

**PUBLIC UTILITY COMMISSION**  
**IN RE: "AVOIDED COST" FOR DEVELOPMENT OF "WHOLESALE" DISCOUNTS FROM RETAIL**  
**RATES - DOCKET NO. 2518**  
**MEMORANDUM OPINION AND ORDER**

1. On January 10, 1997, this Commission released a Notice of Inquiry ("Notice" or "NOI") on the subject of the calculation of "Avoided Cost" for determining the amount of discount from retail rates that New England Telephone (doing business as Bell Atlantic [formerly NYNEX]; hereinafter "Bell Atlantic") must grant its competitors in the local exchange market (competitive local exchange carriers; "competitors" or "CLECs") under the terms of the federal Telecommunications Act of 1996 ("Act"), P.L. 104-104, 110 Stat. 56, codified as 47 U.S.C. §§ 151-760, particularly § 251(b)(1) and § 251(c)(4). The Notice of Inquiry also addressed rules that the Federal Communications Commission ("FCC") promulgated to interpret and enforce these provisions, in its First Report and Order, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, FCC Mimeo 96-325, August 8, 1996. These rules were codified in 47 C.F.R. §51.601 through §51.617, and we referred to them in our Notice, but they have since been overruled on appeal by the Eighth Circuit Court of Appeals in *Iowa Utilities Board, et al. v. FCC et. al.*, Case No. 96-33321, Opinion, July 18, 1997. [Footnote 1](#)

2. In the Notice, we asked three basic questions, each of which had many sub-questions.

.....(1) Which services must be offered at retail? (¶¶ 4-11)

.....(2) What restrictions on resale may lawfully be imposed (¶¶ 12-17)

.....(3) How should the "wholesale discount" be calculated? (¶¶ 18-45)

3. We received comments from Bell Atlantic, AT&T Communications of New England ("AT&T"), MCI Telecommunications Corporation ("MCI"), Sprint Communications Corporation L.P. ("Sprint"), and Cox Rhode Island Telcom, Inc. ("Cox"), and the Department of Attorney General, Division of Public Utilities and Carriers ("Division"), which filed comments that included a summary chart of the positions of the other parties. We hereby incorporate by reference the Division's chart of the positions of the parties.

**SERVICES TO BE OFFERED AT RETAIL**

4. The parties generally agree that Bell Atlantic must offer at retail all services contained in its NYNEX Tariff P.U.C.-R.I. No. 15 (Bell Atlantic's General Intrastate Telecommunications Tariff for Rhode Island). (See Division at p. 2, Bell Atlantic at p. 4). AT&T defines the list of services in terms of the accounts in which their revenues are kept (AT&T at p. 8), Sprint provides a categorized list of services (Sprint at p. 4), and MCI believes that a "tariffed service which NYNEX offers to the public, however sparingly," (MCI at p. 5) should be subject to resale, even if it is not often used by the public, as distinguished from other carriers. Cox believes that all retail services should be available, but that there may be reason to prevent resale of services offered "below cost," although it notes that evidence on the cost of services presented in rate cases is often not very compelling (Cox at p. 2).

5. We are reluctant to define the list of services available for resale in terms of a specific tariff for two reasons: (1) as MCI implies, there may be services that are generally offered to other carriers, but which may have some retail customers; and (2) Bell Atlantic may, in the future, tariff some services under other tariffs that should, none the less, be available for resale, and our rules would create an ambiguity if they were couched solely in terms of a specific tariff. We are also reluctant to define the services in terms of their revenue accounting, partly because accounting is controlled by the FCC, and partly because Bell Atlantic may have some flexibility in the way it accounts for some future services. We are very reluctant to adopt a list of services or service categories to be offered, since new services are being developed and introduced almost daily.

6. That said, we find that, as a practical matter, Tariff No. 15 does provide a useful and unambiguous list of services to be offered for resale, so we adopt the position of Bell Atlantic and the Division. However, if a competitor finds some services not included in Tariff No. 15, but which Bell Atlantic is actually selling to a retail customer (that is, a customer who is not licensed as a common carrier in the state of Rhode Island), it may petition this Commission to order the service made available for resale. In deciding such petitions, we will examine the particular service, and, rather than simply accepting or denying it, the Commission may permit the CLEC to obtain the service for resale to limited classes of customer or impose other restrictions on its resale.

