

for the efficient financing of the regulated operations. He points out that on a regulated basis a 60% or even a 56% equity ratio is substantially higher than the consolidated USW Inc. equity ratio of 47%.

Mr. Hill also looks to the gas industry which, he argues, faces similar risks to those faced by local exchange companies. Despite these similarities, Mr. Hill does not believe that gas distribution companies are perceived to be as risky as the telecommunications industry.

Public Counsel/TRACER argue that Mr. Cummings recommends the use of an actual capital structure without performing an evaluation of the most basic standards: Safety and Economy. They argue that Mr. Hill did present evidence that his recommendations would produce reasonable results. They argue that the Earnings Before Interest and Taxes Plus Depreciation and Amortization (EBITDA) studies are theoretically valid, noting that the company has placed some reliance on EBITDA themselves. They point out that Public Counsel is not recommending \$35 billion in debt, but note that the study indicates the level of safety being experienced by USWC even at a 60% debt ratio. Finally, they argue that the benchmarks of the rating agencies are advisory not absolute.

Mr. Hill cites the gas company equity range of 44-47% to be below the proper ratio for the telecommunications industry and establishes the 47%, also USW, Inc.'s consolidated equity ratio, as the bottom of the range appropriate for a local telecommunications company. He argues that top of the range should be significantly below the Value Line industrials average equity ratio of 56%. He identifies the 52% regulated leveraged equity ratio used to finance USWC and uses it as the top of the range. In this proceeding he chooses the 52% as the acceptable equity ratio. After identifying the 52% equity ratio, Mr. Hill goes on to demonstrate the safety of his proposed capital structure through comparison of earnings before interest and taxes to the company's total interest expense. His comparison also includes interest as if the Company had been only 40% equity financed.

Mr. Hill states that the use of preferred stock, as proposed by Ms. Folsom, does not achieve the desired goal that she stated. He indicates that while the market cost is similar to long term debt rate, the tax implications make preferred substantially more expensive than debt. He also states that the use of preferred stock is not common in the telephone industry.

Mr. Cummings opposes Mr. Hill's proposed capital structure. Mr. Cummings contends that Mr. Hill's reliance on financial reporting capital structures is inappropriate, and that the use of the financial reports is not in agreement with the investment used for ratemaking. He argues that Mr. Hill's proposed capital structure is inconsistent with the risk associated with the company's AA bond rating and looks more like an A or BBB rated company. Mr. Cummings argues that Mr. Hill's cross-subsidization argument uses inconsistent data, namely financial reporting for U S WEST, Inc, versus regulatory structure for USWC. He also argues the reverse, that is, use of Mr. Hill's capital structure, may result in cross-subsidization of USWC. With respect to Mr. Hill's safety analysis, Mr. Cummings states that the results simply produce

unreasonable results. He argues that the level of debt (\$35.5 billion) assumable under Mr. Hill's analysis would produce results that could not be considered financially safe by rating agencies or investors.

The Company argues that Mr. Hill's references to financial reporting capital structures of his comparable companies is improper and that regulatory capital structures should have been used, instead. Public Counsel/TRACER respond that the regulatory capital structure is 52% equity, adjusted for parent company leverage, is an example of the excess of the company's actual structure.

Conclusion: In reviewing capital structure,

The Commission's function is to set as the appropriate capital structure for ratemaking purposes that structure which best balances economy with safety. (WUTC v. Continental Telephone co. of the Northwest, Cause No. U-81-14, 2d Supp. Order (1981).)

The Commission accepts Mr. Hill's analysis and his proposed hypothetical capital structure. We find that Mr. Hill's proposal best balances safety with economy. We find that the existing capital structure is unreasonable and unwise for the company and that it so unreasonably and substantially varies from usual practice as to impose an unfair burden on the consumer.

We find it significant that US WEST Inc can set the Company's capital structure at whatever level best fits with its larger corporate objectives, rather than whatever is the best balance between debt and equity for both business and ratepayer concerns for USWC as a stand-alone company.

Mr. Hill's proposal is supported by comparable data and it is shown to be both economical and safe by earnings volatility tests.

E. Commission's Rate of Return/Capital Structure

<u>Type of Capital</u>	<u>Ratios</u>	<u>Cost Rates</u>	<u>Weighted Costs</u>
Long term debt	38.9000%	7.570%	2.945%
Short term debt	9.100%	6.000%	0.546%
Preferred equity	0.000%	0.000%	0.000%
Common Equity	<u>52.000%</u>	11.300%	<u>5.876%</u>
TOTAL	100.000%		9.367%

IX. Revenue Requirement Determination

Pulling together the financial elements of this Order, the following table shows the calculation of the Company's revenue requirement.

In calculating the Company's revenue requirement, it is necessary to use a conversion factor to account for such factors as taxes, to derive the number of pre-tax revenue dollars needed to produce the required net operating income. The parties' briefs do not state that there are disagreements as to the appropriate conversion factor to use. Consequently, we use Mr. Hua's proposed factor in this calculation.

Derivation of Revenue Requirement

Pro Forma Rate Base	\$1,561,793,482
Authorized Rate of Return	9.367%
Return Requirement	\$ <u>146,293,195</u>
Pro Forma Net Operating Income	\$ <u>204,749,579</u>
Net Operating Income Deficiency (Surplus)	(\$ <u>58,456,384</u>)
Conversion Factor Multiplier	1.565458
Revenue Deficiency (Surplus)	(\$ <u>91,511,013</u>)

PART FIVE:**RATE DESIGN ISSUES****I. Policy**

The parties agree that the policy factors that are most significant are those set out in Chapter 80.36 RCW, especially those in RCW 80.36.300.⁴⁰ The Commission keeps those factors in mind as it reviews the issues and makes its decisions on individual elements of this proceeding and on this matter as a whole. In particular, the statutory goal of universal service is a significant element of Washington State policy goal. It underlies many of the parties' arguments, particularly those of Public Counsel/AARP for achieving low residential exchange rates. USWC has contended that universal service may be maintained despite substantially higher residential local exchange rates than exist at present.

Universal service remains a primary and continuing Washington State policy. The Commission notes the existence of a pending docket aimed specifically toward exploring the meaning of universal service in a changing economic and regulatory environment (Docket No. UT-950724). The Commission will make no close examination of universal service in this proceeding. First, the other cause is pending and its scope will go substantially beyond the issues as they are framed in this matter, and second, by virtue of the revenue reduction that we find to be required we are not faced with rate increases that might threaten the existing universality of local exchange service. The topic will be addressed in the pending proceeding.

The principal policy issue that the parties chose to address is competition -- the role of competition in transitional regulation, the correct response of a regulated utility to encounters with competition, and even whether "competition" as each party defines it exists.

