published and Non-listed Directory Services should be reclassified from Discretionary to Competitive because there are multiple competitors for these services. Second, the Company argues that Low Capacity Special Access should be reclassified from Basic to Discretionary because this service is similar to Private Line. Thus, BA-MD contends that the Commission's treatment of these services should be identical. Third, the Company believes that Operator Handling Charges should be reclassified from Discretionary to Competitive because there are multiple competitors providing this service. Finally, BA-MD contends that Repeat Call should be reclassified from Discretionary to Competitive because customers can obtain similar functionality through a "redial" button on their telephones.

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See BA-MD's Price Cap Plan, Attachment A, for specific services baskets.

Staff's plan also proposed changing existing service classifications.<sup>37</sup> Staff proposed reclassifying Coin Calls and Directory Assistance (residential) as Core Services. Staff contends that payphones are an essential service and that Directory Assistance should be reclassified to allow customers to obtain numbers not yet listed in the book.

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See Staff's Price Proposal, pages 1-2, for Staff's proposed service baskets.

One of OPC's proposals<sup>38</sup> was to reclassify ISDN services into "basic residence" and "basic business" categories. OPC contends that ISDN essentially is an enhanced basic local service. In addition, OPC proposed to categorize as competitive the currently deregulated services of Voice Mail, Inside Wire Maintenance, Customer Dialed Account Recording, and Yellow Pages.

#### **E. Pricing Limitations**

Several questions were posed concerning the pricing limitations to be applicable to the differing baskets. First, the parties addressed the question of what criteria should be used to determine which services should be capped and how long the cap should remain in effect. The second question was whether the alternative regulatory framework should include different pricing rules for each basket. Finally, the parties addressed the need for a relative pricing mechanism for each basket.

The BA-MD plan proposes an effective date of January 1, 1996 unless modified by the Commission. The plan caps prices for Access and Basic-Residential services at current levels through December 31, 1997. Prices for services in the "Basic-Other" category,

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See OPC's A Price Cap Proposal for Bell Atlantic-Maryland, Inc., pages 4-6, for OPC's proposed service baskets.

consisting primarily of business services, would be capped through December 31, 1996. At the expiration of the cap, the PCI formula would come into play and prices would rise or fall based upon the available revenue change. Prices for discretionary services may be increased up to 25 percent annually without Commission approval, and prices for competitive services are accorded full pricing flexibility. Prices for Co-Carrier Services are not directly regulated under BA-MD's plan, since those rates were only recently established by the Commission as interim rates and are subject to on-going proceedings before both this Commission and the FCC.

Staff urges that BA-MD's caps should be rejected for several reasons. First, since the cap would last only between 6 and 18 months with an indexed cap to be applied thereafter, the duration of the cap is inadequate to allow for the development of effective competition. Second, because the inflation offset in the indexed price cap formula is less than the rate of inflation, captive consumers will experience annual rate increases. Third, Staff criticizes BA-MD's failure to apply a capping mechanism to all OTC services.

FEA objects to that aspect of BA-MD's plan which would permit the Company to increase prices for any discretionary service by as much as 25 percent in any calendar year. FEA recommends that the increase for

Discretionary services be limited to the change in GDP-PI, less a 5.3 percent productivity offset, plus 10 percentage points. FEA argues that residential rates should not be frozen at their present level unless BA-MD can demonstrate that these services are contributing to common and fixed costs in the same proportion as all of the Company's services in the aggregate.

According to OPC, the purpose of the time periods for caps on prices and other transitional mechanisms is to allow effective competition to develop in Maryland before the safeguards expire. OPC recommends that any time period for caps or other safeguards should begin to run at the time the Commission orders the institution of a price cap plan. Furthermore, OPC argues that the length of BA-MD's cap on residential rates is insufficient to allow competition to develop in the residential market. Finally, OPC criticizes BA-MD's proposal to allow, with Commission approval, revenue neutral price changes between baskets. People's Counsel contends that such changes would be anti-competitive.

In contrast, OPC's plan would institute a three-year cap,<sup>39</sup> after which prices would be subject to the

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Staff objects to OPC's cap of three years, contending the period is insufficient to allow effective competition to develop. Staff also says a three-year cap will not allow sufficient rate stability.

PCI. While OPC does not believe that one extra year will bring competition, it does believe that its recommended PCI, with the 5 percent productivity offset, will cause rates to decline.

Under Staff's price cap plan,<sup>40</sup> prices for Basket 1 (Competitor Inputs)<sup>41</sup> and Basket 2 (Core-Residential/Business)<sup>42</sup> are capped for five years, because Staff believes that these services require protection from inappropriate rate hikes and require rate stability during the transition to competition. Staff concludes that it will take at least five years for effective competition to develop in Maryland's local exchange market, and that the cap should remain in place until competition becomes the market regulator.

Furthermore, under Staff's plan, the indexed price cap formula would apply to Basket 3 (Basic, Other) and Basket 4 (Discretionary Services). Within these baskets, BA-MD would have the option to apply all or part of the price increase allowed under the PCI formula and recover the increase in a subsequent year's price cap compliance filing. BA-MD also would have the option of making price changes for individual services once or twice during the calendar year. Increases to any individual service in Basket 3 could not exceed 10 percent during a calendar year. Similarly, increases to

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<sup>40</sup> Sprint states that it supports Staff's proposed pricing rules.

<sup>41</sup> Under Basket 1, switched access rates will be reduced to the level of interconnection rates in equal installments over a three year period, while Residential Interconnection Charge and Carrier Common Line charges will be reduced to zero over the same time period.

<sup>42</sup> Staff's proposed rules for Basket 2 prohibit a reduction in local calling areas during the duration of the cap.

any individual service in Basket 4 could not exceed 25 percent during a calendar year. BA-MD would not be permitted to decrease prices for a service in either Basket below the service's incremental cost. Services classified as competitive (Basket 5) would not be subject to a cap or any type of indexed price cap formula.

According to BA-MD, OPC and Staff are proposing stringent limitations unrelated to market conditions. BA-MD contends that these limitations would serve primarily to assure that the rate structure in Maryland would remain seriously out of balance and impair the Company's ability to compete. BA-MD says Staff's and OPC's caps would deny the Company the freedom to vary prices in response to market conditions and consumer demands.

BA-MD also criticizes Staff's and OPC's plans on the ground that they would needlessly restrict the Commission's authority by sharply curtailing the Commission's right to approve revenue neutral changes.<sup>43</sup> BA-MD argues that revenue neutral changes must be allowed so that the Commission can gradually move rates towards costs, while at the same time preserving the Company's ability to respond to competitive pricing pressures.

#### **F. Exogenous Factors**

Another issue on the list suggested concerned

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<sup>43</sup>Staff's Plan bars any revenue neutral changes for its "Competitor Input" and "Core" business and residence services, bars all revenue neutral changes between baskets, and limits any revenue neutral increase to no more than 10 percent for Basic-Other services and 25 percent for ~~46~~cretionary services.

exogenous factors. We asked the parties to discuss what exogenous factors should be included in any price cap index formula. Also, the parties were to address what procedures should be used to modify prices based on such factors.

Staff recommends that we adopt the FCC's position which considers exogenous changes to the extent these changes impact the cash flow of the telecommunications industry and not the economy as a whole.<sup>44</sup> Also, Staff recommends that exogenous factors should be considered to the extent they impact the Maryland telecommunications industry and not the national telecommunications industry or the economy as a whole. To determine what qualifies as an exogenous cost, Staff recommends that we use the FCC economic cost standard. The standard includes changes such as shifts in cost between interstate and intrastate jurisdictions, tax changes uniquely and disproportionately affecting LECs, and sales and swaps of exchanges. The standard does not include generally accepted accounting changes not affecting cash flow.

Staff also recommends that we follow the FCC approach by requiring BA-MD to submit a petition for an exogenous factor change (and the proposed rates that

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<sup>44</sup> CATV agrees with Staff's proposal on exogenous factors.

would be adjusted), at least sixty days prior to BA-MD's annual price cap filing.

MCI's proposal eliminates any automatic pass-through of exogenous costs. MCI contends that this factor fails to emulate a competitive market.

### **G. Imputation Standard**

The issue list questioned whether BA-MD should lower its rates for "essential monopoly input functions" to the level of economic cost. Comment also was sought concerning which services should be considered essential monopoly input functions, and on the definition of economic costs. Finally, we specifically asked if a "markup" above cost should be included in BA-MD's rates for these services.

BA-MD's proposed access imputation standard would require the rates for the Company's competitive toll services to be set at a level sufficient to produce revenues which exceed the unavoidable access charges incurred by the interexchange carriers and the remaining incremental costs BA-MD incurs in providing competitive toll service. Under the plan, BA-MD will be deemed to have met this requirement if the price charged for an average call exceeds an amount determined by: (i) multiplying the access minutes associated with the call by the tariffed rate for BA-MD's End Office Local

Switching, Feature Group D; plus (ii) BA-MD's remaining incremental costs including any transport and tandem switching costs.<sup>45</sup>

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<sup>45</sup> BA-MD's position is to only impute those essential elements of access and add to this the incremental cost for the non-access components, thus creating the price floor.

AT&T and OPC criticize BA-MD's imputation standard because it would apply imputation only when, in the Company's view, the monopoly input was "essential" to the competitor.<sup>46</sup> AT&T argues that BA-MD should not be permitted to escape imputation in this way; if the Company uses the monopoly input in its own service, then it should impute the tariffed rate it charges others for the input.

A second criticism raised by AT&T is that BA-MD's imputation requirement would not apply to its toll services, including its message toll service. AT&T contends that an imputation standard should apply to MTS in the long distance toll market because MTS requires access, a competitive input subject to significant monopoly power.

AT&T states that the purpose of the imputation safeguard is to ensure that BA-MD does not place competitors in a "price squeeze" by charging them more for the OTC components needed to provide their services than the Company charges its end users for its competing service. AT&T and Sprint agree with Staff's proposed imputation standard, which is that BA-MD should be required to impute into its retail prices the sum of the tariffed charges for any monopoly inputs it uses to

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<sup>46</sup> OPC also objects to the discretion left with BA-MD in determining whether special access service can be substituted for switched access service.

provide a particular retail service, plus any other incremental costs it incurs in the provision of the retail service. Both AT&T and Sprint view the reduction of access charges to incremental cost as an important aspect of this imputation standard.

Staff states that the price floor should equal the tariffed rate for appropriate OTC components plus the incremental costs for remaining non-tariffed components.

Staff recommends that the imputation safeguard be applied to all retail services, while BA-MD appears to limit the safeguard to services that use "access" and "competitive services". While BA-MD recommends that the appropriate OTC component must be "essential," Staff recommends that if any service component is needed by any competitor, then it is essential and should be included in BA-MD's price floor.

