

- BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH -

In the Matter of the proposed Revisions of)	<u>DOCKET NO. 99-049-T05</u>
U S WEST COMMUNICATIONS, INC. to)	
its Utah Exchange and Network services)	<u>REPORT AND ORDER</u>
Tariff by Advice Letter 99-05)	

ISSUED: July 28, 2000

SHORT TITLE

Competitive Response Tariff

SYNOPSIS

The proposed tariff is rejected without prejudice.

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By The Commission:

On February 19, 1999, U.S. West Communications, Inc. (U.S. West, USWC, or the Company) filed revised pages of its Exchange and Network Services Tariff, Re: Competitive Response Offer. On March 3, 1999, the Division of Public Utilities (Division) recommended suspension of the proposed tariff, and proposed hearings to examine the need for the tariff and its potential impact on local exchange competition. The Commission suspended the proposed tariff on March 11, 1999, and scheduled hearings for Thursday, March 18, 1999, at 9:00 a.m. On March 17, 1999, at the request of U.S. West, the hearing was continued without date.

On March 31, 1999, AT&T Communications of the Mountain States, Inc. (AT&T) petitioned to intervene. On April 7, 1999, we granted the requested intervention.

On April 29, 1999, U.S. West submitted revised pages of its Exchange and Network Services Tariff to replace those originally filed and requested that a hearing be scheduled for May 7, 1999 at 9:00 a.m. Our April 30, 1999 Scheduling Order set the hearing date for that date. On May 4, 1999, at the request of the parties, the Commission vacated the May 7 hearing and continued it without date.

On May 4, 1999, NextLink Utah, Inc. (NextLink), and on May 6, 1999, Sprint Communications Company L.P. (Sprint), petitioned to intervene. We granted the requests on May 14, 1999.

A November 30, 1999 Division Memorandum recommended approval of the revised tariff based on information indicating that the proposed tariff would meet the price-floor, also referred to as the "imputation," test of Utah Code Title 54-8b-3.3 and Commission Rule R746-349-6. On December 15, 1999, NextLink filed a letter asserting that the proposed tariff would not meet the price-floor test because U.S. West's basic recurring and nonrecurring rates charged CLEC's for essential elements exceeded the rates customers would pay under the proposed tariff. U.S. West's December 22, 1999 response denied this claim and urged the Commission to approve the proposed tariff.

On January 10, 2000, the Commission issued a Notice of Hearing, scheduling hearings in this matter for January 26, 2000, and directing parties to present evidence on the total service long-run incremental costs (TSLRIC) of nonessential facilities and the prices of essential facilities that are required by statute.

At the hearing on January 26, 2000, U.S. West, the Division, and NextLink disagreed about implementation of the price-floor test. The Commission directed the parties to prepare a joint exhibit showing a price-floor test using common assumptions and time periods or, separately, the results of the test using each party's assumptions and data.

On January 27, 2000, U.S. West asked the Commission to issue a protective order for the Docket and on that date the Commission issued the requested Order.

On February 4, 2000, the Commission received filings from both U.S. West and NextLink. The parties had been unable to prepare a joint exhibit and so filed additional exhibits and comments separately. On February 7, 2000, the Division

filed a memorandum recommending approval of the tariff and proposing a monitoring system, to be employed by U.S. West, to track its implementation.

U.S. West proposes to contact former business and residential customers in order to offer inducements, in the form of credits, to return to U.S. West for telecommunications service. Specifically, U.S. West proposes that residential customers

. . .will receive either a waiver of the current nonrecurring charge, up to two months of recurring rates, or both, on selected services determined by U.S. West. Amounts and types of the waivers may vary. In addition, customers may be eligible for waivers of intraLATA MTS charges. . . . Total charges waived will not exceed \$100.00 per customer location. (Section 5, Page 66.4, Release 1)

The proposed tariff does not indicate the time period for which a returning customer must commit to take service from U.S. West to be eligible for the credit. For business customers, U.S. West proposes to waive

. . .the current nonrecurring charge(s), or up to two months of the current monthly rate(s), or both, on selective services as determined by U.S. West. In addition, returning business customers may be provided waivers of intraLATA MTS charges. . . . The total credit amount will not exceed the total nonrecurring charge(s) plus two months service of the monthly rate(s). (Section 5, Page 66.6, Release 1)

The proposed tariff requires at least a one-year service term in order for the credit provisions to apply.

