the location of various components of the outside plant facilities. For the same 1200 sample, an air to route mile ratio (air mileage over sample cable length) was developed to use for each individual census block group (CBG). The HPM is based upon a more geometric calculation rather than any sampling of the outside plant. Therefore, there is a possibility of either underestimating or overestimating the loop length associated with the HPM.

- Each CBG is assumed to be assigned to a wire center. In the initial meetings, Pacific expressed concerns that HPM did not include over 190 central offices. Even though Hatfield corrected the problem, DRA is concerned about the possibility of misassignment of central office with a CBG in determining proper length in both CPM and HPM.

- Some of the cost inputs for the CPM come from the OAND cost studies while other costs for the OAND proceeding come from the CPM outputs. On the other hand, HPM has no connection (nor consistency) with the cost estimates in the OAND proceeding.

- Some of the modules (part of the original BCM) in the HPM cannot be changed to include items that are a part of the outside plant network. The original developers are refining the original BCM to allow variation in some of the input assumptions. DRA understands that BCM has a list of modifications that are under consideration.[15] DRA compliments the sponsors[16] of the model for considering these improvements, but unfortunately, these modifications, if implemented, will not be completed before June 1, 1996. Some of the modifications will address some of the criticisms of BCM, however, other DRA recommended modifications, as discussed in this chapter, will make CPM more adaptable to changes of investment and cost data in the various modules.

- Pacific used the 1994 maintenance repair amount to calculate the "forward-looking" maintenance repair cost. DRA needs further information to verify whether this maintenance repair estimate fairly reflect costs associated "forward-looking" technology.

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15. February 21, 1996 Ex Parte communications to FCC by U.S. West relating to Docket 80-286.

16. The sponsors of BCM are MCI Telecommunications Corporation, The NYNEX Telephone Companies, Sprint Corporation and U S WEST Inc.

23 DRA believes that most of the model differences can be resolved by parties (if the parties are willing). However, it is DRA's impression that these issues will not be resolved by parties since the preliminary cost level estimates for basic service as calculated by CPM and HPM are over $1 billion apart and therefore the Commission must adopt CPM and require Pacific to make DRA's recommended changes discussed throughout in this chapter and summarized on page 2 of Chapter 2.

V. [Q.4] What are the cost differences associated with providing customers the choice of flat or measured rate service, and the technical feasibility of providing that choice?

24. DRA is not aware of any technical difficulty in providing flat or measured rate service at this time, but may comment further on this issue in its reply testimony. On the issue of costs, both Pacific and AT&T/MCI are improving their models in order to identify costs of 1MR and 1FR separately. According to Pacific, its preliminary outputs show 1MR having different average loop lengths but the impact of different loop lengths on costs is small.[17] However, due to the rate difference between 1FR and 1MR, the subsidy amounts are greater for measured service.[18]

25. In the OAND-P, Pacific identified the usage cost difference between 1FR and 1MR at less than [......]. However, their monthly tariff rate differences, including end user common line charge (EUCL) for Pacific and GTEC, are $5.25 ($14.75 and $9.50) and $7.25 ($20.75 and $13.50), respectively. The 1FR and 1MR are comparable services. [~~The Commission recognizes that a favorable~~ pricing policy for measured service should not be maintained in the long run. In D.~~94-09-065, the~~ Commission ~~stated the following~~]

Due tothe cost difference between 1FR and 1MR service, the subsidy amounts will necessarily be greater for measured service. DRA agrees with the Commission that the 1MR rate must move closer to the 1FR rate in order to equitably reflect the actual cost difference.[18a] DRA will put forward testimony inthe OAND proceeding addressing this issue. Nevertheless, the substantial discounts for 1MR will require a larger subsidy for purposes of providing Universal Service.

17. March 26, 1996, Pacific response to DRA's verbal data request

18. Id.

18a. D.94-09-065 at p.47.

> ~~Measured rate service is available to all residential~~ customers, regardless of their income level. The discounts from flat rate service charges make measured rate service a practical alternative for residential customers who do not find flat rate service economical for their particular needs. Measured rate service may also appeal to customers of limited means who do not qualify for ULTS. We will retain measured rate service at a price attractive to consumers, but will increase the monthly rate so that the price for the service captures more of its costs. (At 47.)

With the high cost voucher fund in place, DRA believes that it would be appropriate to move the 1MR rate closer to the 1FR's in order to equitably reflect their cost differences. Continuing the substantial discounts for measured service will require a larger subsidy. DRA will discuss in detail its subsidy mechanism ~~proposal for both 1FR and 1MR in Section VII of this report~~.

VI. [Q.8] What relationship is there, if any, between the cost data used for the proxy cost model, and the cost data prepared for the Open Access and Network Architecture Development proceeding?