Another issue is the scope of "remaining non-tariffed components." BA-MD recommends that for toll services, only access be included. In contrast, Staff recommends that additional marketing advertising, billing and interoffice transport be included.

BA-MD objects to the IXCs' and Staff's contention that all possible access charges, even those charges which can be avoided by competitors, should be imputed to the Company's own toll rates. BA-MD argues that requiring it to impute the cost of the by-passed

component will place the Company at risk of being priced out of the market because it will have to charge a higher rate for a toll call than a competitor may be able to charge and still recover its (the competitor's) costs.

Finally, BA-MD argues that Staff's revised "Retail Service Pricing" standard<sup>47</sup> should be rejected in its entirety. According to the Company, this standard is massively over-inclusive with regard to the charges it would require to be imputed. BA-MD contends that this standard would mean that, no matter how inefficient at least one competitor is, the Company would have to price its toll service as if it were equally inefficient.

#### **H. Competitive Standard**

As noted earlier, we asked the parties to address the criteria to be used in grouping services. An important subset of this issue is what standards the Commission should use to determine if a new service can be placed in the competitive basket and thus avoid being subject to any pricing limitations. Furthermore, we asked for proposed standards governing whether a current service, which was not competitive when the price cap

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As noted above, this standard would require that if any competitor uses a competitive input, then it is essential to competition and therefore must be included in the price floor. Staff would apply this imputation requirement to any service sold to end-users, including basic residential and business services.

plan was initiated, is now subject to sufficient competition to warrant moving the service into the competitive basket.

BA-MD proposes that the Commission rely on its existing standards as supplemented by an objective test for showing that the standards have been met.<sup>48</sup> Furthermore, BA-MD contends that the Commission should have the flexibility to classify a service as competitive for a particular geographic area or subset of customers.

OPC contends that BA-MD's test for competitiveness was disputed by every other witness testifying on the subject. It observes that the other witnesses agreed that a market power test, including a market share component or market concentration analysis, should be applied to determine when a service is ready to be classified as competitive.

Finally, OPC notes that BA-MD was forced to substantially modify its proposal under cross-examination to include a determination by the Commission as to whether the competitor who has entered the market can serve all customers in the market with the same quality of service as BA-MD. Additionally, OPC contends that a second modification involved a subjective determination by the Commission that all customers throughout the exchange look upon the service as a viable substitute.

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<sup>48</sup> According to BA-MD, the objective test is met for all business (or residence) services within an exchange when BA-MD offers unbundled loops in that exchange and when a co-carrier offers business (or residence) local exchange service within that exchange.

According to OPC, this modification, coupled with the fact that every other witness addressing this issue urged the Commission to adopt a market power analysis, should lead the Commission to the conclusion that a market power analysis is the appropriate analysis to following in determining whether a service could be classified or reclassified as competitive.

OPC also objects to that aspect of BA-MD's plan which would allow the Company to regroup exchanges at will. OPC contends that this authority would permit the Company to attack the most competitive areas of the State, a county, or even a city block, and subsequently raise extra revenue by decreasing local calling areas and making more calls intrastate toll. OPC also argues that the provision for regrouping exchanges could be used by BA-MD to increase revenues in less competitive areas of the State by increasing the number of rate groups (which now stands at four) and "rebalancing" the revenues from those rate groups.

AT&T cites three problems with BA-MD's suggested approach. First, AT&T objects to the fact that the Company wants to address services on an exchange-by-exchange basis or even by a "subset of customers". Second, AT&T objects to BA-MD's desire to declare an exchange competitive if it offers unbundled loops in that exchange and a competitor offers some level of service in

that exchange. Third, AT&T faults BA-MD's proposal for not providing for an examination of the relevant market shares of the Company and its competitors before deciding whether the market is sufficiently competitive to deregulate the price of the service.

MCI contends that in order to classify a service in the competitive category, BA-MD must bear the burden of demonstrating that it lacks market power over the service in question. BA-MD should be required to prove the availability, to all or a sizable portion of consumers, of substitutable services from financially viable alternative providers.

Staff proposes using Department of Justice criteria for measuring the competitiveness of service offerings.<sup>49</sup> This incorporates both a market power and a market share test, as well as employment of the Herfindahl-Hirschman Index ("HHI"). According to Staff, the market share analysis is a necessary element to a factual-based determination of "competition" and is a component in all Department of Justice-sponsored examinations.<sup>50</sup>

AT&T proposes seven criteria which should be examined to determine the presence of effective competition. These include a determination of the breadth of the relevant market; market share characteristics of BA-MD in the relevant market;

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<sup>49</sup> Sprint supports Staff's proposed standard.

available evidence on ease of entry and exit; factors that facilitate or inhibit the ability of entrants and competitors to expand capacity and capture sales; factors that facilitate or inhibit the willingness to switch providers; the price elasticity of demand in the relevant market; and market data on the percent of customers for whom choices are available and the percentage who have availed themselves of such choice. AT&T claims that its criteria are similar to the criteria suggested by Staff.

Furthermore, AT&T argues that the Commission should require BA-MD to inform interested parties whenever it makes a request to classify or reclassify a service. According to AT&T, the notice should provide sufficient information to demonstrate that the test for competitive service has been satisfied and that the proposal satisfies the relevant safeguards.

BA-MD argues that a market share test is unnecessary and impractical. According to BA-MD, the record shows that market share analysis creates a host of practical problems, including the need to collect competitively-sensitive market share data on relevant product and geographic markets. BA-MD argues that AT&T's open-ended, multi-part test would be contrary to the public interest because it would invite delaying abuses.

BA-MD also objects to AT&T's, Staff's and OPC's market definitions. BA-MD contends that LECs are

competing on an exchange-by-exchange basis and that Staff's and OPC's market definitions would prevent the Company from responding on the same basis.

Finally, BA-MD objects to Staff's assertion that a service should not be classified as competitive unless the Company's competitors possess sufficient capacity to serve the entire market. BA-MD argues that such a requirement is unnecessary and has no economic or practical justification. According to BA-MD, given the availability of resale and unbundled loops, companies will have no difficulty in serving as many customers as they can capture.

#### **I. Rate Reduction**

As previously mentioned, we joined OPC's rate reduction petition with our consideration of the alternative regulation proposals. In this proceeding, OPC recommends a rate reduction for OTC services of \$218 million prior to beginning price cap regulation. Staff recommends a \$117 million rate reduction.

OPC argues that adopting a price cap plan at current rate levels would assure BA-MD of a large reliable revenue stream sufficient to position it to fend off potential competitors in the local exchange market, at OTC ratepayer expense. Therefore, OPC proposes many ratemaking adjustments.

OPC proposes five adjustments to BA-MD's rate base. First, OPC recommends that the Commission adjust the balance of accrued interest during construction on the short term plant under construction to reflect only the remaining balance of \$15,745,000. Second, OPC would modify the rate base component of Bellcore Research Costs to reflect only the rate year level of those capital costs. Third, OPC would not reflect any accruals to the depreciation reserve in BA-MD's rate base. Fourth, OPC recommends that the net impact of the impairment loss<sup>51</sup> should be removed from OTC operations and assigned to competitive operations.

Finally, OPC recommends that the depreciation rates approved by the Commission in Case No. 8462 be retained for ratemaking purposes. OPC does not propose any reduction to BA-MD's depreciation expense; it merely recommends that a portion of the expense be assigned correctly to those services which caused the additional expense.

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An impairment loss is an economic devaluation of existing plant assets reflecting the recognition that future cash flows from the plant will be less than the net book value of existing plant.

OPC argues that BA-MD's rate of return should be reduced to 9.28 percent.<sup>52</sup> OPC argues that conditions have changed since the Company's current rate of return was set over three years ago. According to OPC, there has been significant improvement in capital market conditions. Also, OPC contends that the discounted cash flow analysis of the cost of equity for BA-MD indicates a significant decline in the cost of equity since the allowed return on equity was established. OPC also recommends that the Company's existing capital structure of 39 percent debt and 61 percent common equity should be rejected in favor of a capital structure of 45 percent debt and 55 percent equity.

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<sup>52</sup> Staff recommends an authorized rate of return of 9.6 percent

OPC also recommends several changes to the Company's operating income. First, OPC contends that accelerated Other Post Employment Benefits Transitional obligation ("OPEB") expense should be eliminated.<sup>53</sup> Second, OPC disagrees with the quantification of the three adjustments to income proposed by BA-MD related to interest synchronization, corporate advertising and directory imputation. OPC's recommendation to change the amount for interest synchronization arises from the fact that it has proposed a different rate base and capital structure for BA-MD. Further, OPC recommends that the adjustment for corporate advertising be modified to reflect the removal of advertising that was of no direct benefit to consumers. OPC contends that BA-MD's corporate advertising adjustment does not comport with the treatment for advertising ordered by the Commission in Case No. 8462.

Next, OPC recommends that all test year directory income and investment be reflected in the OTC revenue requirement. OPC also proposes that, due to a change in the financial accounting rules under SFAS 71, the Company is now required to write-off certain debt discount premiums and issuance expense costs which ordinarily would be reflected as an amortization in the

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<sup>53</sup> Staff also advocates removing the entire OPEB expense. Staff believes that OPEB has been fully recovered for ratemaking purposes.

regulated revenue requirement. OPC recommends that because the costs in question have traditionally been reflected in the revenue requirement, those costs should continue to be so reflected. OPC proposes that the remaining costs be amortized over three years.

Next, OPC notes that in 1994 BA-MD implemented a force management program which was to result in the elimination of 390 positions. Approximately 196 employees have yet to be separated. OPC argues that it is appropriate to make income adjustments related to the loss of these positions. Since the separation expenses are non-recurring, OPC proposes to amortize them over two years.

Finally, OPC notes that on December 8, 1993, the Commission allowed BA-MD to "true-up" its interstate and intrastate depreciation reserves over a two-year period ending December, 1995. According to OPC, these costs are still reflected in BA-MD's rates even though they were fully amortized in 1995. As with the OPEB amounts, it recommends that these costs be removed. The removal of this depreciation reserve deficiency, in conjunction with the removal of OPEB, results in a reduction to BA-MD's revenue requirement of \$132.2 million.

Staff argues that a revenue requirement analysis is the appropriate mechanism to determine the reasonableness of BA-MD's current rates. According to

Staff, the first reason the Commission should reduce BA-MD's rates is to comply with Section 69(e),<sup>54</sup> in that the concept of reasonableness has historically been based on the relationship of rates to costs.

A second reason advanced by Staff to adjust BA-MD's rates is that current rates do not reflect the infrastructure improvements paid for by consumers. Third, Staff and OPC note that the ratepayers had certain regulatory expectations created by BA-MD's last rate case. One of these was the re-examination of the reasonableness of rates.