The issue in this Docket is whether the pricing restrictions set forth in Utah Code 54-8b-3.3 (3) allow subsidization of a specific service by bundling it with other services. Stated differently, may USWC rely on the total expected revenues from a customer to pass this test or must each (group of) service(s) required under the tariff pass the test separately? Throughout the testimony of the parties, this requirement is variously referred to as a "price-floor," "imputation," or "cross-subsidy test". For reasons of clarity, and because the test identifies the minimum legal price that an incumbent can charge its retail customers, we will refer to it as the price-floor test.

Section 54-8b-3.3 (3) states:

(3) An incumbent telephone corporation may not price any public telecommunications service at a level which is less than the sum of:

(a) the total service long-run incremental cost of nonessential facilities used to provide the public telecommunications service in a particular geographic area; and

(b) the price of essential facilities used to provide the public telecommunications service in a particular defined geographic area.

This statute ensures that monopoly services do not subsidize competitive services, and that a dominant carrier can not sustain losses in one geographic area in order to prevent a competitive carrier from gaining market share. A dominant firm might find it in its economic interest to cross-subsidize products -- to lower the offering prices of competitive products below what a competitor must charge (to breakeven), while making up the revenue shortfall from products provided in the monopoly market -- in order to drive potential competitors from the market. Cross-subsidization could be used in connection with a loss-leader strategy to limit a competitor's market share. Any of these activities would be a hindrance to the development of a competitive market.

The law promotes the development of a competitive market structure, and it is to attain this purpose that we apply it here. We review applicable law, and based on the record provide the means of implementing it using the price-floor test.

Section 54-8b-3.3 (3) begins: "An incumbent telephone corporation may not price any public telecommunications service . . ." All parties discussed at great length what items should be included on the price side of the price-floor analysis. U.S. West suggests that including all revenues is appropriate. NextLink argues that only the prices of the specific services required by the tariff should be included in the analysis. The Division testifies that inclusion of revenues from features and toll may be appropriate, but its analysis does not include them. The statute simply states that the incumbent cannot "price a service" below a certain level. Logically this must refer to the price a customer actually pays for a service or bundle of services. For application of the price-floor test, we determine that the term "price" refers to the price a customer pays net of credits offered by the proposed tariff. The net price guides a customer's economic decisions. Any other interpretation disconnects the effective economic price, which the customer actually pays, from the price used in the price-floor test. Such a disconnection would produce market distortions harmful to the development of an efficiently competitive market place.

Application of the price-floor test requires specification of a time period for the analysis. If the time period is restricted to the moment the customer first returns to U.S. West, few credit programs would ever pass the price-floor test because the credits and the nonrecurring charges would appear in total rather than as amortized. All parties agree that a reasonable period to amortize credits and nonrecurring costs must be used. Where the initial price for a service is reduced by a one-time credit, and the customer remains connected for a long period, the effective on-going monthly price (in both U.S. West's and the customer's minds) is not reduced by the full credit amount, but by a fraction of it. Hence, the credit must be amortized over the relevant period of time to determine its effect on the on-going price perceived by the customer and U.S. West.

According to statute, the price of a service must be compared to the sum of the costs of nonessential facilities and the prices of essential facilities used to provide it. Section 54-8b-3.3 (3) (a) continues: "the total service long-run incremental cost of nonessential facilities used to provide the public telecommunications service in a particular geographic area . . ." (Emphasis added.) The term "nonessential facility" is introduced. The term does not mean "unnecessary," but rather that a competitor need not acquire the facility from an incumbent. The competitor can provide the facility itself or acquire it from another source. In other words, it is not "essential" for the incumbent to provide these facilities. They may be obtained elsewhere or the competitor must supply them itself, in order to provide a service equivalent to that provided by U.S. West. Thus, the total service long-run incremental cost (TSLRIC) of nonessential facilities enters the price-floor calculation.