26. In review of the HPM, the ~~two~~ common link~~s~~ between the *
HPM and Pacific's and GTEC's OAND cost studies ~~are~~ is the use of *
LECs' 1994 ARMIS reports as a starting point for the development
of expense estimates~~, and, purportedly, the use of LECs'~~ *
~~Commission-authorized rates of return to estimate capital~~ *
~~carrying costs~~. The HPM does not use any outputs from either the *
OAND-P or GTEC's OAND cost study (OAND-G).

27. A comparison of the CPM and the OAND-P shows that while the two are independent cost studies, they are dependent on each other. Independently, the CPM develops the cost of the loop on a per foot basis. The OAND-P develops and identifies other costs, such as support investment capital cost, operating expenses, directory, operator service, usage, white page listing, shared and common costs, and many more. Dependently, they use each other's relevant outputs to derive the total cost of service. The CPM did not use any of the outputs from the OAND-G. A comparison of the CPM's estimates of GTEC's costs and costs

identified in the OAND-G shows a significant difference. (Table 3.2.)

28. The OAND-I and OAND-G develop TSLRIC costs for various basic network functions and services based on company-specific costs. The results of these studies provide a means of verification of the reliability of the proxy cost model adopted by the Commission. The Commission intends to issue an interim decision resolving issues relating to Round I and II OAND cost studies by May 22, 1996.[19] DRA recommends that the Commission include in the CPM relevant cost data from the OAND cost studies it adopted. This proposal also meets the Commission's expectation that the "proxy cost model should closely reflect actual costs without having to develop all of the cost data necessary for cost studies of each individual LEC."[20]

VII. [Q.9] Should the Commission consider offsets to the results of the proxy cost model, and if so, what offsets should be considered?

29. DRA's recommended offsets to the results of the proxy cost model are directly related to its subsidy mechanism and pricing proposals. Therefore, DRA will discuss in detail its proposals and how its recommended offsets should be applied under the appropriate captions below. In summary, DRA's proposed subsidy mechanism is described as follow:

- o A benchmark zone for residential service be identified using Pacific's current rate for 1FR plus the EUCL.
- o High cost areas are those areas whose TSLRIC is above the TSLRIC of the benchmark zone.

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19. March 25, 1996, Assigned Commissioner's Ruling Extending Procedural Schedule and Disposing of February 29, 1996 Emergency Appeal by Four Members of the California Telecommunications Coalition.
20. D.95-12-021, at 6.

- The amount of subsidy for a particular area is its TSLRIC minus the TSLRIC of the benchmark zone.
- Subsidies would be available in high cost areas for each residential line.
- Subsidies would be available to all carriers of last resort.
- The annual subsidies from the California high cost voucher fund for carriers of last resort should be offset by their annual revenues from the interstate USF and the interstate CCLC.

A. Objectives of the Subsidy Mechanism

30. For a subsidy mechanism, DRA believes that there should be a proper balance between maintaining a reasonable basic service rate for all Californians and minimizing the social burden of subsidizing basic services. DRA identifies the following objectives for the Commission's proposed high cost voucher fund:

- It should be competitively neutral;
- It should not be used to lower basic service rates for <u>all</u> Californians; and
- It should not function in a manner that would provide a guaranteed return on investments for the service providers.

B. Benchmark Zone and High Cost Areas

31. P.U. Code 739.3 requires the Commission to establish a fair and equitable local rate structure for small LECs serving rural and small metropolitan areas for the purposes of promoting universal service and reducing any disparity in the rates charged by all LECs. In compliance with this mandate, the Commission has, typically, been using Pacific's rates as benchmarks to set rates for high cost LECs. DRA developed a similar approach using Pacific's current 1FR rate as a reference to identify high cost areas where subsidies would be available to reduce rate disparity between high and low cost areas.

32. The CPM and HPM group the census block groups (CBGs) by density into seven and six zones, respectively. There are more than 20,000 CBGs in California. Grouping CBGs into a manageable number such as those presented in the CPM and HPM, and determining the amount of subsidies for each zone is reasonable and appropriate. DRA has analyzed the outputs of the CPM and found that the cost differences for the majority of the CBGs were by an increment of a penny. (Table 3.3.) This confirms that setting subsidies for each CBG is unnecessary and would be burdensome.

33. In selecting a benchmark zone, DRA proposes that the Commission use Pacific's existing 1FR rate plus the EUCL as a reference. Both CPM and HPM identified the cost of basic service based on total company costs. The sum of the 1FR rate and EUCL, or $14.75 for Pacific, is the amount that subscribers pay directly towards reimbursing the company's total costs of providing 1FR service. Therefore, DRA proposes that the benchmark zone be the zone having the highest TSLRIC that does not exceed $14.75. This criteria would ensure the maintenance of the existing 1FR rate, and also minimize the size of subsidies by not subsidizing residential lines whose costs are at or below Pacific's existing 1FR rate. If the TSLRICs of all zones exceed $14.75, DRA proposes that the zone with the lowest TSLRIC be set as the benchmark zone. This proposal would avoid subsidizing all customers in order to minimize the subsidy requirement, and at the same time would maintain basic service rates at a reasonable level.