Finally, Staff argues that failure to review BA-MD's revenue requirement would deny OPC due process. According to Staff, until the Commission actually approves an alternative regulatory scheme as authorized under Section 69(e), OPC has the right to request rate adjustments under Section 69(a).

According to Staff, corporate advertising expense should be reduced by the amount booked to Account No. 6722.1. Staff contends that such items typically are excluded from the revenue requirements calculation, and that this adjustment is consistent with Commission practice.

Staff also proposes revising the imputation for

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<sup>54</sup> Both CATV and FEA support rate deductions.

Yellow Pages income to reflect more recent financial information than that which was used in the last rate proceeding. According to Staff, this adjustment stems from the initial divestiture order in which directory advertising was intentionally assigned to the operating telephone companies. Staff also proposed OPEB and depreciation adjustments.

BA-MD contends that by presenting traditional rate cases, Staff and OPC have failed to focus on the requirements of Section 69(e). While their analyses focus on the overall earnings of the Company and whether its overall rates are reasonable, Section 69(e) requires the Commission to focus on whether the rates for basic local exchange service are affordable and reasonably priced. BA-MD argues that it has demonstrated that the Company's current rates for basic local exchange service are affordable and reasonably priced and will remain so under its plan.

BA-MD raises several objections to Staff's and OPC's rate base/rate of return analyses. First, the Company argues that using traditional RB/ROR regulation is inappropriate because the Commission can no longer assume that BA-MD's revenues, expenses and investment will grow proportionally; instead, competition will alter these relationships.

Second, BA-MD contends that Staff's and OPC's

analyses are flawed, alleging that both parties fail to reflect accurately the effects of competition. The Company criticized Staff and OPC for recommending reductions in its rate of return, as if opening BA-MD's business to competition somehow has made it less risky, rather than more risky. BA-MD contends that the evidence shows that the Company's overall cost of capital exceeds the Commission's previously authorized rate of return of 10.1 percent.<sup>55</sup> This increase is due to its increased risks arising from the authorization of local exchange competition and the Telecommunication Act of 1996.

Furthermore, BA-MD argues that these cost of capital recommendations are the product of flawed analyses. The Company contends that: both incorrectly used the Regional Bell Holding Companies ("RBHCs") as cost of equity proxies for BA-MD; both under-estimate the RBHC's future growth potential; Staff's discounted cash flow ("DCF") model is flawed because it does not reflect that dividends are paid quarterly; and OPC under-estimates the cost of capital by using a hypothetical capital structure rather than the actual capital structure.

BA-MD also noted that those parties made no adjustment for competitive losses in computing a revenue requirement. BA-MD believes that OPC and Staff made

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<sup>55</sup> OPC recommended that the overall allowed return be reduced from 10.10 percent to 9.28 percent, based on the allowed return on equity being reduced from 12.20 percent to 11.25 percent. Staff recommends an overall rate of return of 9.60 percent and an allowed return on equity ~~of~~ 11.5 percent.

inadequate allowances for the higher depreciation rates BA-MD must use in an increasingly competitive environment. BA-MD argues that the depreciation reserve deficiency should be amortized over a shorter period of three to five years in light of the new competitive environment. Finally, the Company asserts that both parties continue to rely on a cost allocation manual, adopted in earlier proceedings, which allocates costs between competitive and other-than-competitive services.

BA-MD objects to Staff's and OPC's proposal to impute profits from BA-MD's competitive Yellow Pages business to support OTC rates. According to BA-MD, the Telecommunications Act of 1996 has supplanted the divestiture order and the legal and regulatory structure it established. The Company argues that under competition it no longer will be possible to maintain the old subsidies, so that rates for all services must move closer to cost. BA-MD also contends that Staff's and OPC's Yellow Pages adjustments are inconsistent with the Commission's last rate case decision, in which the Commission decided to hold constant the net earnings from Yellow Pages rather than reflect current earnings.<sup>56</sup>

## **J. Access Rates**

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<sup>56</sup> Order No. 70324, Case No. 8462, 84 Md. PSC 4, 23 (1993).

Staff proposes reducing competitor inputs towards Long Run Incremental Cost ("LRIC").<sup>57</sup> Staff's plan proposes a reduction in the cost of competitor inputs over a three-year period as a means of encouraging competition while preserving the financial viability of BA-MD.

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<sup>57</sup> CATV supports setting monopoly inputs at cost.

Initially, according to Staff, switched access rates should be lowered to reflect the Commission's adopted rates for local call termination service.<sup>58</sup> The rate should be based on LRIC plus some contribution towards BA-MD's joint and common costs. Staff maintains that rates for other essential monopoly inputs should be considered in future proceedings and lowered to some corresponding level.

AT&T argues that the best way to foster competition is to require BA-MD to immediately price the input functions it provides to others, such as switched access, at prices equal to the Total Service, Long Run Incremental Costs ("TSLRIC") of providing those inputs. AT&T recommends that the correct cost basis for intrastate switched access services is TSLRIC. Mr. Wood stated that TSLRIC data is available to permit the Commission to set intrastate switched access rates at a level equal to direct economic cost in this proceeding. AT&T contends that reducing switched access rates to cost will generate substantial immediate benefits because it is likely that every dollar of the access reduction would go straight to Maryland consumers.

According to AT&T, reducing access rates to incremental cost will not only have immediate benefits

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<sup>58</sup> Sprint agrees with Staff on this issue.

but will generate substantial long term benefits because it will force all carriers to compete on their relative efficiencies. Furthermore, AT&T contends that pricing access at cost is necessary in order to eliminate BA-MD's ability to place competitors in a "price squeeze".

AT&T also argues that reducing access rates to cost will not harm BA-MD. First, AT&T contends that the expiration of the OPEB will offset, dollar for dollar, the reduction of switched access prices to cost. Second, AT&T contends that BA-MD already is financially and technologically able to protect its existing markets and to capture new and emerging markets, even without the excess access revenues it currently obtains from its potential competitors.

Finally, AT&T argues that universal service will not be harmed if access charges are reduced to cost. AT&T contends that BA-MD's local residential service is fully compensatory and that, therefore, the Company does not bear a universal service burden which must be subsidized by inflated switched access charges. The revenues BA-MD currently receives from its basic exchange services more than cover its costs of local service on a statewide basis.

According to MCI, setting rates for BA-MD's essential monopoly input functions, such as access, at cost is the only way to ensure that the Company cannot

use its control of these crucial competitive inputs to harm competition. MCI also argues that an imputation rule does not prevent the possibility of a price squeeze because the monopoly profit is entirely in the mark-up in prices of the essential monopoly input functions.

MCI argues that there are four essential access input functions whose rates must be set at TSLRIC. First, local interconnection must be set at TSLRIC because competing LECs must interconnect to terminate local exchange calls or else no provider can offer ubiquitous service. Second, the local elements of switched access also must be priced at TSLRIC. MCI proposes that access charges be reduced by about \$85,024,000 annually. Of this amount, \$39,400,000 is attributable to eliminating the Carrier Common Line Charge ("CCLC").

Next, MCI calculates that, under its Competition Plus plan, local switching rates will decrease from the current level of \$.012559 per minute of use to \$0.0042 per minute of use. Eliminating the RIC and reducing the local switching rate to its direct economic cost of \$0.0042 per minute of use will reduce access revenues by an additional \$45,624,000.

MCI observes that revenues from its proposed interim universal service surcharge will replace some of the revenues lost to BA-MD if switched access rates were

to be reduced. MCI estimates that the level of universal service support required is approximately \$13,322,000 annually.

Thus, the net effect of the switched access revenue reductions and universal service fund revenue increases is an annual revenue reduction of \$71,702,000.

MCI pledges to pass through access charge reductions, net of payments to the universal service fund, directly to its Maryland customers.

The last two functions to be priced at TSLRIC, according to MCI, are collocation functions and unbundled loops. However, MCI proposes that the local transport element of switched access not be treated as an essential monopoly input because properly structured collocation rates will allow local transport to become effectively competitive in most locations.

Finally, MCI contends that prohibiting BA-MD from recovering overhead costs from this limited subset of essential monopoly functions does not place BA-MD at a disadvantage because the Company, like other competitors, will be able to recover these shared or overhead costs from its retail service.

OPC objects to MCI's proposal to reduce only essential monopoly inputs. Its position is that a massive rebalancing of access charges is not in the public interest. According to OPC, any revenue reduction

should be used to equally reduce intrastate switched access, intraLATA toll and local exchange rates.

BA-MD disagrees with MCI's and AT&T's argument that approved mark-ups on switched access and "monopoly inputs" are too great and discourage efficient competition. BA-MD's position is that the Commission should not reduce the rates for "essential monopoly input functions" to the level of economic costs. BA-MD justified the need for a markup because of inadequate depreciation, continued pricing of basic residential service below cost-of-service levels, and the fact that effective rates have to exceed direct incremental costs if true economic costs are to be recovered. BA-MD also contests their assertions that ordering access charge reductions would benefit consumers.<sup>59</sup>

BA-MD contends that reducing access charges would require the Commission to reverse long-standing policies designed to promote universal service, and also require the Company's rate structure to be completely redesigned. According to BA-MD, even if these reductions are passed on to customers, it would not significantly benefit most consumers, including those the Commission has attempted to reach through its universal service policies. BA-MD argues that the place to consider such proposals is the Commission's separate docket on

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<sup>59</sup> According to BA-MD, in Case No. 8462, the Commission set some of the Company's rates at artificially low levels and others substantially above costs in order to meet important policy objectives. Order No. 70324, January 22, 1993, at 117-23.

universal service. BA-MD further argues that it would be irresponsible to eliminate the subsidies built into current rates without addressing residual pricing, geographic averaging and the other mechanisms which were implemented to keep basic telephone rates low.

Moreover, BA-MD asserts that TSLRIC pricing would deny it the ability to recover its shared and common costs, and that by applying a permanent hard cap on rates for basic services it would be virtually impossible to recover such costs from its retail customers. Finally, BA-MD contends that MCI's proposal would make it impossible for the Company to recover its direct costs of providing access and other services to competitors because the MCI proposal calculates TSLRIC on the basis of a theoretical model which assumes the existence of a hypothetical network that is substantially different from the real network. According to BA-MD, the Company would be forced to sell switched access and other inputs well below its actual direct costs.

#### **K. Universal Service**

We also asked the parties to address what universal service mechanism, if any, we should adopt in conjunction with any alternative regulatory plan. Furthermore, we raised the question concerning what services are basic and what services promote universal

service.

