

studies on which the CPUC relied for this claim is substantially mischaracterized. The study in question, by two FCC staff members, Evan Kwerel and John Williams, analyzed the impact of the reallocation of a single UHF television channel in Los Angeles from broadcasting operations to a third cellular telephone system.<sup>63</sup> Kwerel and Williams concluded that cellular prices in Los Angeles could be expected to fall by approximately 25 percent as a result of introducing a third cellular competitor.<sup>64</sup>

However, as the Charles River report explained,

...even if Kwerel and Williams have correctly analyzed the impact on cellular prices in Los Angeles of the entry of a third cellular operator, their work does not indicate that cellular pricing in Los Angeles is noncompetitive. The effect on price that they estimate results not just from adding a third competitor, but from an increase of 18 MHz in the spectrum allocated to cellular service (that is, spectrum is reallocated from UHF broadcasting to cellular service).<sup>65</sup> The Commission's conclusion confounds the effects of increased competition with the effects of increased spectrum capacity.

Indeed, Kwerel and Williams do not use their analysis to evaluate whether the pricing of cellular service in Los Angeles is competitive. Instead, their purpose is to examine whether spectrum is efficiently allocated between television broadcasting and cellular telephone service. They reach no conclusion about the prices of cellular service. Rather, they state: "Our analysis confirmed the preliminary evidence that a

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<sup>63</sup> Evan R. Kwerel and John R. Williams, OPP Working Paper Series Changing Channels: Voluntary Reallocation of UHF Television Spectrum, November 1992.

<sup>64</sup> Kwerel and Williams, p. vii.

<sup>65</sup> Kwerel and Williams, p. vii.

significant misallocation of UHF spectrum exists between television broadcasting and cellular telephone service."<sup>66</sup>

Report at 18-19, emphasis added.

The CPUC's final line of argument with respect to cellular rates centers on what the CPUC perceives as the similarity of prices between cellular carriers. The Commission states that "While similar prices may be observed in competitive markets, one cannot assume that similar prices always indicate a competitive market." "This statement is perfectly true...as a general proposition, price similarity is as consistent with competitive pricing as it is with non-competitive pricing."<sup>67</sup> The fact that the sellers of a homogenous product are quoting identical prices, by itself, tells us nothing about the degree of price competition in the market." Report at 19.

Far more importantly, the CPUC is simply wrong in stating that rates are nearly identical in California cellular markets. Table 5 attached to Appendix A records the differences in both basic rates and the optimal rate per

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<sup>66</sup> Kwerel and Williams, p. 1.

<sup>67</sup> "A common price can mean simply that it is not profitable to charge a lower, or a higher, price than other suppliers are charging. A nearly identical price--or indeed an identical price--among all sellers could as well have been arrived at through independent competition as through a collusive pact. Hence it is not useful evidence of either." Armen A. Alchian and William R. Allen, Exchange and Production: Competition, Coordination, and Control, 3rd ed. (1983), p. 276.

minute of service charged by each of the two cellular carriers in five of the nine largest service areas in California.<sup>68</sup>

Table 5 demonstrates that the rates charged by competing carriers are often very different. In Sacramento, for example, basic rates differ between carriers within a range of 11 to 18 percent depending on call volumes. Significant differences in basic rates appear for both Bakersfield and Fresno/Visalia for low-volume and medium-volume usage, and in San Francisco/San Jose for all usage levels. Of these major markets, only in Los Angeles are rates under the carriers' basic rate plans identical, but there are substantial differences between the optimal rates of the Los Angeles carriers, ranging from 8 percent at 480 minutes of usage to 47 percent at 60 minutes of usage. Significant differences were common for optimal rate plans in virtually all areas. In fact, rates for the optimal plans were identical in only 3 of the 15 instances examined. Variation in prices ranged between 3 percent and 47 percent, with an average variation of 9.6 percent.

As explained in the Charles River report,

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<sup>68</sup> Table 5 was prepared by the firm of Ernst & Young at the request of Carriers Association using tariffed rate plans submitted by Carriers Association's member carriers. Ernst and Young define the optimal rate plan as the plan offering a customer the lowest total cost per minute of use for a given level of usage, i.e., either 60, 120, or 480 minutes per month. The differences were calculated based on the rates in effect on December 31, 1993 for both the basic and optimal plans.