7. In all future tariff filings, Bell Atlantic must state whether or not each service is a retail service available for resale, and what restrictions on resale, if any, are appropriate. If other parties wish to address the question, we will consider their positions and issue a ruling.

8. It is not practical to distinguish between services that the competitive local exchange carriers may be reselling, and those that they are using for their own purposes. Accordingly, we will permit CLECs to use any discounted service for their own internal use, except for those services which have explicit restrictions on resale (such as Residential Service, or Lifeline Service). Thus, the wholesale discount applies to access lines for coin service when ordered by a CLEC either for resale to its customers or for its own use (that is, for use with coin telephones it owns, itself). However, in general, "aggregators" that are not licensed common carriers in Rhode Island, including operators of coin telephones, are not eligible to obtain services at the wholesale discount. Indeed, licensed common carrier status in Rhode Island is a prerequisite to obtaining any services at the wholesale discount.

9. The parties did not generally address the matter of promotional rates, or tariffs for promotional services or technical trials. The FCC ruled that where these are provided for more than 90 days they, too, must be discounted. With respect to promotional rates, we agree. However, with respect to rates for experimental services and technical trials, we will permit Bell Atlantic to apply for restrictions on resale as part of the tariff. We may determine that such services might be offered for resale only to members of the same customer group (which might be defined geographically, by customer class, or in some other way), or not available at all.

### **SERVICES OFFERED BELOW COST OR AT DISCOUNT**

10. The parties (except Cox), generally believe that any Bell Atlantic retail services that are being offered below cost must, nonetheless, be offered for resale. No party, including Bell Atlantic, is able to provide a list of such services, although all believe that there are some such. Furthermore, many services now contain discounts of various types: bulk or volume discounts, term, and so forth. Only Bell Atlantic provided a list of such services; other parties did not comment directly. (See Division, p. 3; Bell Atlantic, p. 6; AT&T, p. 8; MCI, p. 6; Sprint, p. 3; Cox, p. 2.)

11. While we generally agree that services offered below cost or at a discount must be offered for resale, there are statutory exceptions, and others that good public policy may require. In general, there is no basis for restricting sale of business services (services offered to customers that are not residential customers), although there may be issues with respect to experimental services and technical trials. We will deal with these individually as cases arise. With respect to residential services, since we deliberately price these services at less than comparable business services, it would clearly be an untenable situation for competitors to resell residential services in direct competition with Bell Atlantic's business services. Accordingly, and in accordance with 47 U.S.C. § 251(c)(4)(B), we will specify that residential services may not be resold to customers who do not meet the definition of "residential customer" as defined in Bell Atlantic's tariffs. Furthermore, we will admit the possibility that there may be, in the future, other services offered to restricted classes of customer that should not be resold to other classes of customer; Bell Atlantic may, at the time, petition for appropriate restrictions on resale. The FCC believed that such restrictions are presumptively illegal. (See Bell Atlantic, p. 9, Sprint, p. 3 [citing First Report and Order, ¶¶ 963, 964]). We do not find the FCC's restrictive view in the plain language of the Act, which explicitly permits restrictions on cross-class selling, as FCC termed the practice. However, we do not expect that we will often find such services to be justified. In this record, Bell Atlantic proposed CENTREX as another example (Bell Atlantic at p. 9), that might be used to aggregate customers, increasing

provisioning costs, but did not request a restriction on resale of the service. Since city-wide CENTREX has long been used by telephone companies to provide service to customers, and since some non-carriers (such as Internet service providers) currently use CENTREX lines to provide service to their customers, we are pressed to see how resale of this service could be restricted at this time.

12. We note that it is a long-standing practice that services a reseller acquires with a bulk discount may be resold to customers that do not, individually, qualify for such a discount, provided the reseller meets the quantity requirements for the discount. It appears that similar requirements should apply when a reseller obtains a discounted rate by agreeing to a long-term contract.

13. Lifeline and Linkup America services may be resold only to customers who qualify for them, as specified in the tariffs and relevant Commission orders. Any support for these services that is paid from the Universal Service fund will be paid to the incumbent local exchange carrier if the competitive carrier receives the services at a discount from the Lifeline or Linkup rate, or to the competitive local exchange carrier if the competitive carrier receives the services at the full residential rate.

14. "Grandfathered" services, that is, services that are no longer offered to new customers, but which continue to be provided to present customers, may be resold, but only to customers who are otherwise eligible to receive them. That is, they may be offered to existing customers but not to new customers. This is the position of the Division (Division at p. 5); the other parties did not address the issue of withdrawal of services.