MCI's proposal includes a two-year Transitional Universal Service Reform plan. As noted earlier, MCI asserts that this plan would allow the Commission to reduce to cost the prices of essential monopoly input functions while fully protecting universal service. MCI's plan assumes that universal service consists of connection to BA-MD's network plus unlimited local calling. MCI has proposed that for a transitional period of two years, designed to last until the Commission has adopted a permanent and competitively neutral universal service support mechanism, MCI and the other IXCs simply agree to pay to BA-MD the total sum of \$13,571,681. According to MCI's study, in the two least densely populated zones, BA-MD's cost of service exceeds its rates for those services by this amount. MCI notes that this approach is not competitively neutral, because the IXCs absorb all the costs while the benefits are enjoyed by other competitors and because BA-MD gets all the money. MCI states that as the Commission lowers access charges to cost, creating the structure necessary for real competition, it is assumed that universal service will not be threatened.

OPC contends that, on a Statewide basis, BA-MD's basic residential service revenues cover its direct costs of providing basic residential service. OPC believes

that this evidence supports a reduction in the prices for these services.

BA-MD objects to MCI's proposal concerning universal service. According to BA-MD, MCI's evidence does not support its proposal. BA-MD contends that the analyses underpinning both MCI's and OPC's proposals systematically understate the costs of providing residential service and overstate the revenues associated with it. According to BA-MD, the analyses share two fatal flaws. First, neither study measured the actual costs incurred in providing basic local exchange service in Maryland today. MCI used a theoretical model, while OPC used loop cost figures from Pennsylvania.

Second, both analyses include local usage revenues in determining the deficit in the profitability of providing local service. According to the Company, this overstates the revenue side of the analysis. According to BA-MD, this approach confuses the issue of the cost of allowing universal access to the network with the question of how that access is currently funded. BA-MD argues that, given the lack of merit to the two approaches, the Commission cannot rely on them and should defer its consideration of universal service to an appropriate proceeding. Staff agrees that universal service should be considered in another proceeding.

#### **L. Review Process/Termination Date**

The parties were asked whether the alternative regulatory plan should be considered a trial with a given expiration date, or whether it should it replace rate base/rate of return regulation without a specific review or termination time in place. If a review period is necessary, the parties were to address the benchmarks or review process to be used to judge the effectiveness of the plan, and how often this review process should occur.

BA-MD's plan does not contain a set termination date or formal review process, but requires BA-MD to provide quarterly service quality information and detailed financial reports. According to BA-MD, termination of the plan should occur when all services the Company offers are competitive.

MCI argues that the operation of competitive marketplace forces will serve as a natural sunset for the plan's governance of individual services, and the operation of the alternative regulatory regime as a whole. Nevertheless, according to MCI the Commission should continue to review BA-MD's activities through monitoring the development of competition every two to three years. Similarly, the Commission should monitor and resolve complaints regarding barriers to entry.

OPC's proposal establishes a formal review after three years, and the plan would terminate after five

years. Similarly, Staff's plan is subject to review after five years. OPC argues that a scheduled formal review will serve several purposes. It would allow the Commission and parties a time frame to plan for the allocation of the significant resources necessary for a comprehensive review of any price cap plan. Also, it would allow necessary adjustment of provisions of the plan that are not operating as envisioned by the Commission without waiting for acute difficulties to arise that necessitate an emergency review of the plan.

Staff recommends that the Commission conduct a comprehensive formal review to judge the effectiveness of the price cap plan after five years.<sup>60</sup> The five-year time period was chosen by Staff as an appropriate time span to allow for the development of competition in the local exchange market. After five years, it will be necessary to gauge the level of competition in order to determine whether to extend the price cap plan, make adjustments to the plan, or terminate the plan.

According to BA-MD, the reviews proposed by both OPC and Staff are little more than truncated rate cases intended to return to customers the benefit of any

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<sup>60</sup> CATV agrees with Staff's five year review.

efficiency gains or market success BA-MD may be able to achieve. The Company argues that adopting a price cap plan with a rate base/rate of return review built into it is contrary to the purpose of adopting a price cap plan in the first place, which is to encourage cost cutting and the development of new innovative services which will serve the public interest.

## **VI. DISCUSSION**

### **A. Adoption of an Alternative Regulation Plan for BA-MD**

The traditional and long-standing method for setting rates for regulated monopolies throughout the United States has been what is generally referred to as rate base/rate of return ("RB/ROR") regulation. Under RB/ROR regulation, utility rates are set so as to recover all prudently incurred operating expenses as well as a return on prudent, used and useful investments sufficient to cover the carrying costs of those investments and attract new capital when needed. Thus, under RB/ROR regulation, customers bear responsibility for capital investment and expenses related to the provision of utility service. Moreover, since dollar earnings are explicitly tied to a utility's rate base investment under RB/ROR regulation, a utility can increase its dollar earnings by enlarging its rate base.

Thus, RB/ROR regulation provides incentives to firms to attempt to inflate the size of the rate base.

A common feature of rate base/rate of return regulation is the rate case. Upon instigation of a rate case, a regulatory commission determines the reasonableness of the utility's expenses and investments, and estimates the cost of capital that the utility is likely to incur in the future. Specifically, during a rate case, the commission determines test year revenues and expenses, computes the size of the rate base, and sets a rate of return. The utility's revenue requirement is then calculated by multiplying the rate of return by the rate base. The difference between the revenue requirement and test year revenues, adjusted for taxes, is the amount of increased (or decreased, at times) rates that the utility is entitled to collect from its customers.

New rates are then designed to collect the total revenue requirement. These rates stay in effect until the next rate case. Obviously, rate making can be a time consuming and expensive process. Moreover, it is a fairly static analysis dependent to some extent upon the proposition that the past will accurately reflect the future.

One of the central foundations underlying regulatory reforms arises from a belief that under

traditional regulation, a regulated utility with monopoly markets has no particular economic incentive to operate efficiently, and may actually have an incentive to operate inefficiently. Similarly, the indirect cost of traditional regulation -- the time consuming process of introducing new services, changing tariff rates and the litigious nature of the administrative process in general and rate cases in particular -- slows, if not forestalls, competitive responses and results in lost revenue-producing opportunities for the utility.

Given the drawbacks of traditional regulation, alternative forms of regulation are becoming widespread in the United States.<sup>61</sup> These forms include features such as price caps, earnings sharing contracts, deregulation of services offered by firms that compete with the regulated utility, and increased marketing flexibility. Alternatives to RB/ROR regulation are intended to more closely approximate competitive market forces and encourage utilities to respond to those forces, while maintaining some degree of restraint on the potential abuses of monopoly power that utilities might still exercise. As noted earlier, we already have employed some of these alternative forms in our regulation of BA-MD.

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<sup>61</sup> In addition to Maryland, the following states have adopted some alternative form of regulation for their dominant local exchange telecommunications companies: Alabama, Delaware, Florida, Georgia, Illinois, Indiana, Kentucky, Maine, Massachusetts, Michigan, Mississippi, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, ~~So~~uth Carolina, South Dakota, Tennessee, Virginia, Wisconsin, Wyoming, and Washington, D.C.

Well-designed alternative regulation encourages the utility to operate more efficiently, and provides the utility with greater flexibility to respond to and anticipate market forces for any non-monopoly services which it provides. Alternative regulation can do this by weakening the link between costs and prices, and by ending the utility's opportunities to initiate rate cases covering OTC services. These are the central features of price cap mechanisms. Thus, rather than encouraging growth in capital investment, the best method to improve financial performance becomes reducing operating costs, increasing efficiencies, initiating new services, and improving existing services.

Of course, alternative regulation alters the investment decisions of the utility. By eliminating the "cost-plus" investment stimulus of RB/ROR regulation, alternative regulation introduces new market uncertainty into those decisions. Recovery and return occur only when customers respond positively in the market, while the costs of failed investments are borne by the utility's shareholders and not the ratepayers. Once the cost-plus feature is removed, the utility will engage in modernization and plant replacement only to the extent that these actions are predicted to improve the firm's financial performance. Thus, one of the hallmarks of price cap and some other alternative regulatory plans is

the utility would be subject to substantially similar capital investment rules and incentives as companies in non-regulated industries. Similarly, alternative regulation can allow utilities which are operating in markets undergoing rapid technological and economic change to adapt to those forces more efficiently.

Based on an analysis of traditional regulation when compared to alternative regulation, and after considering specifically the requirements of 69(e) of The PSC Law, we find that it is in the public interest to adopt an alternative form of regulation for BA-MD. Alternative regulation provides significant incentives and opportunities not present under RB/ROR regulation, benefiting both customers and shareholders alike.

The increased efficiency and marketing incentives offered by alternative regulation will benefit BA-MD's customers. Customers receive the advantage of more efficient service, faster and more extensive development of new services, and more innovative service packaging and pricing. Moreover, customers no longer bear the responsibility to assure recovery of BA-MD's capital investment and expenses related to the provision of utility service. For example, in the future the fact that BA-MD's prudently-incurred costs exceed its revenues would not trigger the rate increase filing that would occur under RB/ROR regulation. This is a critical step

as we move toward competition.

Shareholders also benefit because any savings that BA-MD realizes from improved efficiency and cost containment measures are retained by the Company. Affording BA-MD the opportunity to retain profits resulting from efficiency improvements will provide the Company with an increased incentive to continually look for new ways to cut costs and streamline its operations.

The testimony in this proceeding confirms that no party opposes implementation of a properly structured price regulation plan. Naturally, each party proposing a plan argued that only its plan met the requirements of Section 69(e). We have carefully considered the views expressed by each of the parties, and find that the following alternative regulation plan will benefit both customers and shareholders, will encourage competition and the deployment of new technologies, and is in the public interest. We are adopting a plan that carefully balances BA-MD's need for flexibility in a changing telecommunications environment with this Commission's need to protect Maryland's consumers.

The price cap regulation we adopt today is authorized specifically in Section 69(e) of The PSC Law.

We find that our plan protects consumers by producing affordable and reasonably priced basic local exchange

service. Our plan also ensures the quality, availability, and reliability of telecommunications services throughout the State, encourages the development of competition, and is in the public interest.

## **B. The Adopted Plan**

### **1. Overview**

After considering the proposed plans and the evidence in this proceeding, we find that none of the plans is acceptable in its entirety. However, we also find that we can craft an acceptable price cap plan from this record. As detailed below, the plan that we adopt provides for grouping services in baskets, allows pricing flexibility among services within baskets but not between baskets, caps and freezes rates for the services contained within certain baskets, and requires BA-MD to continue filing tariffs.

Additionally, we establish mechanisms, including reporting requirements and complaint procedures, to detect and rectify inadequate service in the event any were to occur. We reduce access charges, and establish (or affirm, in some instances) safeguards ensuring that captive customers will not subsidize BA-MD's competitive service offerings and that competitive services are not offered at unfair prices.