⁴⁰ The statute reads as follows:

80.36.300 Policy declaration. The legislature declares it is the policy of the state to:

- (1) Preserve affordable universal telecommunications service;
- (2) Maintain and advance the efficiency and availability of telecommunications service;
- (3) Ensure that customers pay only reasonable charges for telecommunications service;
- (4) Ensure that rates for noncompetitive telecommunications services do not subsidize the competitive ventures of regulated telecommunications companies;
- (5) Promote diversity in the supply of telecommunications services and products in telecommunications markets throughout the state; and
- (6) Permit flexible regulation of competitive telecommunications companies and services.

(1985 c 450 § 1).

Throughout the proceeding the Company has contended that it is beset with competition on all sides and that the Company should be permitted to set prices as though marketing issues were the predominant criteria. Time and again, it supported proposed pricing not by factors involving cost, but by factors involving marketing.

The Company contends that the goals of this proceeding are to establish a realistic revenue requirement for USWC and to rebalance rates to reflect competitive realities. The Company argues that need exists now, not in the future, and it contends that failure to respond is potentially unlawful and confiscatory. It bases its rate restructure principally on the need to meet market requirements.

Commission Staff, however, responds that USWC vastly overstates the existence of and near term prospects for competition. It urges that the level of competition that exists today is not strong enough to substitute for regulation in constraining prices and providing customers choices.

Commission Staff cites Mr. Selwyn's suggested goals for the transitional environment: (1) minimize duplication by requiring resale and unbundling; (2) promote entrants' efficient use of the existing network; (3) promote development of networks through private investment so competitors have comparable risks and rewards; (4) promote greater responsiveness to specialized needs than feasible for a single provider -- i.e., encourage "niche" providers. The Commission finds that these goals are appropriate, and it has considered them in its rate design deliberations.

Public Counsel/AARP contend that the Commission should "expose the fiction" that residential rates are subsidized, and make a specific finding that residential rates are not subsidized. The Commission believes that the evidence is overwhelming that local exchange service does cover its total service long run incremental costs (TSLRIC) -- even as calculated by the Company in its Average Service Incremental Cost (ASIC) presentation -- and makes that clear in its discussion of residential rates, below.

Public Counsel/AARP contend that USWC has alleged that it faces competition but that it has not presented objective evidence on market share, market power, or the existence of price-constraining competition. The Commission finds this to be true, and it observes that this is one of the central factors in the result of this proceeding. It is uncontested that some entrants are preparing to provide or are providing competitive services. It is also uncontested that the future holds many unknowns. Cable television providers may package two-way telecommunications with one-way programming services. Wireless services may supplant rather than supplement wire-based communications in the future. Internet-based services may provide a viable alternative to measured toll service. The future presents a multitude of options, any or many of which may ultimately take a significant share of the Washington State telecommunications market.

But USWC has presented no credible evidence that the future is upon us to the extent that we may shift regulatory focus from costs to market-based pricing. USWC made no showing that the nascent competition of which it presented anecdotal evidence has the power to constrain prices. The Commission anticipates that at some point, it will indeed be necessary to shift regulatory focus from costs to market prices -- but that point requires the existence of effective competition that can constrain prices. USWC can achieve a shift toward market pricing by securing competitive classification of particular services through the statutory mechanisms for doing so -- which requires a demonstration that the service is subject to effective competition. The Company could negotiate or seek approval of an AFOR in which pricing flexibility is granted and earnings regulation relaxed as part of a larger agreement.

We are sensitive to USWC's situation and its concerns. We find our Order to be consistent with the transitional market that now exists and with sound preparation for competitive markets. We also will authorize the Company to file banded rates for any service that it believes is likely to face competition. Banded rates provide as much pricing flexibility as the law -- and our duty to protect captive customers -- permit. See, RCW 80.36.340.

Public Counsel/AARP ask the Commission to end USWC's use of "black box" cost studies by announcing a number of specific cost study requirements; the Commission will address those matters below.

The Department of Defense/Federal Executive Agencies (DOD/FEA) argues that the federal government needs viable competitors for its contracting policies to work effectively to save the government money. The Commission believes that its actions in this order do promote the development of effective competition in a way consistent with both State and Federal law. DOD/FEA cite to the recently-enacted Federal Telecom Act and its role in advancing implementation of effective competition for local exchange service.

The Washington State Department of Information Services argues that the Commission should promote competition (or at least do nothing to hinder competition). Again, we believe that our actions are consistent with advancing competition in a way consistent with law and all parties' rights. WITA, the Washington Independent Telephone Association, asks the Commission to consider policy choices from the perspective of all players so that clear and appropriate signals are sent. We have done our best to do so in this Order.

II. Cost Studies

This case is the first in which this Commission has attempted to measure on a systematic and consistent basis the costs incurred by USWC to provide various services. There has been remarkably little debate about the need to measure service-specific costs as one element of determining reasonable and sufficient rates. Nor has there been great disagreement that costs should be measured from the ground up, i.e., on a long-run, incremental, going-forward basis and without consideration of the actual costs incurred in the past by USWC.

The degree of consensus about the need to do cost studies and the need to do them on a long-run incremental basis is in stark contrast with the lack of consensus about the specifics of the cost calculations. Parties disagree about virtually every aspect of the cost study process, notably about what constitutes an incremental cost, what costs should be included in a study, and what analytical model should be used to calculate costs.

In addition, while there is general agreement about the need for studies, there is substantial disagreement about what should be done with cost studies. The parties do agree that rates for individual services should not be set below incremental cost so as to have one service subsidizing another service. Many parties identify particular services that they believe should be priced at or very near incremental cost. Some parties acknowledge, and the Commission finds, that setting all rates at incremental cost would not produce enough revenue to meet USWC's revenue requirement, which is determined on the basis of its embedded costs. Except for USWC's flawed Average Direct and Shared Residual Cost (ADSRC) calculations, no party offers a systematic approach to reconciling the revenue requirement of the firm with the incremental costs of individual services.⁴¹

To address the contested issues regarding methodology and cost study inputs, it is important first to state clearly the purpose to which the end product will be put: The Commission will use incremental cost studies primarily to establish price floors for individual services. When USWC introduces a new service or seeks to lower the rates for an existing service, it is important to ensure that the rates at least cover the incremental costs of providing that service. Guarding against cross-subsidy and predatory pricing is the primary function of the incremental cost studies.

The Commission will use incremental cost studies secondarily to guide and inform its decisions on rate spread in this case. No party has suggested any sort of mechanistic relationship between incremental costs and rates, such as an equal percentage markup over incremental costs, and any such formula would appear to be inappropriate. It could, for instance, result in rates for some services that would exceed the revenue-maximizing level. It would be foolish to set rates so high that the service actually produces less revenue than it would at a lower rate. Neither are rates based on equal markup over incremental cost necessarily fair. An equally "fair" rule, with potentially very different rates, would be to have equal discounts from the stand-alone cost of each service.