34. The 1FR and the 1MR are comparable services. DRA does not recommend more favorable pricing treatment for either service. In order to treat 1FR and 1MR in an equitable manner, DRA recommends that the same benchmark zone be used to identify high cost areas and their subsidy amounts. Using the outputs of the CPM as an example, Zone-7 should be selected as the benchmark zone. Zone-7 which TSLRIC is $14.08 ~~$12.65~~ is the zone having the highest TSLIRC not exceeding $14.75. (Table 3.4.) High cost *

areas should be those zones in which the TSLRIC is above the benchmark zone. Again, using the CPM as an example, under DRA's proposal, high cost areas would include Zone-1 through Zone-6. (Table ~~3.3~~ 3.4.)

~~C. Price Floors and Price Ceilings~~

35. In D.96-03-020, the Commission re-classified basic exchange services to Category II effective March 31, 1996.[21] The Commission also maintained its current policy that Category II services are subject to flexible pricing rules with established floor and ceiling limits.[22] Therefore, DRA believes that the proxy cost model has a dual purpose. One purpose is to set the levels of subsidy ~~on a deaveraged basis~~ to ensure basic telephone service is available and affordable to all Californians. The other is to use the proxy cost results to set price floors of basic services for the incumbent LECs.

~~36. The Commission intends to rely on the OAND cost studies to set price floors for the incumbent LECs.[23] DRA believes this is reasonable except for basic services. In the OAND-P, Pacific developed statewide average costs for its basic services, and GTEC developed its basic service costs for three density zones: high, medium, and low. Rather than requiring Pacific and GTEC to deaverage their OAND cost data and to deaverage them in some consistent manner, the Commission should refer to the proxy cost study, which has deaveraged data readily available, to set price floors of basic service for all incumbent LECs.~~

~~37. It is clear that the local exchange market is not sufficiently competitive.[24] The Commission should set floors and ceilings between which the incumbent LECs may exercise their~~

21. D.96-03-020 at 54.
22. Id. at 56.
23. Id. at 56.
24. D.96-03-020 at 48.

~~pricing flexibility. DRA proposes that the price floors for low~~ cost areas be set at the respective TSLRICs developed in the proxy cost model. The price floors for the benchmark zone and high cost areas should be the TSLRIC of the benchmark zone. DRA's proposal of setting a price floor for basic service at the TSLRIC meets the Commission's adopted imputation rule which DRA will explain in detail in Section X.

38. The price ceilings should be established by adding a reasonable proportionate contribution towards recovery of LECs' shared and common costs. The amount of shared and common costs that LECs recover should be LEC-specific. The appropriate proceeding to address this particular issue is the upcoming ~~pricing phase of the OAND proceeding.~~ DRA intends to ~~elaborate~~ set forth its ~~price ceiling~~ proposal for pricing basic service in its ~~May 15~~ June 14, 1996 testimony in the OAND proceeding.

D. High Cost Voucher Fund

39. DRA proposes that the high cost voucher fund provide subsidies to high cost areas for purposes of minimizing rate disparity between high and low cost areas and maintaining reasonable basic service rates for Californians. Subsidies for a respective zone would be calculated by the difference between its TSLRIC and the TSLRIC of the benchmark zone. (Table 3.4.) Under this proposal, carriers of last resort would be guaranteed a minimum revenue stream from basic services at the TSLRICs. DRA's proposal to subsidize basic service up to its TSLRIC rather than at the TSLRIC plus shared and common costs serves several purposes. First, it would require a smaller subsidy. Secondly, it would promote efficiency because firms that are more efficient would retain higher profits. Thirdly, carriers of last resort would not be guaranteed a recovery of their shared and common costs. These carriers must make their own pricing decisions regarding the amount of shared and common costs to be recovered from basic service in accordance with their assessment of the market.

E. Offsets to the Results of the Proxy Cost Model

40. The Commission-adopted proxy cost model would develop basic service costs based on total company costs as it does in the HCM and CPM. In recognition of jurisdictional separations and federal subsidies for the provision of basic service, three offsets are necessary to account for these federal funds. They are the EUCL, the interstate Universal Service Fund (USF) and the interstate carrier common line charge (CCLC). The EUCL is established by the FCC for recovery of a portion of the LEC's interstate non-traffic sensitive costs. It is assessed on ratepayers on a per line basis. Ratepayers pay the effective basic service rate and the EUCL for their subscription to basic service. The Commission has no control over the amount, nor the method of recovery of the EUCL. Therefore, ~~for the pricing flexibility exercise~~, DRA proposes that the Commission include ~~require the LECs to include~~ the EUCL in ~~the~~ setting the subsidy amount. ~~of the rates. That is, the sum of LEC's effective rate and EUCL should not be lower than the price floor, and their sum should not be higher than the price ceiling.~~