The following sections explain these decisions

in detail.

## **2. Service Baskets**

The price cap regulation plan we adopt will allow flexible pricing of various telecommunications services. However, to provide a safeguard against cross-subsidization between services that face varying degrees of competition and that have varying levels of necessity and importance to customers, separate pricing baskets with differing pricing rules will be established for six service classifications.<sup>62</sup> In some of these market segments, competition is effective and comes from numerous sources. In other segments competition is not established, and although competition probably will increase over time, it would be unwise to regulate as if competition were an accomplished fact when it is not.

Accordingly, grouping services into baskets will allow us to impose a higher degree of protection on the services that require it, while permitting BA-MD the flexibility to respond to the market and the specific needs of some customers in the market segments where competition is an effective regulator of corporate behavior. The factors we considered in categorizing services include: the degree of competition BA-MD faces in providing each service; possible effects on adjacent markets that depend upon or are interrelated with the service in question; customer perception; and possible

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A service basket is a group of services with certain common characteristics that, for the purpose of the alternative regulatory plan, are subject to the same regulatory rules.

effects on social policy objectives. The services contained within the baskets we have established are relatively homogenous in terms of demand elasticity and competitive alternatives. Thus, BA-MD's only incentive to adjust the prices of services within a basket should be those reflective of specific market and general industry conditions. Furthermore, since our plan prohibits rate adjustments between services located in different baskets, cross-subsidization of competitive services by monopoly services is forestalled.

The plan we adopt contains six service baskets.

Basket 1 is the Basic Services - Residential Basket. Generally, this Basket contains those services required to provide basic local exchange service to residential customers and which currently are not provided by other telecommunications companies.<sup>63</sup> Basket 2 is the Basic Services - Business Basket. Like Basic Services - Residential, these services are required to provide basic local exchange service, but to business customers.<sup>64</sup> Unlike the services in the Basic Residential Basket, however, some of these services currently are beginning to be provided by other telecommunications companies.

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<sup>63</sup>

See Appendix 2 for a list of those services included in Basket 1.

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See Appendix 2 for a list of those services included in Basket 2.

As discussed in more detail in the next section, the prices for services in Basket 1 and Basket 2 that are in effect as of the starting date<sup>65</sup> of our plan shall be the maximum prices charged for these services for a period of three years. Upon expiration of the rate freeze period, BA-MD may adjust prices subject to the index formula adopted by the Commission.

Basket 3 is the Access Services Basket. These are services that allow other telecommunications providers to interconnect with BA-MD's network in order to originate or terminate a call. The services in Basket 3 are collocation services and switched access other than High Capacity Service for Direct Transport. Basket 3 contains monopoly bottleneck services upon which competitors rely in order to offer service. Because this basket contains monopoly inputs, the Commission finds that the appropriate pricing flexibility for these services will be the same as the pricing guidelines established for basic residential and basic business services.

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The effective date of this plan will be January 1, 1997.

Basket 4 is the Discretionary Services Basket.<sup>66</sup>

Discretionary services are services which are optional, nonessential enhancements to basic local exchange service, which may or may not be provided by other suppliers but for which competition is not a sufficient regulator of the price of those services. Prices for services in Basket 4 may increase each year in accordance with our adopted price index formula and other safeguards set forth below.

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See Appendix 2 for a list of services included in Basket 4.

Basket 5 is the Competitive Services Basket.<sup>67</sup> Competitive services are those services for which competition or the potential for competition in the market is an efficient regulator of the prices of those services. Therefore, prices for the services in this basket are not subject to regulatory constraints. BA-MD will have full pricing flexibility for these services, subject to the safeguard that no price for a service may be lowered below that service's applicable incremental cost.

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See Appendix 2 for a list of services included in Basket 5.

Finally, Basket 6 is the Miscellaneous Services and Elements Basket.<sup>68</sup> A service or an element will be placed in this Basket because it has been detariffed or unbundled due to statutory requirements or federal action. We note that all existing services not subject to our regulation prior to January 1, 1996 will remain unregulated unless the Commission determines that regulation of any such service is necessary to fulfill the requirements of Section 69(e) or is otherwise in the public interest.

BA-MD may not transfer a service from one basket to another without our prior approval. As part of any request to classify or reclassify a service as competitive, the Company must indicate in the filing the steps it will take to comply with all applicable safeguards. Any interested person may object to either the categorization of a service or to BA-MD's compliance with the safeguards, or both. Although BA-MD is the most likely party to request that a service be transferred to another basket, any interested person may petition the Commission to reclassify a BA-MD service. The burden of proof will be on the proponent to demonstrate why the service should be reclassified.

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See Appendix 2 for a list of services included in Basket 6.

Finally, as noted in Order No. 73010, issued today in Case No. 8731,<sup>69</sup> any service shall be available for resale regardless of its classification pursuant to Section 251(c)(4) of the Telecommunications Act of 1996.

BA-MD shall remove all applicable resale restrictions and shall not place any new resale restrictions on any service subject to resale under the Telecommunications Act of 1996. Prices for resale will be determined by the Commission consistent with the Telecommunications Act of 1996.

With regard to unbundling, we find that any service classified as competitive and included in Basket 5 must be unbundled as provided in the discussion on page 84, supra. BA-MD may refuse an unbundling request only if it demonstrates that the requested unbundling is technically or economically impractical. Rates for the unbundled service shall be consistent with the Telecommunications Act of 1996.

We find that the segregation of services in these baskets will provide a safeguard against cross-subsidization while allowing BA-MD more flexibility to respond to market conditions. Specifically, these baskets are designed so that BA-MD may attract customers to its service offerings by improving price, performance, quality or other aspects of these services, rather than

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Case No. 8731 concerns several requests for arbitration of interconnection issues arising out of negotiations between BA-MD and several offer telecommunications companies. The negotiations were established by The Telecommunications Act of 1996.

by degrading features or increasing prices for an existing, other than competitive service.

### **3. Pricing Rules**

Our price cap plan provides for varying degrees of pricing flexibility. As noted earlier, the current rates for Basket 1 "Basic Services - Residential," Basket 2 "Basic Services - Business," and Basic 3 "Access Services," are frozen and not included in the price cap index formula for the first three years that the plan is in effect. The maximum price for each service in Baskets 1 and 2 will be the existing rate for that service. As discussed below, rates for Basket 3 "Access Services" will be reduced and then frozen for the three-year period.

One effect of the freeze is that BA-MD loses the right to seek rate relief for three years and assumes the financial risk of cost increases which may occur during that period. Another advantage to customers of the rate freeze is that it eliminates the possibility that rates for these services would be raised to offset any revenue decreases that may occur in services subject to competition. The potential for cross-subsidization is a concern not only for captive customers whose rates would increase, but also for competitive providers who would be unable to compete on an equal footing. Since our plan does not permit upward pricing flexibility for monopoly

services for three years, and thereafter only to the extent permitted by the caps, the possibility of cross-subsidization by captive customers is greatly diminished.

Basket 4 - Discretionary Services is the only Basket immediately subject to the price cap index formula discussed below. However, Baskets 1, 2, and 3 also will be subject to this index after the three-year rate freeze period ends.

In general, under our price cap index ("PCI") prices are subject to three basic adjustments. First, we allow an upward adjustment to reflect the actual rate of inflation. Second, we direct a downward adjustment to reflect an expectation of continuing productivity by BA-MD and its employees. This downward adjustment commonly is referred to as the productivity factor. Finally, our PCI includes the possibility of exogenous change adjustments. These adjustments can be up or down, and are designed to reflect changes in costs which are outside of BA-MD's control and which are not included in the inflation adjustment. These adjustments should enable the PCI to allow price changes similar to those encountered in products and services provided in competitive markets.

All parties who proposed a price cap index agree that the GDP-PI is the appropriate index to represent the effect of the rate of inflation in the costs of

production. Accordingly, we accept this factor for our PCI.

The record in this proceeding demonstrates extensive differences of opinion concerning the appropriate productivity factor, which will serve to offset the rate of inflation. The criteria we used to establish the appropriate productivity factor are that the productivity factor should be reasonably stable, readily and periodically available from a reliable source, and generally accepted by the public. Taking into account this criteria, we find that the Consumer Price Index ("CPI") constitutes a reasonable proxy for expected future productivity gains.<sup>70</sup> We also note, parenthetically, that use of the CPI as a productivity offset has, in the recent past, provided a result quite similar to 2.76 percent, which is the average of the inflation offsets used in 13 other states.<sup>71</sup> However, in order to avoid swings in the CPI, we employ a three-year running average of the CPI as our productivity offset. We find that the implementation of this offset will protect consumer income from telephone service cost increases up to the point that such increases exceed the CPI.

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Both the GDP-PI and the CPI are reported in the U.S. Department of Commerce publication entitled "Survey of Current Business" on an annual basis for the United States. The CPI is a measure of the rate of inflation that consumers experience. It represents an assortment of goods and services that consumers tend to purchase.

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The final component of the indexing mechanism is the exogenous costs change factor, commonly referred to as the "Z factor". The adoption of a Z factor is a recognition that a price cap regulation formula is a simplification of a traditionally complex rate setting process. Under certain circumstances, the PCI formula may not be able to reflect changing circumstances and balance competing interests fairly. As noted earlier, exogenous changes involve external factors that are out of BA-MD's control and do not affect the entire economy, such as changes in patterns of telecommunications industry taxation.

With regard to the Z factor, we accept Staff's recommendation that BA-MD or others may propose price adjustments consistent with the FCC's price cap plan.<sup>72</sup> Thus, exogenous costs that may be proposed include those costs triggered by administrative, legislative or judicial action that are beyond the control of BA-MD and not otherwise included in the price cap formula.

Before a cost item is eligible for Z factor treatment, the proponent must demonstrate that: the cost is the result of an exogenous event; this event occurred

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The FCC rule is codified at 47 CFR 61.45(d). In the LEC Price Cap Order, the FCC determined that certain costs incurred by LECs caused by administrative, legislative or judicial requirements beyond the control of the carriers should result in an adjustment to the PCI to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates. The FCC found that a decision not to recognize these costs in the PCI would either unjustly punish or reward the carrier by incorrectly treating them as changes in the carrier's level of ~~04~~ efficiency. Performance Review Order, 10 FCCR at para. 274.

after implementation of the price cap plan; the cost is clearly beyond management's control; the cost is not a normal cost of doing business; the event has a disproportionate impact on telecommunications providers; the event has a major impact on BA-MD's costs; the costs proposed are reasonable; and that actual costs can be used to measure the impact of the change, or the impact can be measured with reasonable certainty.

BA-MD, or any other proponent, is required to submit a petition to the Commission for an exogenous cost change. After interested parties have the opportunity to comment, the Commission will then render a ruling or take other action as may be appropriate.