⁴¹ The record also is silent as to the appropriate price ceilings for various services. Incremental costs provide a theoretical price floor for each service: the price of a service should at least equal the costs that the firm would not incur if it were to cease providing the service. If prices are set lower than incremental cost, other firms could be prevented from entering the market, even if they have lower costs than USWC. The price ceiling, by contrast, would be defined as the costs that a firm would incur if it were to provide a particular service on a stand-alone basis. Local exchange service, for example, should not be priced above the cost of building a stand-alone network of loops and switches dedicated solely to local service. Public Counsel argues that the price ceiling for local service is obtained by including the local loop in the cost of local service. The Commission does not accept this argument, because it assumes without factual basis that other shared and common costs would be avoided in a local-only network.

Incremental cost studies provide one more useful tool in determining fair, just, reasonable, and sufficient rates for individual services, but they do not in themselves determine those rates. Other considerations, such as the traditional factors discussed by TRACER,⁴² remain an important part of the rate-setting process.

A. Methodology

USWC's cost studies measure Average Service Incremental Cost (ASIC), Shared Residual Cost (SRC), and Average Direct and Shared Residual Cost (ADSRC). The main points of contention are whether and how to account for shared costs; whether to include the cost of the loop in the incremental cost of one or more services; and what analytical model to use.

The Commission finds, consistent with the presentations of most parties that addressed cost issues, that the appropriate measure of costs is Total Service Long Run Incremental Cost (TSLRIC). The Commission has found this measure of costs to be appropriate in prior cases.⁴³ Incremental costs are appropriate because they measure the additional costs that are incurred by providing an additional service. TSLRIC therefore represents the economic price floor. If the revenues from a service exceed the TSLRIC of that service, then that service is not being cross-subsidized. If the firm were to stop providing that unit, its revenues would fall by more than its costs.⁴⁴

1. Inclusion of Shared Residual Costs

The Commission rejects the concept proffered by USWC of incremental costs that include what it labels variously as "shared," "family," or "group" costs. USWC's cost studies measure Average Service Incremental Cost (ASIC), Average Shared Residual Cost (ASRC) and Average Direct and Shared Residual Cost (ADSRC) in the following relationship:

$$ADSRC = ASIC + ASRC$$

⁴² The cited elements are the following:

1. Effectiveness in yielding total revenue requirements under the fair return standard; 2. Fairness in the apportionment of total costs of service among different consumers; and 3. Efficiency in discouraging wasteful use of services while promoting all justified types and amounts of use, in view of the relationships between costs incurred and benefits received.

⁴³ Notably, these are the orders in the "term loops" case, 4th Supplemental Order, Docket No. UT-930957, et al., and in the Interconnection case, 4th Supplemental Order, Docket No. UT-941464. The Commission acknowledges that the latter order remains involved in post-order process.

⁴⁴ Having prices exceed their respective TSLRICs is a necessary but not sufficient condition in determining whether those prices are fair, just, reasonable, and sufficient. That determination requires consideration of a much broader set of factors than the TSLRIC of the service.

The Commission agrees with Staff, Public Counsel, and others who argue that ADSRC is not a relevant measure of the economic cost of providing a service. ASIC is the element in USWC's studies that most closely approximates TSLRIC. Inclusion of SRC in incremental cost results would allow USWC to manipulate costing concepts to suit its pricing purposes. It could assign more of the shared costs to services that have captive customers.

USWC contends that ADSRC, while not the economic price floor, is a useful measure for setting prices of individual services. It urges that pricing at ADSRC ensures the recovery of shared residual costs from the group of services that share the SRC. It contends that under almost no circumstance should a service be priced at ASIC, the theoretical price floor. If the Commission chooses to ignore the ADSRC in declaring cost floors, argues USWC, the shared and common costs must nonetheless still be recovered in prices.

The Commission agrees that shared and common costs, if they qualify as a part of the Company's revenue requirement, must be considered in setting rates. It does not follow, however, that doing so requires that rates be set at ADSRC. The ADSRC value may be useful to USWC's management as a pricing target, and there is nothing wrong with its use as a management tool when it prices unregulated services. It should not, however, define either the floor or the target for regulated ratemaking.

2. Inclusion of the Local Loop in Incremental Cost Studies

USWC includes the cost of the local loop in its calculation of the TSLRIC of local exchange service. According to USWC, allocation of any loop costs to access and toll service violates the principle of incremental costing, because the entire loop cost would exist even if no carrier access or toll services were provided.

Public Counsel/AARP argue that USWC has significantly overstated the incremental cost of local exchange service by including the cost of the local loop, which they assert is not incremental to local service. Their argument is that the loop would be required to offer virtually every other service besides local exchange service and, therefore, that the cost of the local loop is not incremental to local exchange service. Since the loop is required if USWC is to provide any one of toll service, access service, or local service, it is incremental to none of the services.

The Commission finds, consistent with the presentations of Public Counsel/AARP, and other parties that the cost of the local loop is not appropriately included in the incremental cost of local exchange service. The local loop facilities are required for nearly every service provided by the Company to a customer. Neither local service nor in-state long distance service nor interstate long distance nor vertical features can reach a customer without the local loop. Should USWC cease to provide any one of these services, its need for a local loop to provide the remaining services would remain. The cost of the local loop, therefore, is not incremental to any

one service. It is a shared cost that should be recovered in the rates, but no one service is responsible for that recovery. USWC's presentation that the local loop is appropriately and necessarily an element of the cost of local exchange service, made through the testimony of witness Farrow, is not credible in light of the purposes of a long run incremental cost study and is inconsistent with accepted economic theory regarding such studies.

USWC argues that allocation of any loop costs to access and toll service violates the principle of incremental costing, because the entire loop cost would exist even if no carrier access or toll services were provided. This argument addresses why loop costs should not be included in the incremental cost of toll and access, but it does not explain why they belong in the incremental cost of local service. The argument applies equally well in application of the costs to local exchange service. Indeed USWC's brief supports the principle that the loop is a shared cost rather than the direct cost of any one service:

All multi-service firms have shared and common costs by definition, but they are particularly significant for a LEC, which offers very capital and expense intensive local services which require a separate loop from the central office to every premise in its service territory... (USWC brief, 11).

Our conclusion that the local loop is correctly treated as a shared cost is consistent with the testimony of USWC's cost witness Brian Farrow, who testified:

U S WEST recommends that the Commission deal with the recovery of loop costs as a pricing exercise. The loop costs calculated in U S WEST's cost studies calculate the loop costs as though the loop is the cost object. The recovery of those costs is a pricing exercise. (Ex. T-338, p. 14).