[t]he CPUC's discussion of price similarity contains an incorrect premise and is also wrong on the facts. Not only would similar prices by themselves not reliable indicators of noncompetitive pricing, but there is also considerably more variation in prices between competing carriers than the [CPUC] acknowledges. Report at 20.

Once again, the CPUC's shortsighted focus on basic rates and its refusal to carefully examine the existing retail discount rates contained in the carriers' own tariffs has lead it to the wrong conclusion.

**c. The CPUC Entirely Misconstrues The Evidence Relating To The Earnings Of Cellular Carriers**

The CPUC points to the returns earned by cellular carriers in California to prove that the carriers possess market power.<sup>69</sup> The two types of evidence on profitability which it submits are the carriers' accounting rates of return and Q ratios (the ratio of the market value of a company to the replacement cost of its assets). However, the CPUC misuses this evidence in its analysis. The CPUC also discusses the scarcity value of the radio spectrum allocated to cellular service, and attempts to conclude that excess capacity in the cellular networks is evidence of unreasonably high rates. However, its analysis and its conclusions are flawed.

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<sup>69</sup> "If a cellular firm earns returns consistently above competitive levels, this is an indicator of market power." Petition, p. 46.

The Charles River report comments that, "the CPUC's conclusion that the returns of cellular carriers are excessive and reflect their market power is undermined by several serious flaws in the Commission's analysis and its use of data on the carriers' earnings." Report at 21. The CPUC errs both by incorrectly assuming that market power can be inferred from accounting rates of return and by omitting the opportunity cost of using scarce radio spectrum to provide cellular service from its calculation of such rates of return, thereby overstating the carriers' profitability.<sup>70</sup>.

As the authors of the Charles River report explained,

In considering the carriers' earnings, the CPUC implicitly assumes that accounting rates of return are good proxies for economic rates of return, the measure of profit that is relevant to the issue of monopoly and market power. This assumption is wrong. In a classic article, Franklin M. Fisher and John J. McGowan demonstrated that accounting rates of return, even when corrected for various problems of definition and measurement, are not a reliable measure of economic rates of return. They conclude that "...there is no way in which one can look at accounting rates of return and infer anything about relative economic profitability or, a fortiori, about the presence or absence of monopoly profits."<sup>71</sup>

The economic rate of return on an investment is the discount rate that equates the present value of the investment's expected net revenue stream to the initial outlay. Accounting rates of return, on the other hand, are calculated by dividing profits

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<sup>70</sup> The accounting rates of return are also subject to distortion because certain capital outlays are not included in the companies' investment base.

<sup>71</sup> Franklin M. Fisher and John J. McGowan, On the Misuse of Accounting Rates of Return to Infer Monopoly Profits, American Economic Review 73 (March 1983) pp. 82-97.

earned in a particular year by a measure of the value of a company's capital assets in that year....This inherent mismatching in the timing of profits and the investments necessary to generate them reveals nothing about the effect on the company's rate of return from additional investment and an expansion of its output.<sup>72</sup>

Report at 21-22.

The second important error in the CPUC's analysis of carriers' earnings is that the rates of return it examined were calculated by relating profits to only part of the carriers' investment, the net book value of their plant. The scarcity value of the carriers' licensed radio spectrum is omitted from their investment, on the erroneous assumption that licenses to use such spectrum have value only if the cellular carriers have monopoly power. On the contrary, "[t]he scarcity value of cellular licenses exists independently of any monopoly rents and is appropriately included in the calculation of cellular operators' profitability.<sup>73</sup> The omission of the scarcity value of the

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<sup>72</sup> For a fuller discussion of the conceptual problems involved in using accounting notes of return to draw inferences about monopoly profits, see Franklin M. Fisher, John J. McGowan, and Joel E. Greenwood, Folded, Spindled, and Mutilated: Economic Analysis and U.S. v. I.B.M., (Cambridge: MIT Press, 1983), pp. 238-242.