41. The total annual subsidies received by carriers of last resort from the California high cost voucher fund should be reduced by their revenues from the USF and the CCLC. The USF is established by the FCC to keep basic service rates affordable for high cost companies. It is currently available only to the LECs. The FCC is in the process of revamping the USF. Pursuant to the Telecommunication Act of 1996, the USF is expected to be extended to non-LECs.[25] The CCLC, which is assessed on interexchange carriers based on minutes of use, is another rate element established by the FCC for the recovery of a portion of the LEC's interstate non-traffic sensitive costs. The proxy cost model will develop costs of basic service based on total company costs. These offsets, the USF and CCLC, are therefore necessary in order

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25. The Telecommunications Act of 1996 at Section 254.

to avoid double-recovery of costs by the carriers of last resort. To account for the USF and CCLC, DRA proposes that all carriers of last resort include in their monthly statement filed with the Commission their USF and CCLC as reductions of their claim from the high cost voucher fund.[26] The covered period for the USF and CCLC should be identical to their monthly statements.

~~**F. Pricing Flexibility and Deaveraging**~~

42. From a policy standpoint, DRA believes that LECs should be allowed to flexibly price basic service between a price floor and a price ceiling established by the Commission. The LECs should also be allowed to exercise different degrees of pricing flexibility in accordance with market demand and competitive pressure in various geographic areas. Here is the framework of DRA's pricing flexibility proposal:

- o LECs should be able to flexibly price basic services within the price floors and price ceilings established by the Commission.
- o Price floors should be established using results of the Commission-adopted proxy cost model.

    For low cost areas, price floors should be set at their respective TSLRICs.

    For the benchmark and high cost areas, the price floors should be set at the TSLRIC of the benchmark zone.
- o Price ceilings should be established by adding to the price floors a reasonable proportion of the shared and common costs.

    The amount of shared and common costs allocated to basic services for recovery should be LEC-specific and to be determined ~~in the OAND proceeding~~.

26. Proposed Rule 6.B.1, D.95-07-050.

~~o The sum of the LEC's effective rate and EUCL~~ should not be higher than the price ceiling, and their sum should not be lower than the price floor.

43. In Table 3.5 of the attachments, DRA further demonstrates its pricing proposal and how it would apply to Pacific. The benchmark zone, Zone-7 as shown in Table 3.4, sets the statewide price floor for the 1FR service. The window for pricing flexibility would be the amount of shared and common costs allowed to be recovered by Pacific. Because Pacific allocates equal amounts of shared and common costs to each access line, the pricing flexibility window is identical across all of Pacific's service territories. DRA's subsidy mechanism and pricing flexibility proposals would provide a minimum revenue stream for Pacific at the TSLRIC. And, Pacific's maximum revenue stream would be capped at TSLRIC plus a reasonable proportion of shared and common costs.

44. DRA concurs with the Commission that the LECs' statewide average rates must remain in place for the present and until relevant cost studies by relevant geographic region have been completed and approved.[27] The Commission indicated that it "... shall coordinate with the ongoing work in companion proceedings [i.e., the OAND, Universal Service, and NRF] and subsequently determine a procedural schedule for the preparation, review, and approval of cost and price studies which can be used for the adoption of geographically deaveraged rates."[28] DRA believes the appropriate proceeding to address these issues would be the OAND proceeding.[29] DRA urges the Commission to promptly

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27. D.96-03-020 at 65.
28. D.96-02-060 at 66.
29. Based on ALJ's Ruling of March 25, 1996 in the OAND proceeding, the issue of geographic rate deaveraging is explicitly excluded from the May 25, 1996 parties' testimony.

(~~Footnote continues on next page~~)

~~set a procedural schedule in the OANP proceeding to address these issues~~.

VIII. [Q.5] What are the additional costs associated with subsidizing business customers in high cost areas?

45. In its position paper filed in this proceeding, DRA proposed that business customers not be subsidized.[30] DRA maintains this position. If the Commission decides to subsidize business service, DRA believes the subsidies should be limited to truly high cost areas. In that scenario, DRA recommends a subsidy mechanism similar to that proposed for residential service with minor modifications, as explained in detail below:

A. Benchmark Zone and High Cost Areas

46. DRA proposes that the benchmark zone for business service be the one with the highest TSLRIC cost which does not exceed \$51.10. High cost areas would be identified as those zones in which the TSLRIC is above the TSLRIC of the benchmark zone. The \$51.10 rate is the current 1MB rate (\$45.10) plus EUCL (\$6.00) for Contel which is currently the highest 1MB rate in California.

(~~Footnote continued from previous page~~)

However, the Commission recognized the importance of geographic rate deaveraging in a competitive environment and the need to develop appropriate geographically deaveraged costs to support such a pricing policy for the LECs' retail and wholesale service offerings. ~~(D.96-03-020 at 66.~~)

30. DRA's January 19, 1996 Position Paper at 5-6.

B. Subsidies

47. The subsidy amount for the 1MB would be determined by the difference between TSLRIC of the respective zone less TSLRIC of the benchmark zone. The same subsidy amount should be available to all certificated carriers of last resort, and applicable to all business lines in high cost areas. Because Centrex/CentraNet and PBX are comparable to 1MB, DRA believes the same per line subsidy should be extended to include these services. However, DRA does not recommend that subsidies be applied to Centrex/CentraNet and PBX at this time until cost and price issues relating to Centrex/CentraNet and PBX are resolved by the Commission in the OAND proceeding.