Commission Staff offered a different approach to the treatment of loop costs in incremental cost studies. Staff argued that the cost of the loop should be allocated to services that use the loop based on a formula adopted by the Commission in Docket No. U-85-23. In that case the Commission said that loop costs should be recovered 25% from interstate toll, 16.95% from intraLATA toll, and the remainder, 58.05%, from local service. Thus staff's calculation of the incremental cost of local service includes 58.05% of the cost of the local loop. Commission Staff argues that the loop costs are not part of the incremental cost of local exchange service but are allocated to local exchange and toll service because of the Commission's past orders. Staff contends that the assignments adopted in U-85-23 were reaffirmed in the recent interconnection order, where the Commission said:

[T]he residential cost study contains a basic flaw: USWC improperly allocates 100% of the local loop to residential service, and 0% to services that rely and depend on the use of that facility.

The Commission in the past has addressed this issue and found it appropriate to allocate a portion of the loop costs to toll and other services. See, Eighteenth Supplemental Order, Cause No. U-85-23, et al (December 1986). Vertical services such as call waiting, or any other services that use the loop, should receive an allocation of the loop's costs.]Fourth Supplemental Order, Docket No. UT-941464, p. 39.]

Staff reads too much into this section of the Interconnection order. The question before the Commission in that case was whether residential local exchange service was priced below its incremental cost. In the quoted passage the Commission merely noted that the Company had made an error in its calculation by including 100% of the loop cost but less than 100% of the revenues derived from use of the loop. Based on the decision in U-85-23, one should not expect local service to be expected to cover 100% of loop costs, because some loop costs had been assigned to other services. The issue here is much broader and should not be controlled by the assignment provided for in U-85-23.⁴⁵

3. Choice of an Analytical Model and Documentation for that Model

USWC submitted incremental cost studies that were developed using various in-house cost models. The manuals alone for these models (Ex. 340) are about 1 1/2 inches thick. Other parties have criticized USWC for lack of adequate documentation and access to these models, as well USWC's use of proprietary data in the models. AT&T goes beyond merely saying that USWC should do a better job with its models and argues that the Commission should take cost studies out of USWC's hands:

The Commission should rely instead on independent studies that use publicly available information. In sharp contrast to the impenetrable maze presented by US WEST, such studies employ transparent methodologies to evaluate verifiable, nonproprietary data. (AT&T rate design brief, 11).

⁴⁵ The allocation factors proposed by Staff can be likened to the ADSRC methods proposed by USWC. Both approaches provide a mechanism for allocating shared costs such as the local loop to individual services for pricing purposes. Neither approach yields the economic price floor or accurately measures the incremental cost of a service. Even as a pricing principle, either method would produce arbitrary results that do not reflect either competitive realities or the public policy considerations that should guide the setting of individual rates.

AT&T suggests the Hatfield Model as the nonproprietary replacement for estimating the cost of basic local telephone service.⁴⁶ The Hatfield Model uses publicly-available (that is, non-confidential) cost information from USWC and other sources, and it incorporates elements of the Benchmark Cost Model that has been presented to the FCC by USWC and others in the context of universal service funding.

MCI also suggests the Hatfield Model "deserves serious attention by the Commission." TRACER recommends that the Commission consider in the future use of the Hatfield Model. Neither Staff nor Public Counsel address the merits of the Hatfield model, but both parties criticize USWC's approach as a "black box" whose operation is not understandable.

USWC opposes use of the Hatfield model to estimate the incremental cost of its local service, arguing that its methodology and inputs are invalid. The model was designed to identify geographic areas that are expensive to serve, USWC argues, not to estimate the average cost of serving all areas. USWC argues that AT&T has not provided documentation for the model and has not justified much of the data used as inputs. Another problem, USWC contends, is that the model uses embedded costs in some cases.

AT&T responds that the model is publicly available; indeed, it uses an intermediate Benchmark Cost Model whose developers include USWC. AT&T argues that the study's incremental cost calculations use as much USWC-specific data as is publicly available, and that this reliance on publicly available data represents a strength of its approach, since the results can be audited more easily. The Commission agrees. Every cost number supplied by USWC has been marked "confidential." Using USWC's estimates therefore requires that we set rates without the ability to tell the public the costs on which those rates are based. In some cases that secrecy may be necessary, but it certainly should be avoided where reasonable alternatives exist.

The Commission rejects USWC's cost studies for local service and the local loop. The most reasonable and accurate measure of incremental cost for these services on this record is provided by the Hatfield model sponsored by AT&T. While USWC complained that the Hatfield Model is inaccurate as to USWC, it provided little verification of its claim. We are satisfied from comparisons of underlying assumptions and comparisons of inputs that it accurately reflects costs incurred by USWC and that, if it errs, it likely errs on the high side through the inclusion of an overhead factor. Correcting the USWC local exchange model with the tools and input available also provides verification for the Hatfield model.

For other services, no party offered an alternative to studies prepared using USWC's models. The USWC models for services other than local exchange, without shared costs and with appropriate inputs as discussed below, are not precise but are sufficient for reference purposes to estimate incremental costs of services other than local exchange service and the local loop.

⁴⁶ See, Ex. 760-T, pp. 4-17; Exhibits 761-T, 762, 763, 764, 765-T, 766, and 767.

4. Overhead Factor

Commission Staff proposes to increase all incremental cost values by an "overhead factor" of 16.41%. The Hatfield Model sponsored by AT&T includes an overhead factor of 6%. Incremental costs usually do not include overhead or administrative costs of the firm, recognizing that those costs will be incurred regardless of whether a particular service is offered. Staff argues that overhead costs actually are sensitive to the number of services being provided. There may be merit to the Staff concerns, but the solution is to identify those costs and include them directly in incremental costs rather than impose an across-the-board multiplier on all results. Moreover, the use of such a factor would suggest more precision than actually exists in the cost study results, which are at best estimates of the actual incremental cost of providing each service. The proposal to inflate incremental costs by an overhead factor should be rejected.

B. Inputs

Some disagreement involved the propriety of various elements of data to be considered (called "inputs") in an appropriate study.

1. Depreciation Rates

The Commission has determined that for regulatory purposes, cost studies should use the depreciation rates prescribed by the Commission. USWC submitted cost studies with greater depreciation expenses, i.e., faster depreciation. Staff, Public Counsel and others argue that USWC should use the economic lives prescribed by the Commission in setting the company's depreciation rates. The parties appear to agree that incremental cost studies should reflect the economic life of the facilities. Their disagreement centers on whether the Commission's depreciation rates reflect the best estimates of economic life (as Staff claims) or a policy of understating depreciation in order to hold down current rates (as USWC claims).

USWC argues that the prescribed depreciation rates are outdated (three years old) and based on backward-looking historical data. USWC says the Commission already decided in the interconnection order that real, current expense inputs should be used in cost studies.

According to Commission Staff, however, "The (Commission-)prescribed lives are economic lives, they are just not the economic lives the Company wants." (Commission Staff Rate Design brief, p. 13). Staff's argument is correct.