<sup>73</sup> Whether the cellular operator purchased the license or was awarded it by the FCC, the scarcity value of the license is the discounted future stream of scarcity rents that the operator expects to earn, and should be deducted from earnings in the calculation of each carrier's profitability.

license from the operators' investments overstates the profitability of their operations.<sup>74</sup>" Report at 23.

The Charles River report defined scarcity and monopoly rents in the following manner:

Economic profits, or rents, may stem from one of two sources: scarcity and monopoly.<sup>75</sup> A resource may be scarce, that is, available in limited supply, and yet be sold at a competitive price. In this case, scarcity rents will be earned, but these rents will not reflect monopoly power. On the other hand, monopoly rents may be earned when a resource is made artificially scarce in order to increase its selling price.

Scarcity rents arise when a good is in limited supply and consumers are willing to purchase all of the units of the good that can be produced at a price that exceeds the average cost of producing the good. In these circumstances, even if price is determined under competitive conditions, the good will be sold at a price that exceeds its production cost. The rents earned by competitive sellers are due to natural scarcity, and the price serves to allocate the scarce good to those who value it most highly. Because spectrum is limited in general, and the spectrum available for the provision of cellular service has been limited by the FCC, holders of cellular licenses can expect to earn scarcity rents.

Report at 23-24.

Although the CPUC claims to acknowledge the distinction between scarcity rents and monopoly rents, it excludes scarcity rents from its analysis of the profitability of cellular carriers, because it appears to believe that

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<sup>74</sup> Clarkson and Miller. See, for example, J. M. Henderson and R.E. Quandt, Microeconomic Theory 1958, p. 101. K. W. Clarkson and R. L. Miller, Industrial Organization (1982), pp. 125-126.

<sup>75</sup> See, for example, Armen A. Alchian and William R. Allen, op. cit., p. 189.

spectrum scarcity has little to do with the real value of a cellular carrier's license. However, the CPUC's explanation of its reasoning in this regard demonstrates a terrible misconception of the value of scarce radio spectrum.

The Commission claims that "[i]f spectrum scarcity was the only or primary determinant of license value, we would expect the value per-MHz of licensed spectrum to be roughly equivalent when compared nationally."<sup>76</sup> This is analogous to saying that if land values are a primary determinant of the value of homes, the price per acre should be the same in Beverly Hills and Lodi....

A lower market value for television broadcast licenses than for cellular licenses does not imply that television broadcasting is more competitive than the provision of cellular service, or that cellular carriers have more market power than television broadcasters. Rather, it means that there is greater demand for cellular licenses (and the service they can be used to provide) than for broadcast licenses, relative to the amount of spectrum provided for each.

Report at 24-25.

The CPUC has failed to adequately consider either the effect of scarcity rents on the value of radio spectrum used for cellular service or the impact of these values on the earnings of cellular carriers located in various markets. These impacts do vary across different carriers' service territories as a result of differences in demand. This is easily seen in the relatively lower earnings of cellular carriers in rural areas. The CPUC claims that this is due to the small customer bases and slow growth of such carriers

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<sup>76</sup> Petition, p. 47.

relative to large fixed costs,<sup>77</sup> whereas, in fact, these earnings almost certainly reflect the lower value of spectrum in these areas. Report at 25.

The CPUC's other major miscalculation with regard to carriers' returns involves its reliance on Q ratios as an indicator of market power. The CPUC is incorrect in assuming that a high Q ratio necessarily implies monopoly profits as opposed to scarcity rents. "High Q ratios, however, are as consistent with scarcity rents as they are with monopoly profits."<sup>78</sup> Report at 26.

The CPUC apparently misunderstands the difference between Q ratios which result because of restrictions on entry as opposed to those which result from anti-competitive behavior on the part of the cellular carriers. As the Charles River report explains,

...there is no inconsistency in there being regulatory-imposed barriers to entry barriers while the firms in the market are competing vigorously. In those circumstances, the Q ratio will remain high if no one can acquire additional spectrum to reduce the gap between market value and replacement cost. The market value of a company depends on investor expectations about its future earnings, while replacement value reflects the firm's past investments. Thus, high Q ratios are perfectly consistent with incumbent cellular operators' competing prices down to the competitive level, that is, the level that would prevail if the same amount of spectrum were divided among a much larger number of firms. Simply put, the values of Q ratios for cellular carriers do not indicate

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<sup>77</sup> Petition, p. 47.