In sum, on an annual basis the price cap will be adjusted to reflect the GDP-PI plus or minus both a productivity factor based on a floating three-year average of the CPI and the exogenous changes factor. This updated PCI will represent the price cap for the following year. Under this plan, BA-MD can increase prices for individual services in a basket covered by the PCI as long as the aggregated rate changes for all services within the basket do not exceed the calculated PCI. Likewise, prices would be lowered should the result of the formula so dictate. BA-MD may elect not to implement all or a portion of a price increase otherwise allowed by the PCI formula. If BA-MD makes this

election, the Company may defer the increase and recover such an increase in a subsequent year's price compliance filing. BA-MD also has the option of making the allowed or required price adjustments in two installments at the beginning or middle of the price cap year rather than implementing the entire adjustment at the beginning of the price cap year. Also twice a year, BA-MD may implement pricing changes for any services within Basket 4 on a revenue neutral basis so long as these actions satisfy the maximum change guidelines.

In an effort to protect both consumers and competitors, the Commission also will adopt the following safeguards for baskets covered by the PCI. In order to avoid rate shock, the price for any individual service may not be raised more than ten percent in a given year.

Also, prices may not be lowered below the service's applicable incremental cost. Under no circumstances will the PCI formula be applied to require rates to be reduced below incremental costs, nor will the PCI formula be applied to reduce prices for those services which currently are priced below incremental cost. While the PCI and other pricing rules we adopt today only apply to Basket 4 initially, these provisions also will apply to Baskets 1, 2, and 3 after the end of the rate freeze period.

We find that this price cap formula establishes

a reasonable framework for governing the average price change that will be permitted or required, and believe that the productivity factor we adopt is a reasonable compromise among the various positions presented. It fairly shares the risks and rewards of future productivity gains between BA-MD and its customers.

The pricing rules we establish are appropriate, constraining basic rates while permitting flexibility on discretionary and competitive services. BA-MD is not guaranteed any particular rate of return and may or may not be successful in its future endeavors. In either case, basic rates are protected and the standards of Section 69(e) are satisfied.

#### **4. Service Quality Requirements**

As noted earlier, both OPC and Staff proposed that the PCI formula should be designed to financially penalize BA-MD for significant declines in service quality. We reject both proposals. The evidence does not persuade us that BA-MD will discontinue its commitment to service quality excellence under a price cap regime. Additionally, we conclude that our existing processes of ensuring service quality are sufficient to ensure that our price cap plan will result in reliable, quality service throughout BA-MD's service territory, as required by Section 69(e) of The PSC Law.

The major rationale for Staff's and OPC's proposals is that the Commission should act before

service quality problems arise, rather than after. However, we find that the rewards and penalties associated with advancing competition will provide more than sufficient incentive to maintain service quality.

Our rejection of these proposals does not indicate a diminishment of our service quality expectations. Our commitment to service quality is evident in our COMAR regulations. These regulations contain customer service, service reliability, access and other qualitative measures of service quality. In fact, COMAR contains most of the elements outlined in Staff's proposed Service Quality Index ("SQI").

Furthermore, The PSC Law provides sufficient authority to enable us to compel adequate and efficient service. We can investigate service problems either on our own initiative or upon complaint. A show cause order for persistent quality of service deficiencies has serious consequences for a company, whose operations would then be open to public scrutiny. Such unwelcome publicity would damage the image of any company operating in competitive markets.

We are aware that consumers in some other states have experienced deteriorating service quality after implementation of a price cap plan, and acknowledge

Staff's concerns in this area. It should be noted that in a recent survey conducted by the National Regulatory Research Institute ("NRRI"), none of the commissions in the sample served by Bell Atlantic companies reported any serious service quality problems for that company.<sup>73</sup> In any event, we retain the right to review BA-MD's service quality performance at any time. We announce today that we will conduct such a review one year after implementation of our price cap regime. If at that time there is evidence that service quality has deteriorated, we will revisit the issues raised by Staff and OPC and explore all regulatory options available to remedy service quality problems.

#### **5. Complaint Process**

As mentioned above, one important service quality protection is an effective complaint process. We accept Staff's proposal, which mirrors many of the provisions of Section 77(a) of The PSC Law, regarding the complaint process to be utilized under our price cap plan.

Under this process, any person may file a

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<sup>73</sup> NRRI, Telecommunications Service Quality, (March, 1996).

complaint with us alleging that BA-MD has violated a provision of this plan. The complainant shall serve a copy of the complaint, along with any supporting data, on BA-MD. The complaint shall be processed pursuant to our regular complaint procedures established in COMAR 20.07.03.03, or on an expedited basis if we find that the allegations warrant such treatment. If we find that BA-MD has violated any requirement of the price cap plan, we shall order BA-MD to comply with the plan and may require any other remedy as appropriate.

**6. Reporting Requirements**

By this decision, we order substantial change to the structure of regulation for BA-MD. This change warrants a comprehensive monitoring of BA-MD's operations in order to provide prompt signals if potential problems arise. Commission Staff must have full access to the information necessary for monitoring, auditing, and investigating in order to effectively monitor BA-MD's operations under the new regulatory framework.

We adopt Staff's proposed reporting requirements, and order BA-MD to provide us with the following information on an annual basis:

1. PSC Surveillance Report;
2. Securities and Exchange Commission Form 10-K;
3. FCC ARMIS Report 43-02 (Form M);

4. Annual Report to the PSC;
5. Company USOA Financial Reports.

Since BA-MD already performs, either for us or the FCC, all of the reporting required above, we are placing no additional burden on the Company. These filings will provide us with important information in determining whether the price cap plan is achieving the desired results.

#### **7. Competitive Safeguards**

We have reviewed the parties' proposals regarding the need for safeguards to ensure that BA-MD's conduct is consistent with the growth of competition in the Maryland telecommunications markets. Competitive safeguards are not new to Maryland, having been in effect since September 24, 1990. We have reviewed the parties' specific recommendations for modifications to the existing safeguards contained in Appendix B of Order No. 68957 in Case No. 8274. We note that under price cap regulation there is no need for cost allocation or attribution safeguards. We find that the following safeguards are both necessary and appropriate.

##### **i) Competitive Service Standard Safeguard**

We have accepted BA-MD's and Staff's definition of a market to be included in the existing safeguard. If BA-MD asks the Commission to categorize any new service as competitive or to reclassify any existing service as

competitive,<sup>74</sup> the Company must make a showing to the Commission that:

a) entry into the market for the service is unimpeded by technical or legal constraints;

b) there are economically viable competitors for provision of the service;

c) like or substitutable services are available at rates and terms of service which allows the market to assure that rates for the service will be just and reasonable.

Furthermore, as requested by AT&T, we require BA-MD to provide the following additional information to the Commission when requesting reclassification of services in Baskets 1, 2, 3, and 4:

a) the breadth of the relevant market;

b) market share characteristics of BA-MD in the relevant market;

c) available evidence on ease of entry and exit;

d) factors that facilitate or inhibit the ability of entrants and competitors to expand capacity and capture sales;

e) factors that facilitate or inhibit the willingness to switch providers;

f) the price elasticity of demand in the relevant market; and

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This standard does not apply to services in Basket 6, Miscellaneous ~~103~~ services and Elements, because services in this basket are regulated in accordance with the Telecommunications Act of 1996.

g) market data on the percent of customers for whom choices are available and the percentage who have availed themselves of choice.

Proposals to move services between baskets must be approved by us. Any party may petition us to reclassify a BA-MD service. The burden of proof will rest on the petitioner to show why the service in question is not appropriately classified.

Whenever BA-MD proposes that a new or existing service be classified or reclassified as competitive, BA-MD shall indicate the steps the Company will take to comply with the safeguards adopted in this Order. Any interested person may file a notice of objection to the categorization of the service as competitive or to BA-MD's compliance with the safeguards.

Thirty days prior to proposing any reclassification of an existing service as competitive, BA-MD will notify those parties who previously requested notification concerning such filings. This notice shall include the name and tariff reference of the service to be reclassified. When BA-MD files its actual proposal for reclassification with the Commission, it will provide a copy to these same parties. Similarly, on the date BA-MD files tariffs to offer any new service, BA-MD will serve a copy of the filing on those parties who have previously requested notification.

Any interested person may notify us prior to the effective date of the tariff that it objects to the proposed classification or reclassification. Within 30 days after the proposed effective date, the objecting party shall file a petition setting forth its objections to the proposed classification or reclassification of the service. A petition objecting to the classification of a new service shall not delay the effective date of the service. However, the classification shall be considered interim and subject to revision. Proposed reclassifications shall not become effective until we rule on the objections.

Finally, we find that a market may be defined as the entire State, a particular geographic area or a particular subset of customers. Services may be classified as competitive in one market and as other-than-competitive in another given market. Services classified in this manner will be considered two separate services and placed in two different service baskets.

ii) Unbundling Safeguard

Existing Commission policy requires BA-MD to unbundle<sup>75</sup> services or elements to the extent that the

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Unbundling generally refers to breaking down the provision of a service into the various elements that make up that service and requiring the provider of the service to offer the sale of the elements on an individual basis rather than only as a complete, bundled package.

purchase of unbundled elements is requested by a co-carrier, reseller or interconnector and is reasonable and technically feasible without causing damage to network integrity. We will retain this existing safeguard and expand its scope to include the unbundling requirements of the Telecommunications Act of 1996.

Thus, if BA-MD proposes a new competitive service or proposes to reclassify an existing service as competitive, and that service combines a competitive service with an other-than-competitive service, BA-MD must file a new or reclassified service on an unbundled basis. In other words, the other-than-competitive service or services will be identified and available as separately tariffed items at the same rates and terms of service as those at which the other-than-competitive service is included in the combined service. Notwithstanding any of the provisions of this Order, BA-MD shall unbundle and offer for sale its services in the manner required by the Telecommunications Act of 1996.

Unbundling requests shall be addressed without delay as specific demand arises. Technical and pricing issues will be resolved through consultation by the interested parties under Staff guidance.

iii) Retail Services Pricing Safeguards

We adopt the following safeguards to ensure that BA-MD's retail rates are consistent with the growth of

competition in the Maryland telecommunications markets. First, prices for competitive and discretionary services shall not be set below incremental costs. To the extent that BA-MD charges competitors for OTC services that are necessary to compete with BA-MD's own competitive or discretionary services, when BA-MD supplies an OTC service to itself in connection with its own competitive or discretionary services, the rates for that competitive or discretionary service shall exceed the rates for the OTC service it supplies to itself plus any additional incremental costs the Company incurs in providing the competitive or discretionary services.