The Commission determines appropriate depreciation rates for regulatory purposes on a frequent basis. As noted in a prior Order in this proceeding, the Commission has just completed a review of depreciation methodology and rates and has approved changes. The Company has sought judicial review of that decision and although now on remand to the Commission, review is not complete. Other depreciation groups will be reviewed very soon in a collaborative procedure called "represcription" involving representative s of the Company, the

Commission Staff, and the Federal Communications Commission. That process, which recurs every three years, is now beginning and according to the record it is typically completed swiftly. The depreciation rates challenged by the Company are rates that were considered in the prior proceeding or are subject to review in the represetation process. The Commission finds that the authorized depreciation rates are proper for cost study use and that they sufficiently reflect USWC's costs that they may be used in an accurate cost study and for ratemaking purposes. We see no reason to approach matters on a piecemeal basis, litigating matters incessantly, when it is both functional and appropriate to make a single and consistent timely determination of appropriate depreciation rates for all regulatory purposes. The function of depreciation, estimating the actual economic lives of physical properties, is identical in every instance. It is far better to have a single consistent and timely approach to depreciation than to relitigate it unnecessarily.

2. Cost of Money

In the interconnection case, Docket No. UT-941464, the Commission determined a forward-looking cost of money may be appropriate for use in a cost study. Parties do not appear to disagree with this principle, though their opinions vary on the right estimate of cost. In addition, Public Counsel argues that using the last-authorized rate of return could provide stability and prevent relitigation of cost of money in rate design cases. The Commission agrees that any theoretical advantage to using "pure" forward-looking values would be more than offset by the practical problems of turning every cost-based rate filing into a cost of money case. The last authorized rate of return provides a reasonable measure of the cost of money for this purpose and will be accepted as an appropriate principle.

3. Fill Factors

"Fill factors" describe the amount of unused capacity that will be included in the cost of a particular service. USWC argues that actual fill levels are often below the objective or planning level and that using objective fill factors would cause the cost of spare capacity necessary to provide a particular service to be treated as a shared cost of all services. USWC says the use of objective fill understates the true cost of particular services and that actual fill factors should be used instead. Staff and Public Counsel have presented evidence that actual fill factors would produce excessively high estimates of incremental cost.

The Commission has previously ordered USWC to develop cost estimates using objective fill factors, and we will continue to require the use of objective fill. In situations where capacity is being underutilized, incremental cost calculations would include costs of capacity that is not required to provide that level of service. That would be inconsistent with the theory that incremental cost studies should be prepared on a forward-looking basis and without respect to the actual costs incurred in the past. Using objective fill will assign a reasonable portion of unused capacity to individual services. The remaining unused capacity is most appropriately treated as a shared cost. This issue ultimately has no effect on whether USWC recovers the cost of this unused capacity, since shared costs also are recovered in rates.

4. Wire Pairs in Residential Loop Cost

USWC's cost study for residential exchange service and the residential loop includes the cost of three wire pairs. USWC includes only a single pair in the cost of a business loop. Only one pair (plus a fraction to allow for bad wires, which is accounted for in the objective fill value) is required to provide service. Staff and Public Counsel argue the three-pair assumption overstates the cost of a residential line. Additional pairs are installed only because USWC expects residential customers to order additional lines. The Commission so finds. The cost of the additional pairs should be matched with the additional-line service for which they are installed and should not be included in the cost of the first line.⁴⁷

5. Weighting of Design Types

The USWC cost studies do not estimate the cost of every possible combination of loop lengths, switches, etc. Instead, costs are developed for several designs, and these are weighted to arrive at an overall number for incremental cost of average service. Public Counsel argues that the weights are based on judgment and not properly documented. Public Counsel contends that USWC was unable to show how the actual distribution of access lines matches with its design types. USWC's cost witness, Mr. Farrow, responding to questions from the bench, said that the weighing is based on an analysis of Washington state data.

The Commission accepts USWC's explanation for this proceeding. However, it is an example of the more general and continuing problem relating to documentation and auditing of USWC's cost studies. Other parties *must* be able to verify USWC's results if the company's cost studies are to be relied upon in setting regulated rates. Parties have provided specific recommendations as to how USWC can improve its documentation. Until those improvements are made, the Commission will limit its reliance on USWC's results and will encourage parties to sponsor alternative results such as those of the Hatfield model.

C. Results

The most important question to be answered by cost studies in this case is whether residential local exchange service is being cross-subsidized by business and toll service. USWC argues that this cross-subsidy exists and is undermining its ability to remain competitive. Other parties, including Staff, Public Counsel, TRACER, MCI, and AT&T, argue that the residential local service rate covers its incremental cost.

⁴⁷ The three-pair error has no direct bearing on the decisions of this case, because the Commission has already rejected USWC's entire residential exchange service and local loop cost study in favor of the Hatfield model results. This error was one factor in the Commission's decision to rely on the Hatfield model results. US WEST's argument that it will be grievously deprived of its rights and its opportunity to recover its costs if the additional pairs are deemed shared or common rather than incremental costs in its cost study is silly, as the Company is allowed under regulation to recover both its shared or common costs and its incremental costs.

The evidence clearly shows that residential service is covering its cost. The incremental cost of local exchange service is approximately \$4.42. This amount is calculated by subtracting the Hatfield model results for loop cost (\$8.96 [Ex. 765-T, 4]) from the Hatfield model results for the total cost of local service (\$13.38 [Ex. 767]), using the modified fill factors. These values are only approximate, in part because any model result is only approximate and in part because the Hatfield model results do not necessarily reflect the input values determined earlier to be appropriate.

The conclusion to be drawn from these cost results is that residential service does not receive a subsidy at current rates. The average residential customer today pays \$10.50 for local service and EAS adders, plus a subscriber line charge of \$3.50. If USWC were to exit the local residential exchange market, its revenues would decrease by \$14.00 per customer, and its costs would decrease by about \$4.42 per customer. Not only does residential service cover its incremental cost (the test for cross-subsidy), it even covers the incremental cost of the local loop that is used to provide local, long-distance, and vertical services, since the revenue from local service, including the subscriber line charge, exceeds the \$13.38 cost of local service plus the local loop.

III. Cost/Revenue Requirement Relationships

The parties generally agreed that rates should be based on, but not necessarily equal to, long-run incremental cost. There also was a consensus among those addressing the issue that the Company's revenue requirement will require that rates be set above TSLRIC. No party proposed a specific method of establishing a relationship between prices and incremental costs that could apply across all services.

The price/cost relationship under existing rates for most USWC services is summarized by the Company in confidential Exhibit 485-C. USWC contends that Ex. 485-C shows the relationship between incremental cost and revenue for most USWC services. Currently, the Company argues, toll and business basic exchange service contribute more than 100% of USWC common costs. These services are at competitive risk, says USWC, and toll revenue is declining. The Company cites asserted problems with rates for residential services, Directory Assistance, and Terminal Loop services. It contends that, even with its proposed rebalancing, switched access and basic business local exchange service would subsidize other services.