<sup>78</sup> Clarkson and Miller, op. cit., pp. 100-103.

whether or not the carriers are behaving competitively.

Report at 26.

Yet another error arises because the CPUC appears to argue that the only acceptable result for a competitive firm is a Q ratio of one, even if the scarcity value of the electromagnetic spectrum is included in the return calculation.<sup>79</sup> The Charles River report comments that,

This statement is true, however, only if the industry is in long-run equilibrium. A firm or industry with a small customer base but with expectations of high rates of growth can have a Q ratio well in excess of one. Furthermore, the value of its Q ratio will remain high as long as scarcity of an input (in this case, spectrum) prevents the flow of additional resources into the market and the expansion of market output.

Report at 27.

The situation described above precisely matches the cellular industry--cellular carriers have a small customer base compared to expectations of the ultimate market for wireless communications, and this has a very significant impact both on the market value of their stock and upon the Q ratios which result. The fact that the Q ratios of cellular carriers exceed one is not proof of monopoly profits or anti-competitive behavior. On the contrary, it is a predictable result of the dramatic success and anticipated future growth of a young industry.

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<sup>79</sup> Petition, p. 62.

**d. The CPUC's Analysis Of Cellular Capacity  
In California Contains Fundamental Errors**

The CPUC makes four key assertions regarding network capacity of cellular carriers in California and the levels of usage of that capacity in order to support its arguments about a lack of competition in California. The CPUC claims that: (1) cellular carriers are not operating at maximum capacity;<sup>80</sup> (2) capacity is underutilized even in the Los Angeles MSA, the state's most populous region;<sup>81</sup> (3) the rate of capacity utilization in the San Francisco Bay Area MSA has remained approximately constant during a four-year period in which demand and capacity have increased,<sup>82</sup> and (4) the number of pricing plans that provide for volume and other discounts has proliferated, demonstrating that the carriers are not using their allocated spectrum to maximum capacity.<sup>83</sup>

While the Carriers Association cannot determine if the CPUC's representations of network capacity are accurate because the data was completely redacted from the CPUC petition, the accuracy of the data is, to a large extent, irrelevant. Even if all the assertions are correct, they do not prove anything about the reasonableness of carriers' rates or returns.

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<sup>80</sup> Petition, p. 51.

<sup>81</sup> Petition, p. 51.

<sup>82</sup> Petition, p. 52.

<sup>83</sup> Petition, p. 54.

The CPUC offers evidence of excess capacity to show that carriers are charging unreasonable rates. However, this wholly ignores the reasons that excess capacity exists in a capital-intensive industry and how it comes into being. Excess capacity naturally results from efficient capital investment strategies. The CPUC's arguments on capacity utilization do not provide effective support for the CPUC's conclusion that cellular carriers are charging unreasonable rates and achieving monopoly returns. To the contrary, each of these claims is equally consistent with competitive behavior on the part of these carriers. Report at 28.

The Charles River report explains the basic relationship between capacity and the ability to serve cellular customer in the following terms:

The capacity of a cellular system is provided by the carrier's physical infrastructure -- the number of simultaneously usable channels in each cell site.<sup>84</sup> Capacity is a primary and essential input to the production of cellular service. When capacity is less than the maximum calling demand, some customers cannot be served, and the quality of service to customers who are able to complete calls is degraded since the probability that their call will be blocked is increased.