Section 54-8b-3.3 (3) (b) requires "the price of essential facilities used to provide the public telecommunications service in a particular defined geographic area," introducing the term "essential facilities." Commission Rule R746-348-7 defines the term and lists the facilities deemed essential. These facilities are also termed "unbundled network elements." Though prices for most of them have been set by the Commission in Docket 94-999-01, interim pricing exist for some.

A complication in applying the price-floor test is the existence of significant nonrecurring costs associated with purchasing certain essential facilities from U.S. West. These costs, as with the proposed tariff's credits, must be amortized over an appropriate period of time. According to the proposed tariff, a returning business customer is eligible for credits if a service commitment term of one year is met; for residential customers, the tariff specifies one month. We determine these to be the relevant time periods for application of the price-floor test.

As a result, we conclude the price-floor test must be implemented (in general) as follows:

1. Identify the service or services offered. A given tariff may require an offering of a group of services (bundling). If bundling is required, the price-floor test will apply to the group of services as a whole.
2. The time period will be that specified by the tariff.
3. Based on the identified service(s) and time period, the on-going effective price (i.e., the price required by the statute) is determined.
4. This price is compared to the sum of the TSLRIC for nonessential facilities and the price of essential facilities, accounting for both recurring and amortized nonrecurring costs.

5. If the price offered the returning customer is less than the sum reached in Step Four, the proposed tariff fails to pass the price-floor test.

In this application, passing the price-floor test means that an economically efficient competitor, in theory, can just match the incumbent's prices by purchasing essential facilities from the incumbent and using them in combination with its own or other nonessential facilities to provide equivalent services.

In its February 7, 2000 Memorandum, the Division set forth six issues concerning the price-floor test which it stated must be answered in order to determine how the statute should be implemented. In explaining our decisions regarding the application of the statute and Commission rules, we feel it instructive to examine each of these issues, review the evidence about them presented by the parties, and provide direction concerning the Commission's view of these issues.

1. Does the proposed tariff require a bundle of services? U.S. West's testimony regarding whether services offered under the terms of the proposed tariff meet the price-floor test relies on all potential revenues from a given customer. This, in effect, means offering a bundled group of services. The tariff, however, does not require bundling services, but in the Division's view allows grouping or bundling of services. The Division therefore recommends performing the price-floor test for grouped rather than individual services. We conclude otherwise.

Since the proposed tariff contains no language requiring customers to buy bundled services, we find that the price-floor analysis must be conducted for each service. U.S. West testifies that the Company has internal guidelines restricting the credits offered to customers based on the services a customer purchases. These internal guidelines are not part of the proposed tariff and are not public. If these "internal guidelines" were both public and required, bundled services might properly be incorporated into the price-floor analysis. In the absence of such tariff provisions, the price-floor test must apply to single services.

2. Essential elements. The Division asks if the revenue and costs from ancillary features, access revenues, and toll services should be counted in the price-floor analysis, in effect taking the statutory term "essential" to mean those services usually purchased as a group when a customer signs up for local basic service. But the term "essential" refers to unbundled network elements (facilities) determined essential by Utah Law and Commission rules implementing it. Further, it is the price of the essential facilities that the law directs to be included in the calculation, not an internal cost U.S. West might incur to provide the similar facilities/elements to itself.

As to whether the revenue and costs (i.e., the prices associated with the essential facilities needed to provide the services) from certain access, feature or toll services are included

in the calculations must depend on the tariff terms proposed by U.S. West. As stated before, if the tariff imposes a specific bundling requirement in order for a customer to qualify for a credit then all of the revenues and costs—calculated in accordance with Section 54-8b-3.3 (3)—may be included in the price-floor analysis. However, since there is no such bundling requirement mentioned in the tariff, these items will not be included in the imputation analysis.