#### **INCREASED COSTS FROM RESALE**

15. In our Notice, we observed that Bell Atlantic's costs might increase due to some forms of resale. In particular, we gave the example of flat-rated services being resold to customers who provide a significantly higher volume of traffic than was assumed when the cost basis of the service was developed. The Division thought that it would be best addressed when the tariff is reevaluated in a subsequent rate case. (Division at p. 4) Bell Atlantic thought that it could be handled by restrictions on resale, at least in the case of flat-rated services, which are only offered to residential customers. (Bell Atlantic at p. 7; see also its remarks on CENTREX, p. 9) Other parties did not address the issue or said they had no information. (MCI at pp. 6-7)

16. We agree with the Bell Atlantic that, since we are restricting the resale of residential services, the issue is not likely to arise in a pressing manner. We agree with the Division that it is an issue that we will, in principle, have to consider in future rate cases.

#### **THE CONCEPT OF AVOIDED COST**

17. In our Notice, we discussed the meaning of "avoided cost" in accounting, transportation, and the fixed utility industries, noting that the term is widely used in the electric industry for pricing under the Public Utilities Regulatory Policy Act of 1978. The basic questions are: (1) whether avoided cost should be considered a short-run concept, that is, one in which fixed costs are not considered to be avoided, or a long-run concept in which some fixed costs may also be considered to be avoided; and (2) whether costs should be considered only if they are actually avoided, or if they are avoidable--that is, those that might be avoided if the incumbent company were to re-optimize its way of doing business.

18. The parties' discussion was very enlightening, and far too voluminous to reproduce here. (For a summary, see the Exhibit A to the Division's brief.) Generally, the parties felt that we should not consider practices in other public utility industries, and most, except Bell Atlantic, supported the FCC's definition. (See Division at pp. 5-6; Bell Atlantic at pp. 13-16; AT&T at p. 11; MCI at pp. 9-10; Cox at pp. 5-6.)

19. Bell Atlantic argued that, theoretically, the avoided cost would be the difference between two incremental cost studies, one with retail operations and one without. This, it claimed, is impractical. (Bell Atlantic at p. 13.) It also argued that it should be "financially indifferent as to whether a service is sold at retail or wholesale". (Bell Atlantic at p. 14) The Division opposes this latter view, calling it a variant of an Efficient Component Pricing Rule that it opposed in Docket No. 2252. (Division at p. 6)

20. We observe that a great deal of progress has been made in the development of the so-called Proxy Models, the Hatfield Model, sponsored by MCI and AT&T, and the Benchmark Cost Proxy Model, sponsored by Pacific Telesis, US West, and Sprint. Moreover, telephone company cost models have had a great deal of development in the past year, to meet the demands of pricing network services. However, the advances in all these models are in terms of long-run costs, with all costs variable, including all capital costs, which might not agree with the conceptual basis of avoided cost if we were to adopt something close to the FCC's concept. However, it is possible that, at some future date, we might be in a position to use alternate runs of a cost model to determine avoided cost.

21. As for Bell Atlantic's view that avoided cost should leave it indifferent as to whether services are offered at wholesale or retail, we fail to find support for this position in the Act, or in the analysis of the Act by the FCC or the other parties in this docket. We return to this point below.

### **THE PRACTICAL CALCULATION OF AVOIDED COST**

22. In our Notice we presented three different practical calculations of avoided cost, as shown in the FCC's First Report and Order. We do not reproduce that chart here. They are based on certain expense accounts that the parties or the FCC believe are related to the provision of retail services. Generally, these include marketing and sales and customer relations expenses, plus some administrative expenses, but exclude plant-related expenses, except those clearly related to "support" for the provision of retail services.

23. We note that only operating expenses associated with the provision of retail services are to be deducted from the rates for those services in calculating the wholesale discount. Since the rates for the services are determined including provisions for profits, taxes, and recovery of capital investment (depreciation), it is at least arguable that, if the incumbent local exchange carrier provides services at wholesale, but recovers costs that include its investments in providing marketing, sales, and customer-relations services, it is at least slightly better off than if it provided the services at wholesale, [Footnote2](#) at least until the next rate case. Thus, we believe that the FCC rules leave the incumbent no worse off financially as a result of resale, and possibly better off.

24. However, because of the asymmetrical treatment of the expenses and capital costs (depreciation, profits, taxes) associated with investments for the provision of retail services, it is impossible to describe the FCC's rules or the other proposals as reflecting either a long-run or a short-run definition of avoided cost.