Capacity utilization is determined by: (a) cell site channel capacity; (b) the carrier's peak

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<sup>84</sup> It should be clear that the term capacity is being used here to describe the level of output that a carrier can provide at a point in time, which depends on the amount of spectrum for which it has a license, and the technology it employs. This is different from the definition of capacity used above in measuring market concentration, which is based on the maximum output a carrier could produce with the spectrum assigned to it if it made the appropriate complementary investments.

demand for calls in the market; and (c) the distribution of peak demand over each cell. Capacity is a "lumpy" economic good -- one that is not finely divisible. Consequently, to supply growing demand carriers must expand capacity in large, discrete amounts. Expansion of cellular capacity occurs by subdividing existing cells, modifying antenna coverage, and using more spectrum-efficient technology. This investment is subject to increasing costs, especially if the service area is repeatedly subdivided.

Report at 28.

The end result of this pattern of network expansion is that, "because additions to capacity are most efficiently made in discrete amounts, cellular carriers will often be observed with what appears to be excess capacity. It is simply uneconomic, in a market with rapidly growing demand and lumpy investments, for carriers to have precisely the capacity that is needed to serve demand at any given time." Report at 29. Accordingly, all of the CPUC's efforts to establish the existence of excess capacity in the Los Angeles market, and elsewhere in California, reveal nothing more than the need for cellular carriers to accommodate a growing demand for their services. The existence of "excess capacity" proves nothing about the competitiveness of the cellular market.

Even the CPUC's observation that the rate of capacity utilization in a major market has remained constant for four years fails to reveal anti-competitive intent. The expansion of capacity at about the rate at which demand is expanding, and hence an approximately unchanged rate of capacity utilization over time, is consistent with optimal investment

planning by competitive firms. Report at 29. Thus, the observation of a roughly unchanged rate of utilization also reveals nothing about the extent of market competitiveness.

The CPUC attempts to make much of the fact that price comparisons between GTE and BACTC (the two San Francisco carriers) do not drop as the CPUC would expect "when excess capacity exists."<sup>85</sup> This conclusion is further contradicted by the CPUC itself when it asserts that discounted rate plans are being offered to "increase usage of existing spectrum capacity."<sup>86</sup> In fact, as discussed above, rates have decreased uniformly in California. However, there is yet another logical explanation for the pricing behavior which the CPUC observes but does not fully understand--namely, elementary retail marketing practices.

As explained in the Charles River report,

Under certain conditions, when increases in capacity are lumpy, it is efficient for the price of service to vary inversely with the rate of capacity utilization. Here, prices would be lowest for service in a segment of the market in which new capacity has just been added, and demand can be stimulated without exceeding the available capacity. As demand grows over time and capacity utilization rises, prices would be increased to ensure an adequate margin of capacity for peak calls. With still more growth in demand, the carrier would install a further lump of capacity and again reduce the service price.

In practice, companies in most capital-intensive industries do not vary prices of their basic products over time, responding to the

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<sup>85</sup> Petition at 53.

<sup>86</sup> Petition at 54.

preferences of many consumers for known, stable prices. Instead, firms use a wide variety of promotional and volume-related pricing schedules to encourage additional purchases in segments of the market in which they currently have spare capacity. Two-part tariffs, volume discounts, limited-term promotional and discount rates are widely used in energy, transportation, and communications service industries.

Report at 29-30.

The combination of basic rates with assorted discounts and promotional tariffs is precisely the type of marketing strategy which the CPUC has observed in the cellular market.

The Report continues,

This analysis has two implications. First, prices are unlikely to be, and should not be, adjusted to eliminate excess capacity at every point in time. Second, the use of alternatives to the basic pricing plan, rather than being evidence of anti-competitive behavior on the part of cellular carriers, instead indicates that the carriers are attempting to raise their utilization rates.<sup>87</sup>

Report at 30-31.

Excess capacity, in and of itself, provides no evidence of unreasonably high rates. Indeed, the pattern of customer growth in the cellular industry is so far in excess of expectations that carriers have a full time job on their hands simply planning to meet the increasing demand they may face. If the CPUC were to retain rate regulatory authority, and

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<sup>87</sup> This is another instance in which the carriers face a "Catch 22" in their dealings with the CPUC. If they do not offer alternative plans, they are accused of having excess capacity. If they offer such plans, this is treated as evidence that they are trying to eliminate excess capacity.

impose upon carriers its misguided belief that excess capacity equates to unreasonable rates, it would not be long before cellular carriers would scale back network expansion plans in an attempt to exactly balance supply and demand. Such a course of action would be absurd and irresponsible. Even worse, eventually it would probably subject the carriers to criticism from the CPUC for failing to maintain adequate service quality.