C. Offsets

48. Similar to residential service, the EUCL is assessed on the 1MB to reimburse LECs for a portion of their interstate costs. Under the FCC's direction, different EUCLs are assessed by different LECs, and different EUCLs are assessed on single and multi-line business service of the same LEC. DRA proposes that each LEC offset their monthly statement submitted to the California high cost voucher fund by the amount of EUCL which differs from $6.00 per line. That is, each LEC should file additional claims if its EUCL is less than $6.00 per line. Correspondingly, each LEC should deduct from its claims if its EUCL is in excess of $6.00 per line.

49. Due to the lack of precise cost information regarding business services, DRA is unable to estimate subsidies required for business services at this time.

IX. [Q.7] What is your best estimate of the cost for providing universal service (throughout the state)?

50. Using the March 26, 1996 outputs from the CPM, DRA estimates the cost for providing universal service for residential customers throughout the state to be approximately

$850 million. (Table 3.6.) If the Commission adopts the CPM as modified by DRA's recommendations discussed in this report, the funding requirement for subsidizing residential services would be reduced. Due to the lack of ~~cost~~ data for other elements ~~business services~~, DRA provides hypothetical numbers to demonstrate the calculation of total subsidy requirement for the high cost voucher fund as shown below: *

o	Residential Service (1MR and 1FR)	$850 million
o	Business Service (1MB)	$7 million
o	Health, Education and Libraries	$100 million
o	Interstate USF and CCLC (reduction)	($300 million)
o	Administrative cost	$15 million
	Total	$672 million

51. DRA estimates the administrative cost for the California high cost voucher fund to be 1.5% of the total required subsidies ($850 + $7 + $100 million). This percentage is based on the National Exchange Carrier Association (NECA) filing made on April 2, 1996 with the FCC in compliance with the FCC's order in the Matter of Commission Requirements for Cost Support Material To Be Filed With 1996 Annual Access Tariffs and for Other Cost Support Material, DA 96-263, released February 29, 1996 and under authority of the FCC's Special Permission No.96-114. NECA manages the collection and distribution of access revenues from the interstate long distance companies. For fiscal year 1996-1997, NECA projected total access revenues to be approximately $2.8 billion. For this period, NECA's administrative cost is approximately 1.35% of total access revenues. (Table 3.7.) DRA believes that the administrator for the California high cost voucher fund will have responsibilities similar to NECA. (Table 3.8.) The California high cost voucher

fund should be smaller in size than the funds administered by NECA. Recognizing that there are economies of scale of managing a larger fund, DRA increased the administrative cost percentage from 1.35% to 1.5% of the total revenues of the California high cost voucher fund.

52. In the Universal Service OIR/OII, the Commission proposed that all telecommunications service providers contribute to the high cost voucher fund.[31] The Commission also proposed that a surcharge be assessed based on all of a carrier's transmission path revenues less access payments to other carriers. DRA supported the Commission's proposals in its September 1, 1996 Opening Comments.[32] In Resolution 15799 issued on November 21, 1995, the Commission approved a new surcharge rate for the Universal Lifeline Telecommunications Service program. In that resolution, it estimated a total telecommunications billing base for California at approximately $12.5 billion. Using this $12.5 billion billing base, DRA estimates the carrier surcharge for the support of the California high cost voucher fund to be approximately 6.5%. (Table 3.9.)

X. [Q.10] How should the funding mechanism for Universal Service account for the existing structure of implicit subsidies, and should the subsidy amounts flow to the existing local exchange carriers before rate deaveraging or rate rebalancing takes place?

53. As discussed in Section VII, DRA proposes that the Universal Service subsidy be offset by the EUCL, the interstate USF and the interstate CCLC. DRA recommends that the existing implicit subsidies to basic services from other competitive LEC services, particularly Yellow Pages, should be excluded from the subsidy offset calculation. Rather than use net revenues from other services as a direct offset to the universal service subsidy, DRA proposes that the LECs use those revenues to recover

31. The Universal Service OIR/OII, proposed rule 6.F.
32. DRA's September 1, 1995 Comments at 30.

the shared and common costs they reasonably incur. More specifically, DRA's proposal allows LECs to use revenues derived from Yellow Pages to recover portions of the companies' shared and common costs associated with unbundled BNF services and other services which DRA proposes should be priced at TSLRIC. This proposal satisfies the Commission's imputation requirement for price floors, and is consistent with DRA's recommendation for pricing LECs' unbundled BNF services at issue in the concurrent OAND proceeding.