3. Nonessential elements. In its final memo to the Commission in this Docket the Division states that the parties agree that the nonessential elements (facilities) are features and toll elements. (Yet later on in the same memo the Division states that these elements were removed from its analysis.) However, NextLink testifies that there are other nonessential facilities involved in the provision of basic service that must be accounted for in the price-floor analysis. Specifically NextLink testifies that the avoided-cost discount offered to resellers of U.S. West's local basic service properly values the nonessential facilities used in the provision of basic local exchange service. The confusion regarding what nonessential facilities should be included in the price-floor analysis relates more to the parties' understanding of the term nonessential than to any underlying analysis problem. We do not view the essential - nonessential designation as the factor which determines whether a service's costs or revenues are included or excluded from the calculation. Obviously the law contemplates that the TSLRIC of nonessential facilities be included. Rather the issue of whether a given facility's cost (and the associated services' revenues) are included in the price-floor analysis relates to the bundling requirements imposed or required by the tariff. If the tariff requires bundling, the associated costs and revenues will be included in the analysis; if the tariff does not require bundling, the costs and revenues will not be included. Since U.S. West's proposed tariff does not require bundling, only the TSLRIC for the nonessential facilities involved in the provision of basic services will be included.

4. Amortization period. In order to conduct a price-floor analysis, a time period must be selected so that both credits and nonrecurring charges can be amortized. For its position on the proper time period, the Division investigated customer-retention periods experienced by local exchange companies. On this basis, it testifies that the three-year amortization period suggested by U.S. West is too long and the one-year period suggested by NextLink is too short. Responses to data requests received from four Utah facility-based providers lead the Division to recommend a two-year period.

U.S. West has the ability to identify each customer who switches to a competitor (if the service is provided using unbundled network elements or resold U.S. West services). U.S. West can analyze the profitability of each of these customers and on this basis can determine whether a win-back offer should be made. That this can be done almost concurrently with a switch-over gives us reason to believe that past indicators of expected customer retention periods are no longer valid. For this reason, we reject the assertion that a customer (once it has switched providers) is likely to remain the customer of a competitor for several years, and find that an analysis of the history of customer retention is not the proper way to determine an acceptable amortization period.

Choice of the proper time is important. If a very short period is chosen, a win-back tariff cannot pass legal muster. If the period selected is very long, almost any program, including those that amount to predatory pricing, could pass the price-floor test. Further, if any period is arbitrarily selected the party on the "losing" end of the analysis could complain that the choice was incorrect and point to another analysis, with the only difference being the time period, supporting its position. As indicated above, the Commission will rely on the one-month and one-year time periods defined by the proposed tariff.

5. Shared or Dedicated Transport. NextLink provides testimony containing a worksheet application of the price-floor test. This example employs dedicated transport. The Division argues that dedicated transport is improperly included in the price-floor analysis because the least-cost method of providing a service must be the basis for the test. Dedicated transport does not meet this requirement. Moreover, the Division notes that U.S. West does not use dedicated transport for local basic exchange service. We agree with the Division and conclude that the price of shared transport, as the required essential facility, should be included in the price-floor analysis.