Commission Staff argues that Ex. 485-C does not show what level of overall markups would apply on average to reconcile incremental costs with revenue requirement. They note that the exhibit contains outdated data on switched access revenue, is only a preliminary analysis, does not use consistent methodologies and inputs, assigns all residential loop costs to local service, and accounts for services providing less than 95 percent of revenues. In addition,

Commission Staff argues that it did not have adequate opportunity to assess the support for the information. It argues that even according to the exhibits, both toll and local rates are above TSLRIC.

Public Counsel/AARP acknowledge that even with its flaws, Ex. 485-C shows that USWC must price above Total Service Incremental Cost (TSIC) to earn a fair return. Properly interpreted, however, Public Counsel contends that the exhibit shows that residential rates exceed TSIC.

The Commission finds that many problems with this exhibit limit its usefulness. It was filed very late in the case; it was revised repeatedly; it does not include all services; and costs are not calculated on a consistent basis. Loop and local exchange costs are based on the USWC study that we reject in this order. With those limitations in mind, however, we find that it does provide a general sense of the relative levels of contribution of various services. Within the context of this proceeding the data in it can provide a useful guide for rate spread decisions, as long as limitations of the data are kept in mind.

The Commission will not attempt to set an equal markup of prices over the incremental costs of various services. That is neither required by competitive pressures nor generally practiced in unregulated markets. It could well produce illogical and uneconomic results, such as some services being priced above market level, causing USWC to exit a market it could efficiently serve if competitive alternatives are or become available.

Examining the relationships between a particular service's incremental cost and its present or proposed price is, however, a reasonable and appropriate factor in determining rates for individual services.

IV. Other Factors Affecting Rate Design/Rate Structure

A. Universal Service

Universal service is one of the State's basic policies with regard to telecommunications service. RCW 80.36.300. All the parties agreed that the Commission should consider universal service when considering rate design -- but each had a slightly different perspective as to what universal service may mean and how to achieve it.

USWC forthrightly acknowledges that universal service is very important and should be accommodated by assigning revenue requirement, if that is a reasonable option and still let the Company earn its revenue requirement. It contends that its proposed \$26 per month residential rate is affordable. It urges that the phased proposed increase would give time to study universal service issues. Finally, it urges that only a very small proportion of USWC customers have expressed opposition to the proposed increase.

Commission Staff disagrees with the Company's conclusion, stating that the Company's proposed increases are huge and that it is unreasonable to deny that there will be an effect on universal service. Public Counsel/AARP argue that USWC has agreed that universal service is the fundamental concept -- the number one public policy goal -- in telecommunications. They argue that at the proposed rates, 39,000 persons would leave the system and that USWC's "affordability" analysis is seriously flawed. AT&T argues that universal service is important, but shouldn't be the determining factor in setting rates. Subsidies should be targeted toward specific individuals who need them, and collected in a competitively neutral manner from all competitors. It notes that household penetration varies with toll rates, not local service rates. It urges that outmoded internal cross-subsidies needn't be perpetuated in the name of universal service, but cites cost study data that show the residential class to meet costs and provide a contribution.

DOD/FEA support universal service, but contend that the universal service objective doesn't require a subsidy to the entire residential class. It cites a Rutgers University study that found most marginal users were driven off the network by toll. DOD asks the Commission to take official notice of the federal Telecommunications Act of 1996.⁴⁸ It suggests the use of a Joint Board to develop equitable and nondiscriminatory measures.

DIS reaffirms the State's statutory Universal Service policy. WITA suggests that the Commission not use the USWC rate case to define universal service, noting that there are other forums in which this is being addressed. WITA supports the USWC offer in Ms. Owen's rebuttal, to provide for a lower rate if necessary, to those customers receiving assistance under WTAP (supported by a higher rate on others).

The Commission reiterates its concern and support for the concept of universal service. The Commission finds it unnecessary and inappropriate, however, to pursue universal service considerations in this proceeding. First, there will be no massive increase to threaten universal service. Second, the Commission has begun Docket No. UT-950724, an inquiry into universal service, to explore universal service in today's transitional regulatory environment and mechanisms by which it may be maintained. The Telecom Act at Sec. 254(a)(1) also requires that the FCC initiate rulemaking to define services that should be supported, the support mechanisms, and other changes.

The compression of residential rate groups into a single statewide rate will cause rate increases to some persons, especially persons in small, rural exchanges. Because the rates are so low, even modest increases will be a significant percentage rise and may be significant to low income individuals. Because of the low base, the modest dollar size of the increase, and the level of the resulting rates, however, the Commission is confident that its order will not adversely affect universal service within the State.

⁴⁸ The Commission believes that the Act may be cited without taking official notice. Nearly all parties have cited the Act on brief.

B. Competition

USWC argues that it faces competition in the markets that currently provide contribution to support services priced below cost: toll, access, and business local exchange. USWC cites the ease of registration as a telephone company, access to public rights of way and USWC structures, free numbering, free interconnection, low-cost number portability, low-cost private lines, a filed unbundled loop tariff, and the passage of federal legislation mandating conditions to promote local service competition. USWC contends that competition has grown to the point that the Company is beginning to have trouble handling the traffic delivered by competitors to its network.⁴⁹

Commission Staff points out that USWC enjoys a ubiquitous network funded by captive ratepayers. Staff contends that *de facto* barriers continue to exist for market entry. Staff acknowledges that competition is increasing, but contends that competitors now have a negligible market share. Staff urges that the Company can ask for competitive classification if it thinks services are competitive. Instead, says Staff, the Company argues that the existence of any competition requires it to act as though the market is fully competitive. Each of the current alternative technologies (wireless, cable, competitive land line) has its own technical and other limitations. There may be pervasive competition in the future, say Commission Staff -- but not now.

Public Counsel/AARP argue that even though there is open entry and some entrants, there is no evidence that effective competition exists in any, let alone most or all, of the markets that USWC serves. Public Counsel/AARP urge that evidence of revenue increases tends to refute USWC's claim that it is losing business to competitors. Some of the competitors USWC cites, say Public Counsel/AARP, have substantial technological or practical barriers to becoming full alternatives for the ubiquitous network. The analysis of competition should focus on price-constraining competition, not anecdotes or speculation. USWC provided no evidence demonstrating the existence of that sort of competition. We find that USWC continues to enjoy substantial advantages: a ubiquitous network on which it enjoys a unique monopoly position; access to every customer; high market shares; substantial market power; some entry barriers remain, such as lack of number portability; USWC can use "special contracts" for large users to compete with entrants; USWC has the 1+ dialing advantage; cellular is benefiting the Company by providing additional access revenues; cable has technical problems; there is no demonstration that competitive access providers (CAPs) are

⁴⁹ Nowhere in USWC's case does it address its competitors' (potential or actual) cost of providing service. USWC has not shown or attempted to show that any competitor can offer a particular service at rates below those currently charged by USWC. Instead, USWC's case for competitive threats to its profitability rests on (1) the absence of legal or regulatory barriers to competition and (2) anecdotes about plans of other firms to enter USWC's markets.

offering lower rates or having a substantial effect upon market share. We find that personal communications service (PCS), specialized mobile radio (SMR) and satellite service are in early development stages and not a competitive threat; and interexchange carriers (IXCs) use incumbents' facilities because it is to their economic advantage to do so.