As the Charles River report commented,

In cellular telephony, capacity can provide a second essential function -- the ability to supply high-quality service. Capacity in excess of the maximum calling demand enables a carrier to supply dial tone and to complete incoming calls during the busiest hours of the week. Greater capacity in the form of a large number of cells reduces the likelihood of geographic gaps in signal coverage and minimizes call drop-outs when subscribers are traveling between cells. Additional capacity can provide unoccupied channels to which calls can be shifted if interference is encountered, thus improving the voice quality of service.

The CPUC claims "that basic economic principles dictate that when excess capacity exists, prices in a competitive market should drop."<sup>88</sup> This single-minded view of capacity entirely neglects the role of capacity in producing service quality and enabling carriers to differentiate their products in service quality -- areas of coverage, voice quality, percentage of calls dropped. The observation of "excess" capacity in the cellular industry is, in fact, evidence of service quality competition.

Report at 31.

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<sup>88</sup> Petition at 53.

**e. Conclusions Regarding The CPUC Economic Analysis**

The CPUC's request for authority to continue to regulate the rates of cellular carriers should be rejected 1) because the evidence on which the Commission has based its request is flawed, and 2) because virtually all of the CPUC's evidence has either been misinterpreted or can equally fairly be interpreted as evidence of healthy competition between cellular carriers. There is no question that the CPUC's original premise was that the cellular market is uncompetitive. Given the ability of the CPUC to ignore evidence as compelling as a 20% reduction in the real cellular rates paid by customers, it is apparent, as the Charles River report stated, that, "the 'evidence' cited by the Commission appears to have played an insignificant role in the conclusion it has reached." Report at 31.

The FCC must carefully examine the serious factual and analytical errors in the CPUC's economic analysis, for they fatally undermine the CPUC's ultimate conclusion that the California cellular market is insufficiently competitive to produce reasonable rates. In many instances the CPUC has failed to account for explanations and inferences which support the carriers' assertion that they are engaged in active and vital competition with each other and with the onrushing efforts of prospective ESMR and PCS providers. The CPUC bears the burden of proof in this proceeding, and its bald assertions that rates should be lower and carriers are

behaving in an anti-competitive manner will not suffice to sustain that burden.

In summarizing the net result of all the passionate arguments of the carriers and the CPUC over economic theory and the evidence of rates, returns, and capacity, the Charles River report concludes with an important and sobering observation.

*...the nation is about to enter a new era in which the number of firms supplying mobile telecommunications services will more than double, effective industry capacity will increase more than fourfold, measured industry concentration will decline by more than half, and the share of the effective capacity of the industry licensed to each of the two current cellular providers will decline by more than two-thirds. As the number of carriers increases, and industry concentration as measured by the HHI decreases, the industry is likely to become more competitive. Thus, the CPUC has chosen to attempt to extend its regulation of cellular carriers at precisely the moment at which the structure of the mobile telecommunications market is being radically changed by increases both in the number of competitors and in the amount of spectrum that is available to provide mobile telecommunications services. It is difficult to think of a request that has been more poorly timed.*

Report at 31-32 (emphasis added).

**2. The CPUC Committed Numerous Procedural Irregularities In Its Decision Which Authorized the Filing of the Instant Petition**

In addition to constructing a completely misguided economic analysis to serve as the foundation of its Petition, the CPUC has committed other significant errors of law and fact in adopting a new cellular rate regulatory policy and in petitioning the FCC for authority to implement that policy.

First, the CPUC improperly relied on confidential information not in the public record. This denied parties the opportunity to comment on the conclusions the CPUC derived from this information. Second, the CPUC engaged in arbitrary and capricious decision-making by designing key provisions of its regulatory program (such as the definition of a dominant carrier) without any record evidence whatsoever. Third, the CPUC violated parties' due process rights by denying them the opportunity for a hearing to present substantive evidence and by modifying previous CPUC decisions without a hearing.