25. Bell Atlantic believes the FCC erred in defining avoided costs as "those that an incumbent LEC would no longer incur if it were to cease retail operations and instead provide all of its services through resellers" (First Report and Order, ¶ 911). (Bell Atlantic at p. 15.) It argues that costs that will not be affected if the volume of retail services changes, but only if the provision of retail services entirely ceases (what it calls "retail fixed costs"), should not be considered avoided costs for the purpose of calculating the wholesale discount, since Bell Atlantic will continue to provide some retail services for the foreseeable future. (Bell Atlantic at p. 16.) However, it provides no examples of such costs.

26. The other parties generally support the FCC's determination. The Division endorses the FCC's definition of avoided cost, as explained in paragraphs 917-919 of the First Report and Order (Division at pp. 5-7). AT&T believes that the appropriate cost standard is costs that will be avoided in the long run, including capital costs (AT&T at pp. 10, 12, 13),

and endorses the FCC's definition of avoided cost as within the meaning of the Act and established usage (AT&T at pp. 13-14). MCI believes that the FCC's definition is as required by the Act, and does not believe that there was any relevant established usage of the term in other fields that might be applied (MCI at pp. 10-12). It notes that the FCC relied heavily on MCI's proposals in developing its rules (MCI at p. 11). Sprint endorses the FCC's position and urges us to adopt it independently (Sprint at p. 4). Cox "essentially agrees" with the FCC's definition, but thinks it may be "too narrow" (Cox at p. 5). However, it presents no alternative suggestions, nor does it suggest other accounts we might examine.

27. Some of the parties support the concept of providing different discounts for the different classes of service, based presumably on differences in the costs of providing them at retail and serving the retail customers. However, most consider this to be impractical. The Division believes that the data do not exist to calculate different discount rates, and does not believe that discounts should be so calculated even if the data were to exist (Division at p. 7). However, it does believe that separate discounts can be calculated for business and residential services, as the Commission did in Docket No. 2458, and endorses that approach, using the arbitrator's decision with respect to Issue No. 22B in New Hampshire Docket No. 96-252 (Division at p. 7). Bell Atlantic believes that different discounts should be permitted, at least for broad classifications like business and residential services, and perhaps in other instances where data exist (but it does not believe that the appropriate data exist to do so for many services, or even that it could bill on this basis). (Bell Atlantic at p. 17.) AT&T believes that only a single discount is appropriate, "as a practical matter," to avoid the need to "arbitrarily allocate" costs among services (AT&T at pp. 15-16). MCI believes that a uniform discount should be used, because estimating avoided costs for each service would create "extensive cost study burdens" for us, and might be anticompetitive or cause delays (citing the example of Connecticut). (MCI at pp. 10-11.) Cox believes that separate discounts for residential and business services may be appropriate, but that discounts for more detailed categories of service might "overwhelm any savings." Moreover, it notes that if Bell Atlantic does not submit service-specific cost studies it has no basis for claiming service-specific discounts (Cox at p. 7). Sprint does not address the issue.

28. All the parties except Bell Atlantic have endorsed the FCC's definition of avoided cost, although with some qualifications. They agree that it is generally a practical approach to the concept, even if they differ in their descriptions of the appropriate conceptual basis for the determination of avoided cost. Certainly, none advanced a markedly different alternative, and only MCI presented a detailed calculation (in Appendix II to its brief). This calculation uses USOA summary accounts from the ARMIS 45-04 report (intrastate jurisdiction) to calculate an overall discount percentage. Unfortunately, by using the summary accounts, it is less detailed than the FCC's definition, which uses the detailed accounts. This may help explain why MCI calculated a discount of over 24 per cent, which is higher than most calculations of the appropriate discount. Accordingly, we accept the FCC's calculation of avoided cost as the only one for which there is widespread support.

29. Three of the parties have endorsed different discounts for residential and business services, two have not, and one is silent. None have endorsed a more detailed schedule of discounts, and several have presented convincing arguments that it would be impractical to do so, and possibly subject to manipulation. We are uncertain as to what advantages, if any, there are to calculating different discounts for business and residential customers: will it promote competition, or will it be anticompetitive? Will it help competition in one market and hinder it in the other? For example, if the discount for residential customers were greater than the discount for business customers, would this promote competition in the residential market and hinder it in the business market? And if, as some aver, the business market is the more lucrative, and the market on which most competitors are concentrating, at least at first, would this inhibit the development of effective competition for local service? Or would business services get the larger discount? None of the parties have addressed this issue. Accordingly, we will not, at this time, decide whether the discount should be calculated separately for residential and business services. However, at each filing of the avoided cost discount, we direct Bell Atlantic to file both an overall discount and separate residential and business discounts, until we have been able to adjudicate this question.