AT&T argues that from the record, competition in local exchange service doesn't yet exist and that USWC cries wolf. But, AT&T argues, emerging competition will be affected by the rates that are set in this proceeding. The DOD/FEA also acknowledge that the specter of competition is much closer now that the federal Telecom Act has been enacted, adding new urgency to USWC's requested rate restructuring. WITA contends that the transition from monopoly to competitive markets demonstrates USWC's need to restructure rates. WITA argues that competition is here and that value of service pricing must be abandoned in favor of cost-based pricing.

The Commission finds that effective or price-constraining competition does not exist. The Commission concludes that, to the extent USWC has predicated its rate spread proposals on competitive threats, those proposals should be rejected. USWC witnesses were not credible in assertions as to the existence or threat of competition, and were not supported with objective information that would permit a finding that effective competition exists. Rates will not be lowered, and costs will not be shifted to captive customers, based on anecdotal evidence. To do so would not result in rates that satisfy the statutory requirements to be just, fair, reasonable and sufficient.

The Commission also recognizes, however, that competition may develop in the markets served by USWC and that it is in the best interest of both the Company and its customers to prepare for greater competition. USWC, unfortunately, has not offered a reasonable approach to emerging competition. We encourage the Company to examine the markets for its various services and, where it appears that effective competition exists, seek to have those services declared competitive as provided for in RCW 80.36.330. Such a competitive classification would enable USWC to raise or lower rates for that service in response to market conditions. Where effective competition exists, market pressures can replace traditional rate regulation.

In addition to encouraging USWC to seek competitive classification where appropriate, we believe it also is in the public interest for USWC to have downward pricing flexibility for services that, while not yet subject to effective competition, are facing competition of some sort. This can be accomplished under Washington state law by using the banded rate provision in RCW 80.36.340.⁵⁰

⁵⁰ The statute reads as follows:

80.36.340 Banded rates. The commission may approve a tariff which includes banded rates for any telecommunications service if such tariff is in the public interest. "Banded rate" means a rate which has a minimum and a maximum rate. The minimum rate in the rate band shall cover the cost of the service. Rates may be changed within the rate band upon such notice as the

USWC has sought to tie its competitive responses to its monopoly services. Its market response -- to lower rates for toll, access, and business services -- was linked to higher rates for monopoly services -- in particular, residential exchange service. In effect, USWC wanted to make residential ratepayers responsible for its success or failure to compete in other markets.

The more appropriate approach is to give USWC the tools it needs to respond to competition while still protecting captive customers from monopoly pricing. The banded rate statute is that tool. It will permit USWC to lower rates when doing so is necessary to respond to competition. If USWC determines that a particular rate established in this order is higher than the market will bear, it will have the flexibility to lower that rate and meet the market. The Commission finds that in current regulatory circumstances, the limited use of banded rates authorized in this Order is in the public interest.

This Order will therefore authorize USWC to file tariffs with banded rates for any service that it believes is likely to face competition. The upper limit for each rate should be the rate determined in this case. The lower limit should be no lower than the TSLRIC of that service, calculated in accordance with the decisions on cost studies in this order, or the price floor set through imputation where required. USWC will be allowed to change rates within the band on 10 days' notice to customers and the Commission, by analogy to the provisions of RCW 80.36.330. Within that period, the Commission may complain against the filing. If it does, the burden is on the Company to demonstrate both that the rate is above cost and that it is fair, just and reasonable. Especially important here, where we have found that the Company does not face effective, price-constraining competition in the markets for many services, proving that a price is fair, just, and reasonable involves a demonstration that it is not anticompetitive.

WAC 480-80-045 requires banded rate filings by telecommunications companies to include a statement of public interest, cost study results verifying that the minimum rate covers cost, and information on the revenue impact of the banded tariff. Because the Commission is authorizing banded rates on record evidence, including market conditions and cost studies, the Commission does not contemplate the generation of new data or studies, but authorizes USWC to refer to record evidence accepted by the Commission as valid, when the Company provides support for its proposed tariff revisions. We expect that the evidence of record will satisfy the requirements of the rule.⁵¹

commission may order.[1985 c 450 § 6.]

⁵¹ The Commission considered banded rates for USWC in Cause No. U-86-40. There, it rejected USWC's request to set a band of \$20 to \$8 for remote call forwarding, which was then tariffed at \$16. The Commission reiterates its conclusion in that proceeding that the upper band should be the revenue requirements level. The circumstances today are sufficiently different from those of years ago that the other guidelines set out in the order in U-86-40 should not apply here. However, the Commission is sensitive to the possibility of unintended consequences and reserves

There may be concern that a set of banded rates, with the upper bounds set at the revenue requirements level, could only result in rates that are insufficient, since any downward price movement would cause revenues to fall below the revenue requirement determined in this case. The Commission believes that concern to be ill-founded. USWC can be expected to use the pricing flexibility of banded rates to maximize its revenues; it is unlikely to lower rates for a service unless competition forces it to do so. Where competition exists, a rate that meets the market will generate more revenue than an above-market rate.

By granting USWC downward pricing flexibility, we are not taking away the Company's ability to seek increases in its overall revenue level or to seek a revenue neutral rebalancing of rates. If USWC believes that a reduction in rates for one service needs to be offset by an increase in rates for another service, it can request that rebalancing. Banded rate authority simply gives USWC a tool to respond more quickly to competition without putting captive customers at risk. This gives USWC more ability to compete without sacrificing our legal obligation to protect captive customers from monopoly pricing. Alternative banded rates provide USWC with the greatest level of pricing flexibility allowed under Washington law without a showing that a service is subject to effective competition.

C. Imputation and Price Floors

Imputation tests must be performed to ensure that USWC does not put a "price squeeze" on competitors using its bottleneck monopoly services. For example, the access charges paid by interexchange carriers are imputed to USWC's retail toll charges, even though USWC does not pay those access charges, to ensure that its toll rates are not anti-competitive.

According to USWC, the test is simple:

Does the price cover at least the incremental cost at the ASIC level plus imputed tariff rates for truly essential services required by competitors to provide the same or similar service? [USWC rate design brief, p. 42.]

USWC argues, however, that the only essential service is interconnection itself; everything else that could be purchased from USWC could also be self-provisioned. Thus, USWC concludes, imputation is a non-issue in this case and all USWC services pass any reasonable imputation test.