~~54. In summary DRA recommends that rates for the LECs~~' unbundled BNF services be set at TSLRIC with no mark-up or contribution for the recovery of the LECs' shared and common costs. This allows price floors for basic services to be set at TSLRIC, as discussed in Section VII, with zero contribution being imputed from the unbundled BNF services, which DRA views as the monopoly building blocks for purposes of the imputation requirement for basic services. Setting rates for unbundled BNF services at TSLRIC keeps prices of inputs purchased by CLCs from the LECs low; hence encouraging competitive entry and greater utilization of the LECs' facilities.

A. Commission's Imputation Requirement

55. The Commission's current imputation rule was adopted in the IRD Decision (D.94-09-065). This rule requires the LECs to impute in the price floors for their bundled retail services any contribution the LECs derive in the tariff rates for "essential services" or "monopoly building block" components of these bundled services. Under the present rule, "contribution" is derived by subtracting the tariff rate of the monopoly building block from its long run incremental cost (LRIC). The Commission's current imputation requirement is summarized in the ~~following equation:~~

~~(1) Price Floor (BS) = LRIC(BS) + Contribution(MBB)~~

(2) Contribution(MBB) = Tariff(MBB) - LRIC(MBB)

where, (BS) represents any bundled service, (MBB) is the monopoly building block, and Tariff(MBB) is the tariff rate of the MBB. (D.94-09-065, pp. 212-214.)

56. As discussed in Section VII, DRA recommends that a statewide price floor for basic services be set based on the TSLRIC of the benchmark zone, as derived from the adopted proxy cost model. DRA's price floor proposal for basic services follows the imputation rule set forth in the IRD decision, except that DRA recommends the Commission change the costing standard from LRIC to TSLRIC in order to conform with the Commission-adopted costing methodology in the OAND proceeding. DRA does not recommend eliminating the imputation rule at this time. DRA still considers this rule to be a necessary safeguard to prevent anti-competitive behavior by incumbent LECs, particularly during the initial stages of competition in the local exchange market. Rather, DRA's proposal to set price floors for bundled basic (retail) services[33] equal to the TSLRICs of the bundled services is premised on the imputation of zero contribution from any "essential service" or "monopoly building block" that could arguably be considered as necessary for the other carriers' (i.e., CLCs') provisioning of competing retail services; i.e,

33. DRA's proposal in this report is limited to the following bundled basic retail services: residential flat rate, residential measured rate, Lifeline flat and measured, and business measured services. Applicability of DRA's price floors and imputation proposals with respect to other LEC services will be discussed in DRA's testimony in the OAND proceeding to be filed on May 15, ~~1996~~.

~~(3) Price Floor (Basic Service) = TSLRIC(Basic Service) +~~
Contribution(MBB)

where Contribution(MBB) = 0.

57. The unbundling of the LECs' network is currently under consideration in the OAND proceeding. DRA expects that the Commission will specify in that proceeding an initial set of basic network functions (BNFs) the LECs would be required to unbundle and offer as separate tariffed services to other competing carriers. Decision 96-03-020 in Phase II of the Local Competition proceeding found that these unbundled services would initially retain monopoly characteristics and appropriately classified them as Category I services. (D.96-03-020, pp. 54-55.) Thus, the unbundled BNF services should be considered essential services or monopoly building blocks for purposes of the imputation requirement.

58. Consistent with DRA's proposal to price unbundled BNF services at TSLRIC, DRA recommends that the LEC impute zero contribution from the unbundled BNF services into the price floors for bundled basic (retail) services.[34] That is,

(4) Price Floor (Basic Service) = TSLRIC(Basic Service) + Contribution(BNF)

where Contribution(BNF) = 0; hence,

(5) Contribution(BNF) = Tariff(BNF) - TSLRIC(BNF)

(6) 0 = Tariff(BNF) - TSLRIC(BNF)

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34. Although the pricing of unbundled BNF services is one of the issues proposed for the OAND evidentiary hearings (see March 25, 1996, ALJ Ruling in the OAND proceeding), DRA addresses the issue in this report because of its implications on DRA's subsidy and ~~price floor~~ proposals ~~in the instant proceeding~~.

~~Rearranging terms in equation (6) above results in the following~~:

~~(7) Tariff(BNF) = TSLRIC(BNF~~)

59. DRA recognizes that pricing unbundled BNF services at TSLRIC means that these services would not be contributing towards the recovery of any of the shared and common costs the LEC reasonably incurs as a company. As per the consensus costing principles that the Commission adopted in D.95-12-016 in the OAND proceeding, shared and common costs are not included as part of the direct costs (i.e., TSLRICs) of a particular service. These costs are to be separately identified and recovery of these costs is considered to be a pricing issue.[35]

60. Under DRA's proposal, the LECs would have the opportunity to recover their respective shared and common costs from sources other than directly through rates for unbundled BNF services. These sources include revenues derived from rates for bundled discretionary and partially competitive Category II services, Yellow Pages and other properly priced Category III