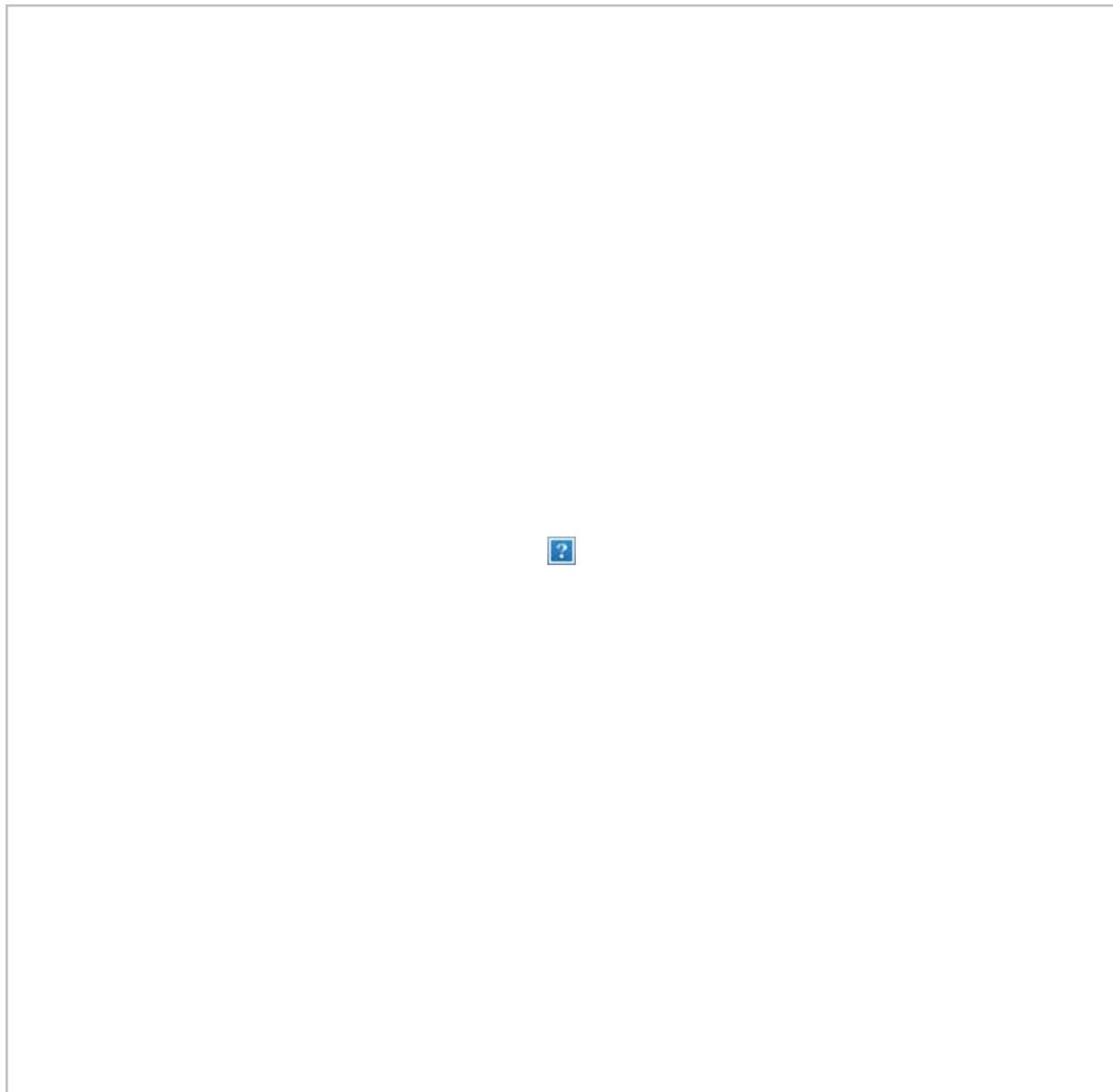
Since the Commission has not yet determined a price for shared transport, the Division recommends using the U.S. West Integrated Cost Model prescribed total element long-run incremental cost estimate provided in Docket 94-999-01 until the price for this essential facility is set. We agree, but note that a price for this element may be determined in a docket other than Docket 94-999-01 if necessary.

6. The nonrecurring charge for the unbundled loop. Parties disagree on a proper nonrecurring charge for the unbundled loop. Currently competitors in Utah, as documented on this record, face one of three nonrecurring charges for an unbundled loop. The first is the basic installation alternative charged a competitor when installation time is not specified and, following installation, no testing of the loop is required. The associated nonrecurring charge is \$120.25. When loop testing is required, but the switch-over of providers is not scheduled, the charge is \$163.64. If the switch-over is scheduled and the loop is tested, the charge is \$219.12. At issue before the Commission is the question of which charge should be included in the price-floor analysis. The Division and U.S. West argue for the lowest cost option. NextLink argues that a serviceable product requires a tested, scheduled loop, and so the highest charge reflects actual business practice.