Beyond its assertion that imputation is a non-issue, USWC does not offer a point-by-point defense of the imputation calculations it placed in the record. In testimony USWC proposed several changes to existing implementation methods used by the Commission. These

the right to reopen this proceeding for the purpose of examining the effect, the performance, and the continuing propriety of banded rates filed in accordance with this Order.

include (1) excluding the local transport rate, (2) excluding access charges imposed by independent local exchange companies (ILECs), (3) and making the calculation on the average toll rate instead of individual toll rate elements.

WITA agrees with USWC that ILEC access charges should not be imputed in USWC toll rates, arguing that the exclusion best balances the policy goals of a designated carrier with those favoring the beginnings of competition.

Commission Staff agrees with the Company that all toll offerings exceed the price floor, and argues that the Company-proposed changes to imputation test are flawed and unneeded. According to Staff, only billing and collection, that have been classified as competitive, may be imputed at its long range incremental cost (LRIC); all other elements must be imputed at tariff rates. Allowing imputation at average rates would stifle competition because the Company could freely devise high-volume plans that others couldn't match. Staff contends that its view is consistent with the Commission's second and third Supplemental Orders in U-88-2052-P and the fifth Supplemental Order in U-87-1083-T.

MCI and Sprint argue that USWC's requested changes in imputation are inappropriate. AT&T criticizes USWC's proposed changes to the imputation method, without disputing that USWC's proposed rates pass the imputation test. AT&T instead argues that imputation tests are not adequate to protect competitive markets from monopoly power. If USWC's toll is priced at the imputation floor, AT&T would earn zero profits while USWC was enjoying the very high markups on access charges, and the solution therefore is to price monopoly inputs to competitors at TSLRIC.

DOD/FEA note that imputation is still required, although its importance declines as services become competitive. They argue that the price floor of incremental cost is now a mandated requirement under the federal Telecommunications Act of 1996.

The Commission rejects the Company's proposal to include only the interconnection rate in imputation. The Commission finds that unless a bottleneck service is effectively competitive, if it is necessary to the competitor using it we cannot assume that a competitor will be able to circumvent it. It must then be imputed at the tariff rate. Unless the Commission finds a service to be competitive, the Company must include all bottleneck functions in its imputation at the tariff rate. Similarly, the Commission rejects other changes that the Company urges for imputation tests. Until services are truly competitive, the Company's services are essential in practice for some or all existing and prospective competitors. Abandoning the imputation standards now in place would allow the Company to price in a manner -- even though above its TSLRIC -- that would restrain the growth and development of competition.

D. Service Differences

USWC argues that the traditional differences between services such as toll, local exchange, EAS, and private lines are disappearing. In the future, competing carriers will offer all sorts of bundled and unbundled service option packages. The Commission should not be bound by traditional concepts of utility rate discrimination when deciding upon appropriate rate spread.

Public Counsel/AARP say that the differences between business and residential service are significant and that they justify the current difference in rates. Business service includes a yellow pages listing, involves more on-peak calling and more total calling, and gets faster repair service. The cost of business service is usually tax-deductible, while residential service usually is not. Public Counsel/AARP recommend equal percentage rate reductions for business and residential service, which results in a greater dollar reduction for business.

The Commission agrees that the distinctions among services may become blurred. As more persons engage in home occupations, as providers of alternative technologies and providers of other services enter the telecommunications marketplace, and as bundling of services occurs for marketing purposes, the traditional distinctions may well blur. The Commission finds that, as with price-constraining competition, that time has not yet come and it finds that distinctions among services still exist and define those services, and that tests relating to competition and pricing should be applied on the basis of services. This Order moves rates in the direction USWC urges, and future proceedings will allow the Commission to evaluate future costs, future market conditions, and other appropriate elements in rate setting.

In this Order, the Commission will maintain the residential local exchange rate at its existing statewide average rate. It will substantially reduce the revenue requirement for comparable business services, narrowing the proportional difference. It believes, however, that the factors Public Counsel/AARP mention -- yellow pages listing, calling patterns and volumes, faster repair service, and tax-deductibility, along with considerations of universal service and gradualism -- do support maintaining a substantially higher rate for business than for residential service. The Commission is sensitive to the needs of small business and believes that reductions in business class revenues, the collapse of rate groups, and the advent of competition will work to increase service options and maintain or lower total telecommunications costs. The Commission believes that equities and social policies continue to support the distinctions among services and the rate differentials we approve in this order.

V. Local Exchange Services**A. Residential****1. Flat**

USWC proposes to increase residential rates in four annual phases, eliminate rate groups, blend EAS increments into the basic line rate, and introduce an "urban-rural" zone pricing structure. The statewide rate for a flat single party line in the final year would be \$21.85 in Zone 1 and about 20% higher at \$26.35 in Zone 2. USWC contends that residential rates must ultimately recover their fair share of costs or be supported by universal service funds. In its brief, USWC says that it must modestly deaverage its rates between urban and rural locations on a cost basis if it is to sustain its operations. It argues that residential rates are now below the national average in Washington State, that 30% of residential customers don't contribute to costs by making toll calls, and that nearly half of all customers don't contribute to costs by subscribing to ancillary services. The Company says the Commission should start by 1) setting a consolidated rate of \$19.69, including an average \$5.46 increase plus the revenues formerly provided by EAS, and 2) indicating its approval of the concept of zone pricing for future rate changes.

Commission Staff contends that the Company's costing methodology has been inconsistent with economic theory and prior orders. Staff contends that the Company has overstated the costs attributable to its basic residential service and that the existing rates are well above the monthly cost for that service (Ex. 602-T, 15-16; Ex. 605-C). If any cross subsidy exists, says Staff, it is contained within residential customers as a group -- not between residential and business customers. Staff supports the Company proposal that the current rate group/EAS additive structure be eliminated and replaced with a uniform statewide residential service rate. Staff, however, recommends a flat statewide rate of \$10 per month per line, which exceeds the monthly cost identified in Exhibit 605-C.

Public Counsel/AARP also contend that rates now cover costs and that the Company's presentation does not support an increase. They urge that common line costs are shared costs and should be recovered from all telephone users. They urge a statewide rate of \$8.43. TRACER cites Dr. Zepp (Ex. 788T and 789-C) and Mr. Spinks (Ex. 602-T and 604-C) to support its contention that residential rates are not subsidized. TRACER and DIS also support a single statewide rate, but take no position on what the rate level should be.

DOD/FEA contend that USWC cost studies for residential service were excessive but it does not endorse a rate reduction because much of the support mechanism for residential exchange service is subject to revocation under the terms of the federal Telecom Act or, for instance, in the case of Yellow Pages, is subject to erosion from increased competition. DOD/FEA contend that the Commission must be prepared for the unpleasant reality that monthly residential exchange rates probably must rise.