Second, for packaged services that combine many functionalities, BA-MD will not be required to provide imputation tests on specific rate elements that make up the packaged service. Imputation testing may be done on a "service" basis. Using this method, the price for the aggregate packaged service must exceed the aggregate incremental costs plus tariffed rates for OTC inputs. However, no party shall be precluded from petitioning us to require that cost data be provided on a less aggregated basis. Furthermore, we will take appropriate action to assure that the packaged services' prices are not anti-competitive.

iv) Access Imputation Safeguard

All toll services BA-MD offers shall be set at a

level sufficient to produce revenues which exceed the access charges the Company imposes on IXCs and the remaining costs BA-MD incurs in providing the toll service. BA-MD shall be deemed to meet these requirements if it meets the following conditions:

a) The price charged for an average call carried over the public switched network shall exceed an amount determined by (i) multiplying the access minutes associated with the call by the tariffed rates for BA-MD's End Office Local Switching, Feature Group D; and (ii) BA-MD's remaining incremental costs, including any transport and tandem switching costs.

b) BA-MD's rates for its toll services shall, as a whole, generate sufficient annual revenues to exceed the sum of the charges described in subparagraph (a), above, for all calls and, in addition, must generate an amount equal to the product of multiplying a per-minute interconnection charge (as defined in

BA-MD's Tariff 217, Section 6) and a per-minute CCLC equal to the CCLC assessed to the IXCs, calculated on a per-minute basis, as determined from the CCLC paid by the IXCs during the most recent calendar quarter, times the total number of access minutes of each toll service which BA-MD provides (to approximate the CCLC which BA-MD imposes on unaffiliated interexchange traffic).

c) For the purposes of subparagraphs (a) and (b), above, "access minutes" shall include the addition of a Non-Conversation-Time Additive to conversation minutes to develop originating access minutes, and terminating access minutes will be determined using a one-to-one terminating-to-conversation minute ratio. Similarly, the term "call," as used in subparagraphs (a) and (b) above, shall be interpreted as the term is defined in Subsection 2.6 ("Definitions") of BA-MD's Tariff

P.S.C. Md No. 217.

If we approve or order any changes in the structure of BA-MD's access charges, as reflected in paragraphs (a) or (b) above, the Company will submit modifications of these safeguards for approval.

v) Audit Imputation Safeguard

Upon our request, BA-MD shall provide us with the information requested to verify the imputation.

vi) Tariffs

Consumers need information to make appropriate choices. Healthy competition depends on consumers being well informed about their choices. Therefore, we require BA-MD to continue to file tariffs for all telecommunications services, including those services characterized as competitive. The rates for competitive services shall be included in BA-MD's publicly filed tariffs unless we determine that the rates are proprietary. Proprietary rates shall be on file with the Commission. BA-MD shall permit interested parties to review the proprietary tariffs under the terms of an appropriate protective agreement, such as those agreements currently executed for proceedings before the Commission.

vii) Resale Safeguard

We have determined that BA-MD shall offer its services for resale in the manner required by the

Telecommunications Act of 1996.

#### **8. Review Period**

BA-MD's price regulation proposal has no scheduled expiration date and no built in periodic review. In contrast, Staff and OPC recommend formal reviews.

Price regulation is a relatively recent form of regulation. Given that, and since the telecommunications industry is in a transitional stage, we find it reasonable to begin a planned review of the Company's performance under the plan no later than the beginning of the sixth year of the plan. Six years is a reasonable time in which the Company may operate under this new form of regulation, and will provide an adequate period for BA-MD to gain experience with price cap regulation. This time period should be sufficient to permit us to review the efficacy of the plan and the state of competition in the telecommunications industry.

Because this particular form of regulation is new to Maryland, we will provide further guidance as necessary during the term of the plan regarding the types of information that BA-MD should file to assist in the efficient and expeditious evaluation of the plan.

#### **C. Going-In Rate Levels**

In Case No. 8462, the Commission extended for three years the regulatory regime under which BA-MD currently operates.<sup>76</sup> Part of our decision in Case No. 8462 was to state that we would review, at the end of the three-year period, the Company's return on equity and all operations of the other-than-competitive side of the business, including the costs of OTC operations. 84 Md. PSC at 13.

As previously described, Staff and OPC proposed adjustments to BA-MD's OTC revenue requirement prior to the initiation of (or "going-in" to) a price cap plan. BA-MD, conversely, contends that existing OTC rates should be the starting point for the price cap plan.

We understand Staff's and OPC's assertions that, based on traditional rate base/rate of return ratemaking methodologies, BA-MD's rates should be reduced. However, underlying their assertions is the assumption that the only appropriate tool to measure the reasonableness of BA-MD's OTC revenue requirement is a RB/ROR approach. We find that The PSC Law does not require us to adopt that assumption. Specifically, we observe that Section 69(e) of The PSC Law leaves to us the definition of "affordable and reasonably priced basic local exchange service." While the reasonableness of OTC service rates certainly

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As explained earlier, the current plan bifurcates BA-MD's services into competitive and OTC categories. The current plan allows the Company to market price competitive services, while the prices for certain basic services are frozen. BA-MD is permitted to propose rate adjustments for other OTC services in a revenue-neutral fashion.

could be determined utilizing a RB/ROR approach, it is neither the only nor the best approach.

After considering the evidence and arguments presented on this issue, we find that it is reasonable to utilize BA-MD s existing OTC rates, except access rates, as we initiate price cap regulation. In doing so, we find that since so many Maryland households currently have telephone service at existing rate levels (in excess of 97 percent), and since existing OTC rates actually are lower now than they were in 1985, current OTC rates are reasonable. Moreover, since the OTC rates set herein will be in effect for an extended period of time, we find it is reasonable to utilize a broader and more forward-looking measure of rate reasonableness than can be attained through an examination and matching of the Company s rate base, revenues, and expenses. Additionally, a broader measure of rate reasonableness also is justified by the competitive incursions into some and eventually all of BA-MD s OTC service offerings that we can expect in the years ahead.

#### **D. Access Rate Reductions**

As noted in the preceding section, we find that access rates should be reduced. As with our decision to not order reductions in non-access OTC rates, our determination to reduce access rates is based not on

revenue requirement grounds, but rather on a broader determination as to the reasonableness of current rate levels.

Historically, access charges have been priced above BA-MD's incremental costs. A justification for pricing access charges at this level was that the local loop is used to provide toll and other custom services as well as for basic local service. Another reason for pricing access charges above cost was that services historically deemed less essential than basic local exchange service, such as long distance, should be priced above incremental cost to permit BA-MD to price local exchange service at or below cost. This pricing approach enabled BA-MD to fulfill its responsibility of making local exchange service universally available. However, it has also served, to some extent, as a market barrier to companies looking to compete with BA-MD.

We have examined the record in this proceeding and conclude that access charges should be reduced to promote telecommunications competition in Maryland and to reduce toll rates for Maryland customers. Effective competition between telecom-munications providers will maximize the ability of the market to introduce new technologies and new services benefiting Maryland

consumers. As Staff Witness Waldau notes, when toll rates decline with lower switched access rates, many consumers will be inclined to use more toll services, efficiency and competition would be enhanced and consumers would benefit.<sup>77</sup> Moreover, increased competition will place faster and more effective downward pressure on rates than RB/ROR regulation.

We will reduce BA-MD's intrastate access revenues by approximately \$32,118,272 annually. We derived the revenue reduction for BA-MD using the methodology described by MCI Witness Murray. For the twelve months ending June 30, 1995, BA-MD received annual revenues from intrastate carrier access services of \$112,955,000 from a total of 2,773,000,000 annual minutes of use. The reduction of the local switching charge from approximately \$.012559 to \$.003 results in a reduction of \$26,507,107. The reduction of the RIC by 25 percent results in a reduction of \$5,611,166.

We direct BA-MD to immediately file new tariffs to reduce its switched access rates in the following manner:

Reduce the local switching rate from \$.012559 to \$.003; and,

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<sup>77</sup> Surrebuttal Testimony, pg. 57.

Reduce the residual interconnection rate from \$.008094 to \$.0060705.

We are not directing any additional changes to the switched access rate elements at this time.

We further direct interexchange carriers or any other regulated entity using local switched access to immediately flow through the access reductions by reducing intrastate toll rates. The carriers' plans to flow through the access reductions should be submitted to Staff for analysis prior to filing the rate reductions with the Commission.

In adopting a \$.003 local switching rate, we accept Staff's recommendation that the local switching rate should be set at the current BA-MD tariffed rate for local exchange, end office termination. The \$.003 rate was adopted by the Commission in Order No. 72348, Case No. 8584, Phase II, and is based on forward-looking economic cost studies.

We reject MCI's proposal to reduce the local switching rate to MCI's estimate of BA-MD's direct economic cost, including non-traffic and traffic sensitive costs. We also reject AT&T's proposal to reduce the local switching rate to AT&T's definition of direct economic costs, \$[proprietary], the incremental cost of the traffic sensitive components of switched access.

MCI and some other parties recommended eliminating the RIC and the CCLC. We seriously considered eliminating the RIC to further promote competition in Maryland. However, we share the FCC's views in the Interconnection Order regarding the interstate RIC, otherwise known as the Transport Interconnection Charge, or "TIC". In determining whether access rates should be collected by the incumbent LEC when a reseller purchases unbundled elements of the incumbent's network, the FCC ruled that for an interim period the incumbent LEC may collect the CCLC and 75 percent of the TIC. The FCC concluded that the nature of most of the revenues recovered through the TIC is unclear and subject to dispute, although a portion of the TIC is associated with certain costs related to particular transport facilities. We therefore find that BA-MD may continue to collect 75 percent of the intrastate RIC for all intrastate minutes traversing BA-MD's local switches.

We are convinced that the monopoly inputs of switched access should be reduced to cost. However, we note OPC's and BA-MD's concern that universal service may be jeopardized by a massive rebalancing of access charges. In view of the decisions contained in today's order, it is time to move forward with the universal service proceeding established in Case No. 8584, Phase II. See 86 Md. PSC at 495, Ordered Paragraph (3). We

direct Staff to submit a list of issues for the universal service proceeding by December 30, 1996. The issue list should include an evaluation of the CCLC and the RIC.

**IT IS, THEREFORE,** this 8th day of November, in the year Nineteen Hundred and Ninety-six, by the Public Service Commission of Maryland,

**ORDERED:** (1) That the Commission adopts a price cap regulatory plan for Bell Atlantic-Maryland, Inc., in accordance with the terms and conditions contained in this Order.

(2) That Bell Atlantic-Maryland, Inc., shall conduct its regulated operations, including the filing of tariffs as necessary, in conformance with the price cap regulatory plan adopted in Ordered Paragraph (1).