Each of these errors contributes to the inescapable conclusion that the Commission should deny the relief requested in the Petition.

To the extent the CPUC's Petition relies in substantial part on confidential information which the FCC may not rely upon in rendering its decision on the instant Petition, such information must not be considered by the Commission. Because of the enormous quantity of confidential information submitted by the CPUC to the Commission and redacted in the versions of the Petition served on the parties, the Carriers Association has filed concurrently with this response its "Motion of the Cellular Carriers Association of California To Reject Petition, Or, Alternatively, Reject Redacted Information," which seeks the rejection of the CPUC Petition, or, at a minimum, exclusion of any redacted material from consideration by the Commission in this proceeding. As set forth in the

Motion, it would be highly improper for the FCC to use non-public information to reach a decision in this matter. Indeed, it would be grounds for reversal of the Commission's decision on appeal.<sup>89</sup> The only appropriate remedies in this situation are rejection of the CPUC Petition or exclusion of the redacted material from the record in this case. If the latter course is adopted by the Commission, the CPUC Petition would be virtually bereft of factual support for its conclusions due to the almost universal redaction of significant rate and market share information,<sup>90</sup> and would be grossly insufficient to sustain the CPUC's burden of proof.

The CPUC's proposed regulatory program is itself seriously defective. For example, the CPUC proposes to implement a dominant/non-dominant regulatory program in which non-dominant CMRS providers would only be required to register with the CPUC. Dominant carriers, however, would be subjected to rate regulation and tariff filing requirements, and could face mandatory rate reductions as a result of unspecified calculations by the CPUC to correct what the CPUC contends are "excessively high rates of return." Petition at 81, Appendix N at 22.

However, the CPUC's determination of which CMRS providers are dominant, and which are non-dominant, is wholly arbitrary

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<sup>89</sup> See, for example, National Black Media Coalition v. FCC, 791 F.2d 1016 (2d Cir. 1986).

<sup>90</sup> See, for example, Appendices E, G, H, I, J, and M attached to the Petition.

and capricious. The CPUC simply reaches into thin air for a number and announces that cellular providers who "control no more than 25% of the cellular bandwidth in a given market" will be considered non-dominant. All other carriers controlling more than 25% of the cellular bandwidth will be presumed dominant. Petition, Appendix N at 22. The CPUC provided no factual support for the 25% benchmark, nor did it offer a single word of analysis, explanation, or even conjecture as to why the 25% figure was a reasonable means of classifying dominant or non-dominant carriers in the cellular market. Such abject failure to explain or support an administrative decision violates both state and federal notions of due process. California Manufacturer's Ass'n v. PUC, 24 Cal.3d 251, 258 (1979); Camp v. Pitts, 411 U.S. 138, 143 (1973). The dominant/non-dominant regulatory distinction is the central facet of the CPUC's proposed regulatory program. The FCC should not empower the CPUC to implement a program which has been constructed on such a totally inadequate record.

In addition, the Carriers Association and individual cellular carriers have initiated administrative appeals of the CPUC decision adopting this program by filing applications for rehearing of D.94-08-022. These administrative appeals catalog a host of procedural and substantive failures in the process used by the CPUC to adopt the regulatory program it has placed before the FCC for consideration. See Appendix C.

The CPUC has denied parties the right to a hearing on contested factual issues, engaged in arbitrary and capricious decisionmaking, modified the findings and conclusions of previous CPUC decisions without due process, relied yet again on non-public information outside of the record to reach its decision, and generally engaged in a wholly inadequate *ad hoc* procedure in order to impose its own preconception of cellular regulation upon the market, irrespective of the lack of record evidence supporting that preconception. The FCC should not be a party to such tactics, and should deny the CPUC the rate regulatory authority it seeks.