30. All parties agree that, since our intrastate retail rates are determined starting from jurisdictional costs, the discount should also be calculated using jurisdictional costs.

31. Most parties believe that uncollectables are totally or almost totally avoided when services are resold (that is, the reseller bears the risk that the ultimate consumer will not pay). While there have been a very few notable bankruptcies of resellers (one in California this year, and Datran over 20 years ago come to mind), the overall risk appears at this time to be negligible. Accordingly, we require that the uncollectables pertaining to retail accounts be considered avoidable; this decision is subject to change if a party can demonstrate that risks have changed.

32. When a service is resold, if the ultimate customer pays his or her bill, he or she should not be disconnected for the default of the reseller. Accordingly, we require that, when a service is resold, the carrier providing the wholesale service must continue to serve the ultimate customers, without interruption, in the event of default of the reseller, and may only disconnect those customers who can be shown not to have paid their bills. Where the carrier providing the wholesale service is regulated, it may include an amount of up to two per cent of its uncollectables (account 5301) in its wholesale rates. Where the carrier providing the wholesale service is not subject to rate regulation it may make its own provision in its contracts with its resellers.

33. Following public notice, the Commission conducted a public hearing on November 18, 1997 to review the draft regulations regarding avoided cost which had been circulated to all those filing comments in response to the NOI. Appearances were entered by Jeffrey Binder, Esq. for Bell Atlantic; Alan Shoer, Esq. for the Division; Scott Sawyer, Esq. for Brooks Fiber; Brian Fitzgerald, Esq. for Cox; and Alan Mandl, Esq. for MCI.

34. The parties agreed upon certain changes to the draft regulations, which have been incorporated in the version which the Commission adopts today.

35. At an open meeting on January 28, 1998, the Commission reviewed the record and certain typographical changes. The only substantive change was to adopt a compromise position as to what percentage of the amount in account 5301 (telecommunications uncollectables) could be included in Bell Atlantic's resale rates, to compensate for the risk imposed by the requirement that Bell Atlantic continue to serve the ultimate customers, without interruption, in the event of default by the carrier reselling its services. Bell Atlantic argued that 2% was too little; the inter-exchange carriers countered that it was too much. Without a factual basis to set the appropriate level, the Commission feels that a level of 1% is equitable.

**Accordingly, it is hereby:(15511) ORDERED:**

That the Regulations Regarding "Avoided Cost" for Development of "Wholesale" Discounts from Retail Rates, as amended by the parties to this docket during the hearing on November 18, 1997, and as further amended by the Commission during its open meeting, are hereby adopted for filing with the Secretary of State.

EFFECTIVE AT PROVIDENCE, RHODE ISLAND ON JANUARY 28, 1998 PURSUANT TO AN OPEN MEETING DECISION. WRITTEN ORDER ISSUED JANUARY 29, 1998.

PUBLIC UTILITIES COMMISSION

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James J. Malachowski, Chairman

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Kate F. Racine, Commissioner

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Brenda K. Gaynor, Commissioner

\*Chairman Malachowski did not participate.

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Footnote1

This opinion is available through the World Wide Web at <http://www.wulaw.edu/8th.cir/opinions/FCC/963321.019>; the body, without approximately 95 pages of headnote, is available as 963321.bdy. Accessed August 6, 1997.

Footnote2

That is, although under the FCC rules and the MCI and AT&T proposals the incumbent does not recover those expenses in accounts 6121 through 6123, General Support Expenses (land and buildings, furniture, office equipment) related to the provision of marketing and other services that are can be shown to be avoided, we note that there is no proposal by the FCC or any party that the related investment (in accounts 2121 through 2123), depreciation expense (account 6561), and the FCC specifically excludes depreciation expense from the calculation (47 C.F.R. § 51.609(c) (3)). Thus, assuming the basic assumptions are correct and the underlying activities are not performed, and the incumbent LEC no longer incurs the support expenses, it still recovers the capital (and profit and taxes) associated with the office space and equipment it is presumably no longer using.