(3) That Bell Atlantic-Maryland, Inc., shall file amended access tariffs reflecting the reductions to the local switching rate and residual interconnection charge directed in this Order.

(4) That the amended tariffs filed in accordance with Ordered Paragraphs (2) and (3) shall be subject to acceptance by the Commission and the designation by it of an effective date(s).

(5) That all interexchange carriers and other regulated entities using local switched access shall, upon

acceptance by the Commission of the tariffs referenced in  
Ordered Paragraph (4), comply with the terms of this  
Order governing toll call tariffs.

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Commissioners

Susanne Brogan, Commissioner Concurs  
in part and Dissents in part

APPENDIX 1

Issues - Case No. 8715

1. How does a new regulatory framework offer improved performance beyond that of the current regulatory structure? What are the deficiencies of the new regulatory framework?

2. How does the proposed regulatory framework further the following legislative objectives:

- a) producing affordable and reasonably priced basic local exchange telephone service;
- b) ensuring quality, availability, and reliability of telecommunications services throughout the State;
- c) encouraging competition; and
- d) serving the public interest.

3. What benchmarks and/or review process should be used to judge the effectiveness of an alternative regulatory framework over time? How often should the benchmarks be reviewed and/or review process occur?

4. What is the appropriate mechanism with which to determine the reasonableness of BA-MD's current rates?

5. Should an alternative regulatory framework be considered a trial with a given expiration date or should it replace rate of return regulation without a specified time by which it would be reviewed to judge its effectiveness?

6. If an alternative regulatory framework includes a cap or rate freeze on some rates (such as basic

residential dial tone line rates), how long should such a freeze be in place? What criteria should be used to determine what services should be capped and how long a cap or rate freeze should be in effect?

7. If an alternative format includes a classical price cap index ("PCI") like "PCI = inflation factor - inflation offset," what should be the value for the following components:

a) Inflation Factor?

b) Inflation Offset (sometimes referred to as the Productivity Factor or X Factor)?

8. How can an alternative regulatory framework best assure the continued protection of service quality? Should alternative regulatory frameworks specifically detail the way in which they will meet the statute's objectives regarding the quality and reliability of BA-MD's services under such a plan? Should such an objective be made a part of the framework itself such that BA-MD's ability/inability to meet specific quality of service guidelines would influence the prices the Company is allowed to charge?

9. Is an earning sharing mechanism a necessary or appropriate part of an alternative regulatory framework? If yes, how would a sharing mechanism be structured?

10. What exogenous factors, if any, should be included in any alternative regulatory framework, and what procedures should be used to modify prices based on such factors?

11. Are the concepts of sharing and exogenous factors closely tied such that a plan should include either both or neither?

12. Should all of BA-MD's services be classified

into service baskets as is done at the FCC and with several other state price cap plans? If so, what criteria should be used in grouping services together and in ultimately deciding the number of baskets which are needed? Provide examples of how current BA-MD services should be classified.

13. If baskets are used, should an alternative regulatory framework propose different pricing rules for each basket? If so, would there need to be a relative pricing mechanism (much like the FCC's use of Actual Price Index's ("APIs")) for each basket in order to compare and eventually to compute the plan's overall PCI index?

14. Should the alternative regulatory framework which is eventually chosen include a list of overarching competitive safeguards which would govern price changes regardless of the basket within which the service is currently included? If so, what should those safeguards be?

15. What financial service quality, and other reporting information, should BA-MD continue to file under an alternative regulatory framework? Should there be any additional filing requirements? If so, for what reason and exactly what information should be necessary?

16. Given that one of the statute's objectives is that an alternative regulatory framework encourage the development of competition, should the eventual framework chosen include issues surrounding intra-LATA presubscription? Should the eventual framework adopted include funding for number portability, preservation of universal service in a competitively neutral fashion, and/or other issues important to the development of competition in Maryland? Should a plan limit BA-MD's ability to separate its prices from its earnings based upon the level of actual competition it faces in the marketplace and/or its willingness to take steps necessary to allow competition to develop?

17. Should the Commission require BA-MD to lower all of its rates for "essential monopoly input functions" to their economic costs? What services might be included within this definition? How are economic costs defined? Should a "markup" above cost be included?

18. What universal service mechanism (interim or otherwise) should the Commission adopt in conjunction with any plan it may adopt? What services are considered basic? What services promote universal service?

19. How does the proposed plan ensure that BA-MD's rates meet the requirements of 69 (e) of The PSC Law?

20. Should the Commission require BA-MD to commit to a certain dollar level of infrastructure development and/or to make specific commitments for infrastructure developments? If yes, what infrastructure developments should be promoted?

APPENDIX 2

**SERVICE BASKETS**

**BASKET 1**

BASIC RESIDENTIAL SERVICES	

**BASKET 2**

BASIC/OTHER SERVICES	

**BASKET 3**

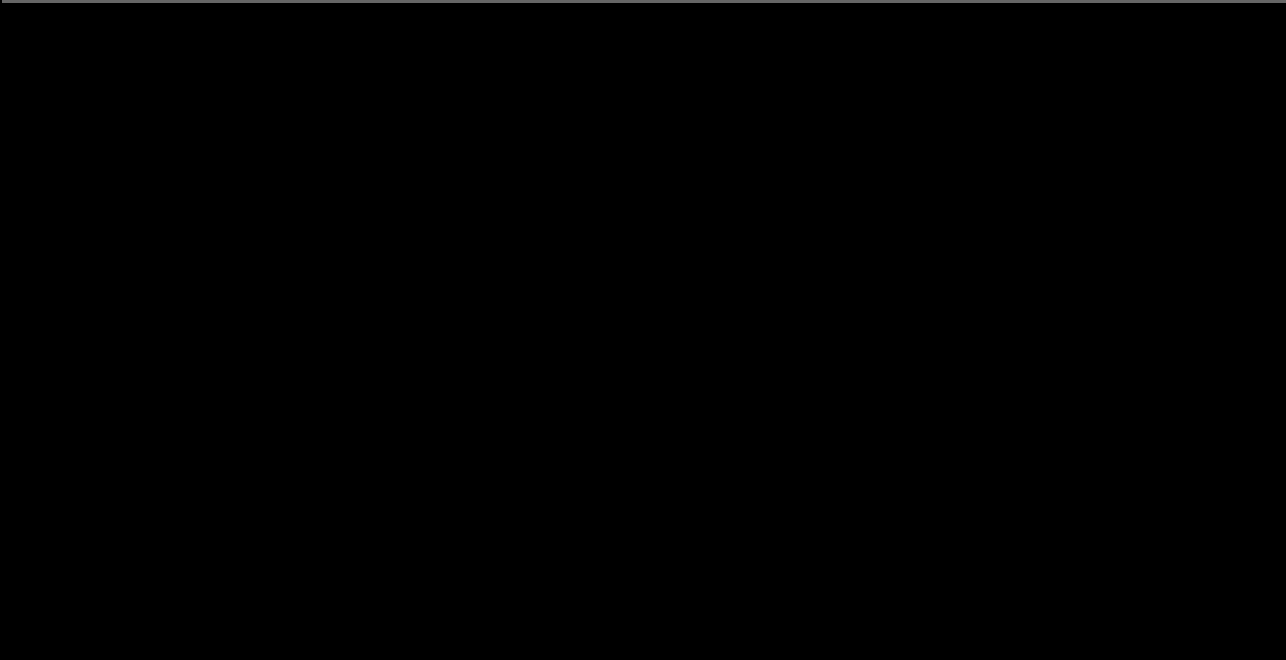
ACCESS SERVICES
Collocation Services
Switched Access (Other Than High Capacity Service for Direct Transport)

**BASKET 4**

DISCRETIONARY SERVICES
[REDACTED]

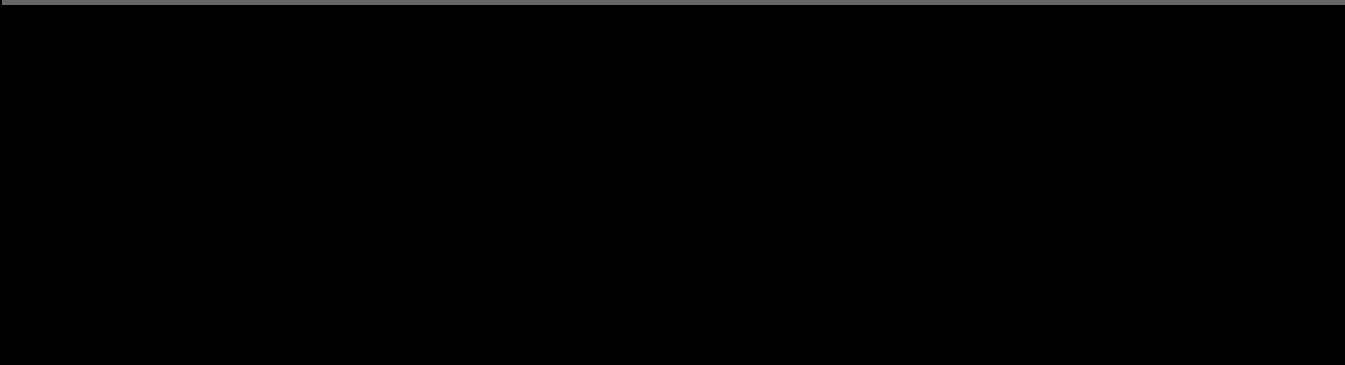
**BASKET 5**

**COMPETITIVE SERVICES**



**BASKET 6**

**CO-CARRIER SERVICES**



**PRICING RULES**

. Prices for services in Baskets 1, 2, and 3 shall be frozen for three years; from January 1, 1997 through January 1, 2000.

. After January 1, 2000, prices for services in Baskets 1, 2, and 3 shall be subject to the price cap index.

. Prices for services in Basket 4 shall be subject to the price cap index as of January 1, 1997.

. The price cap index formula is:

GDPPI +/- three year running average of the  
CPI +/- exogenous changes.

. The price cap index will be adjusted annually.

. Under the plan, BA-MD may increase prices for individual services in a basket covered by the index as long as the aggregated rate changes for all services within the basket do not exceed the calculated price cap index.

. Prices will be lowered should the result of the formula so dictate.

. BA-MD may elect not to implement all or a portion of a price increase otherwise permitted by the price cap index formula. If BA-MD makes this election, the Company may recover such an increase in a subsequent year's price compliance filing.

. BA-MD may make the allowed or required price adjustments in two installments rather than implementing the entire adjustment at the beginning of the price cap year.

. For Basket 4, BA-MD may implement revenue neutral

pricing changes twice a year, so long as these actions satisfy the maximum change guidelines.

. For baskets covered by the PCI, the price for an individual service may not be raised more than 10% a year.

. Prices may not be lowered below the services' incremental cost.