**B. In Contrast to the Assertions of the CPUC, the California Cellular Market Demonstrates Active Rate Competition, Reasonable Rates, and Rapidly Expanding Capacity**

In its Second Report and Order, the FCC has outlined several categories of information, evidence, and analysis which it considers pertinent to its examination of cellular market conditions.<sup>91</sup> The Carriers Association offers the following information and analysis in conformance with the Commission's order. Viewed comprehensively, the facts developed by the Carriers Association in response to the Commission's criteria for analysis reveal a competitive cellular market in California, which is developing as envisioned by federal telecommunications policy. The

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<sup>91</sup> Second Report and Order, In the Matter of Implementation of Sections 3n and 332 of the Communications Act, 74 RR 2d (P&F) 835 (adopted February 3, 1994), pp. 94-95.

California market is highly competitive, and displays a range of reasonable rates. Despite the intense level of regulatory oversight in California the level of competition between cellular carriers and between cellular and other types of CMRS providers is clearly increasing. Consequently, there is no justification for exempting the California market from the blanket preemption of state rate regulation adopted by Congress in the Budget Act of 1993.

**1. The Number of CMRS Providers in California: A Measure of The Level of Competition in The Market**

The first element in the FCC analytical framework is the number of CMRS providers in the market. California is perhaps the most actively contested cellular market in the United States, with a total of 40 carriers providing service in 30 markets.<sup>92</sup> In addition, the CPUC has issued certificates to 78 resellers of cellular service.<sup>93</sup> Cellular service has grown phenomenally since its introduction in California, reflecting the tremendous consumer demand for mobile communications in both the business and residential populations. See Chart A in Appendix B.

In addition to providers of cellular service, there are other CRMS providers commencing or about to commence operation

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<sup>92</sup> The 30 cellular markets in California are divided into 18 metropolitan statistical areas and 12 rural statistical areas.

<sup>93</sup> 78 resellers held certificates from the CPUC as of March 24, 1994.

in California. Nextel Communications, Inc., ("Nextel") is an Enhanced Specialized Mobile Radio ("ESMR") provider engaged in the development of a national wireless communication network. Nextel has concentrated a significant part of its effort in California, has an operational system in the Southern California area, and has announced that services will be available throughout Northern California and San Diego in 1994. See Communications Week, August 22, 1994. Nextel advertises itself as a provider of "cellular service" directly competing with the existing licensed cellular carriers. As Nextel describes it, "In telecommunications, the three key elements are spectrum, spectrum, spectrum! and SMR and cellular spectrum are functionally equivalent."<sup>94</sup> Considerable time and effort has been expended in various CPUC proceedings debating the prospects of Nextel, but this much is clear: Nextel has completed construction of its network and commenced commercial operations in the Southern California market and is approaching operational status in other major California markets.<sup>95</sup> Nextel has substantial financial and technological backing from established communications companies, such as Motorola, Northern Telecom, Matsushita, and Nippon Telegraph and Telephone Corp.<sup>96</sup>

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<sup>94</sup> Nextel Communications, Inc. 1993 Annual Report at 7.

<sup>95</sup> "Nextel Announces Commercialization of its All-Digital Integrated Wireless Communications Network in Northern California" Business Wire, July 8, 1994.

<sup>96</sup> Business Wire, April 5, 1994.

The CPUC has clearly erred by wholly discounting Nextel's competitive impact in California.<sup>97</sup> Indeed, evidence of this impact is already available in the form of rate discounts and other marketing efforts undertaken by cellular carriers in Southern California. Petition at 74-75. To a large degree, such behavior corroborates the FCC's own conclusion that potential wireless competitors have a competitive impact far in advance of their actual entry into the market, because "impending competition can make any collusive pricing or capacity constraints more difficult to sustain today. The approaching increase in competition may limit the ability, and profitability, of attempts to restrict cellular investment today because today's investments can have significant impacts on the profits that will be earned in the face of PCS competition." Second Report and Order at 148.

Further competition for California cellular carriers is imminent in the form of PCS providers such as Cox Enterprises, Inc. ("Cox"), which has been awarded a 30 MHz license in the important Southern California market as a Pioneer's Preference.<sup>98</sup> Cox is planning to develop a PCS network based on its existing cable infrastructure, and can be expected to

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<sup>97</sup> Petition at 66.

<sup>98</sup> See Third Report and Order, GEN Docket No. 90-314 and ET Docket No. 92-100 (1993).