35. See August 23 1995, Consensus Costing Principles/Basic Network Functions: OAND Cost Methodology Workshops ("Consensus Document"), adopted by the Commission in D.95-12-016. Common costs may be distinguished from "overhead" costs and "common overhead" cost. Common costs refer to costs that a LEC incurs by being in business and which can only be avoided if the company ceases operations and goes out of business. Costs often called overhead costs may be included in TSLRIC studies if those costs are caused by the decision to offer a particular service. As per the Consensus Document, p. 4, "no costs shall be assumed to be volume-insensitive common cost on the basis of its accounting treatment." Corporate costs are generally considered as part of common overhead costs.

services.[36] DRA notes that Section 728.2 of the P.U. Code allows the Commission to determine that Yellow Pages revenues may be used as an offset to the LECs' shared and common costs not recovered via the TSLRIC-based rates for their unbundled BNF services. In particular, Section 728.2 (a) allows the Commission to "consider revenues and expenses with regard to the acceptance and publication of such advertising for purposes of establishing rates for other services offered by telephone corporations." (Emphasis added.) ~~DRA's proposal effectively would take into account~~ Yellow Pages revenues in setting rates for unbundled BNF services rather than treating ~~those revenues as a source of subsidies for basic services~~.

61. The LECs' other competitive and discretionary Category II services are further sources of contribution for the recovery of the LECs' shared and common costs. ~~In the case of residential basic~~ services (and business services to the extent they would be subject to ~~the~~ Universal Service subsidy), DRA's pricing flexibility proposal ~~for these~~ services (as discussed in Section VII), would allow the LECs to price ~~these~~ basic services up to a price ceiling reflecting some contribution to ~~their~~ shared and ~~common costs~~.

62. Using Pacific as an example, Pacific estimated in its OAND cost studies that its total shared and common costs are

36. In the case of the small and mid-size LECs, other explicit subsidies such as the current Settlements/Transition Payments, to the extent that they are retained, would also be additional sources of revenues for these LECs' recovery of their respective shared and common costs.

approximately [..............] per year.[37] The validity and reasonableness of this amount is still contentious in the OAND proceeding as per the April 3, 1996, opening comments filed by parties in that proceeding.[38] Pacific's net revenues (after taxes) from Yellow Pages amount to approximately [............] in 1995.[39] This represents 16% of the [..... ....] total shared and common costs reported by Pacific in OAND. DRA considers Pacific's Yellow Pages net revenues to be reasonably sufficient to recover the shared and common costs associated with its unbundled BNF services. ~~which Pacific would not be able to directly~~ recover from these services if they are priced at TSLRIC, as ~~DRA~~ recommends.[40]

63. Implementing DRA's pricing ~~flexibility~~ proposal for Pacific's basic services would enable Pacific to ~~further~~ recover ~~portions of its shared and common costs from these services. As~~

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37. See Pacific's OAND Exhibits and Workpapers, Miscellaneous Binder, Tab 5, Shared and Common Costs, submitted on January 31, 1996.

38. See Comments of the California Telecommunications Coalition on the Phase I and Phase II Cost studies submitted by Pacific Bell and GTEC California, Inc., pp. 40-59; Opening Comments of the Division of Ratepayer Advocates on Round I and II Cost Studies, pp. 4, 18; and Comments of the California Cable Television Association on Pacific Bell's Round I and Round II Cost Studies, pp. 13-25.

39. This is an annualized amount of the [..............] that Pacific reported in Pacific's 3rd Quarter 1995 Year-to-Date IEMR Supplement - Intrastate Category III Reconciliation Report (Monitoring Report No. PF-01-B300), submitted as part of Pacific's monitoring report requirements under NRF.

40~~. A similar example cannot be constructed for GTEC since it~~ has not presented an estimate ~~of shared and~~ common costs in the ~~OAND proceeding to date.~~

~~illustrated in an example presented in Section VII, assuming that~~ Pacific is ~~allowed to~~ price basic services up to a price ceiling which reflects a [.....] per ~~line~~ mark-up above TSLRIC, Pacific would have the opportunity to recover up to ~~[............]~~[41] ~~contribution towards its shared and common costs. This example shows that~~ Pacific could fully recover the remaining amount of shared and common costs from its other competitive and discretionary services such as intraLATA toll, vertical services, and other access services.

64. Using Pacific's Service Specific Tracking Reports filed under the NRF monitoring report program, DRA estimates that Pacific derived net revenues (after taxes) above Direct Embedded Costs (DEC) of about [............], in the aggregate, for various Category I and Category II services (excluding basic access services) in 1995. (See Table 3.10.)[42] DRA believes that this amount is already net of a substantial portion of the total shared and common costs Pacific reported in OAND, except for common overhead costs not included in a DEC calculation. Even adjusting for potential losses in market shares and price

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~~41. See Table 3.5 and Table 3.6 discussed in Section VII. The total amount of [............] is derived as follows: [.........~~
~~....................................].~~

42. As shown in Table 3.10, it appears that certain Category II services (i.e., High Speed digital Private Line and Low Speed Private Line) are priced such that their revenues are not sufficient to cover DEC. DRA notes a similar occurrence for other Category III above-the-line (ATL) services (not shown in Table 10.1), for which Pacific reported negative net revenues of around [..........] (annualized) for 1995. DRA is concerned that such occurrences may be reflective of improper cross-subsidization and below cost pricing by Pacific. DRA therefore urges the Commission to further investigate this issue and possibly require the LECs to reset their rates for the affected services to be more in line with their costs.

decreases as competition intensifies in the markets for these services, DRA contends that Pacific would have ample revenues from these Category II services to recover more than its residual shared and common costs.

~~B. Proposals Balance the Interests of Ratepayers, the CLCs~~, and the LECs.

65. DRA's imputation and price floor proposals for basic services benefit ratepayers because the price floor for bundled basic retail service will be lower than what would result if contribution from unbundled BNF services is otherwise imputed in the price floor for these bundled services. Allowing the incumbent LECs the flexibility to price basic services down to relatively lower price floors affords ratepayers the benefit of more potential price competition in the market. The LECs, in turn, would have a wider pricing window within which to respond to rates offered by competing carriers.

66. DRA's proposal protects basic service customers from price gouging by the incumbent LECs. As discussed in Section VII, DRA recommends that the Commission adopt a price ceiling for basic services based on some "mark-up" over the TSLRIC for the benchmark zone. Imposing such a price ceiling essentially constrains the incumbent LECs' ability to take advantage of customers' relatively inelastic demand for basic services by loading a disproportionate amount of contribution for the recovery of shared and common costs onto these services.

67. Pricing of unbundled BNF services at TSLRIC will encourage competitive entry into the local exchange market. It allows competing carriers (CLCs) to purchase from the incumbent LECs unbundled network functionalities or BNF services at the lowest price possible, thereby minimizing the potential for the ~~LECs to price squeeze their competitors out of the retail~~

~~services market. To the extent that competing carriers require~~ the LEC's unbundled BNF services as inputs into their retail services, pricing these inputs above TSLRIC would increase the costs to these carriers and make it more difficult for them to compete with the incumbent LECs in the retail market.

68. If the LECs charge CLCs inflated rates for the BNF inputs (by requiring a mark-up to reflect contribution to shared and common costs), the result may be uneconomic CLC investments in duplicate facilities to bypass the LECs' networks. Setting prices for the LECs' unbundled BNF services at TSLRIC sends the right signal to the market that only efficient facilities-based carriers, whose TSLRIC costs for equivalent BNF services are lower than the LECs, should invest in such facilities. Greater utilization of the incumbent LECs' networks is also encouraged to the extent that it is more economic for the LECs' competitors to purchase BNF inputs from the LECs rather than build their own facilities.

69. Under DRA's imputation and price floor proposals, the LECs' are afforded an opportunity to recover the total costs they incur as a company. Although DRA's proposal would limit the Universal Service subsidy to the recovery of the LECs' TSLRICs for basic services (offset by the EUCL, the Federal USF, and the CCLC), DRA also recommends that the LECs be allowed the flexibility to price basic services up to a price ceiling; thus, giving them the opportunity to recover their shared and common costs. (See discussion in Section VII.) Furthermore, as discussed in Section X.A above, the LECs have other sources of revenues to recover the shared and common costs associated with unbundled BNF services, without building contribution into the ~~prices of these BNF services directly~~.

C. Jurisdictional Cost Separations

70. DRA's imputation and price floor proposals for basic services take into account that the TSLRIC cost studies Pacific and GTEC have submitted in the OAND proceeding, as well as the Cost Proxy Model (CPM) results Pacific has presented in the instant proceeding, are all reflective of total company costs. These cost studies generally do not segregate costs associated with the use of the LECs' network for interstate services. Pacific and GTEC, for example, derived unit investments for various BNFs using the capacity cost approach, regardless of whether a given BNF is used for intrastate or interstate service offerings. DRA further understands that no jurisdictional separations or allocations were performed on various capital and expense accounts prior to their being used in the cost studies, except in instances when certain accounts are identifiable to be directly related to the LECs' interstate services.

71. Given the total company nature of the TSLRICs that the two LECs developed for unbundled BNF services, using these TSLRICs in setting California rates for such services could be perceived as setting rates which implicitly have contribution built into them. Contribution, in this case, refers to the interstate costs that are implicit in the total company TSLRICs at which rates for the unbundled BNF services are set.[43] One could argue that the total company TSLRIC-based rates for these BNF services should be offset by some amount reflecting allocated

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43. DRA notes that the Commission's discussion of its imputation rule in the IRD decision does not explicitly address the issue of jurisdictional separations of costs. (See D.94-09-065, pp. 204-231.) DRA recognized the issue fairly recently and would like the Commission to similarly consider its implications as DRA points out herein.