A law designed to promote efficient competition would require, and we so conclude, the least-cost option associated with providing the *same or substitutable service*. "Least cost" means ". . . the input combination which minimizes the total cost of producing any *given output level*. . . ." (The MIT Dictionary of Modern Economics: Third Edition, pg. 85, emphasis added.) In our view, the notion of least-cost must apply, in the win-back context, to services that are the same or substitutable to those provided by U.S. West. The competitor must be sure that the customer it gains from U.S. West receives the same, functional phone service. In order for this to occur the essential facilities associated with the customer's line must function properly. Scheduling the switch over is less important, a matter of timing only. For this reason, we direct that at a minimum, the nonrecurring price of \$163.64, that charged for the loop with testing, must be included in the calculation. We note that depending on the type of service being provided, scheduling and testing may or may not be required. We simply find here that for basic exchange service (1-FB and 1-FR) the price of testing must be included.

As a guide to parties, we provide the following worksheet, with explanation, showing the calculation, according to

decisions we herein reach, of the price-floor test for this tariff. For purposes of illustration the analysis includes urban, suburban, and rural sections and covers time periods ranging from six to 36 months. The worksheet covers the business service case.



Throughout the worksheet various terms are used to connote specific concepts, these terms are defined below:

- Recurring charges - charges that occur on an ongoing basis, monthly.
- Nonrecurring charges - charges that are a one time expense.
- Amortized - A calculated recurring amount that equals the stream of payments/amounts that could be generated by withdrawing the recurring amount of money from the principal and associated interest on a monthly basis in such a manner as to completely exhaust the beginning fixed amount of money over the specified time period.

Appendix A contains the formulas used in the spreadsheet. Only the upper left-hand formula for each section is provided.

In Section A, the TSLRIC of nonessential facilities is drawn from testimony filed by NextLink and is derived by applying the 14.5 percent avoided cost discount for a resold service to the current U.S. West retail business service rate. Retailing costs avoided when resale occurs are the nonessential retailing costs incurred when the service is sold at retail. No party responded to NextLink's proposal to use the avoided cost discount to estimate the TSLRIC of nonessential facilities involved in producing basic local exchange service. For purposes of this Docket, we will accept it. Where other non-basic services are bundled, the TSLRIC of the nonessential facilities used to produce them would be added.

In Section B, the price of essential facilities used to provide services is either that set by the Commission in Docket 94-999-01, or, in the case of shared transport, an estimate based on the Division's recommendation in Docket No. 94-999-01 because the Commission has not yet set a price for shared transport. Prices of essential facilities are the recurring and nonrecurring prices currently in effect. We note that zero nonrecurring charges are associated with shared transport, however; if dedicated transport were used nonrecurring charges would be required for the analysis.

In Section C, the recurring costs of nonessential facilities and the recurring and nonrecurring (multiplied by the number of months) prices for essential facilities are summed to arrive at the total cost, for the stated time period, as required by the price-floor test. To illustrate, the sum of recurring costs of nonessential facilities and the prices of essential facilities is shown, and a time period, which varies from six to 36 months, is used to amortize the nonrecurring prices of essential facilities. Section C.2 reduces the total amount to an amortized monthly amount. Specifically it shows the amortized monthly cost for the non-recurring portion, calculated using, again for illustration, an interest rate of 11 percent. This amount is added to the recurring monthly portion.

Section D presents a calculation of revenues. Section D.1 shows recurring and nonrecurring charges from U.S. West's filed tariffs; Section D.2, the deductions or credits a customer could receive under U.S. West's proposed tariff; and Section D.3, the net revenue U.S. West would receive under the tariff. Net revenue is calculated by adding the monthly recurring charges, multiplying the sum by the appropriate time period, the non-recurring costs and subtracting deductions or credits. Section D.4 reduces the net revenue amount to a amortized monthly amount. Section D.4 is calculated by determining the monthly amortization of the net (negative) nonrecurring charges over the appropriate time period, to which is added recurring monthly revenue.

Section E is the difference between the two amortized monthly amounts; that is, Section C.2 less Section D.4. A positive value indicates a subsidy and a failure to pass the price-floor test. A negative (or zero) result indicates that the price-floor

test has been passed.

The worksheet shows that the proposed tariff yields calculations that fail to pass the price-floor test for all time periods but the two-and-one-half, and three-year periods for urban areas, and the three-year period for suburban areas. No requirements in the proposed tariff correspond to these periods. The proposed tariff must be evaluated using the one-year period for business service and a one-month period for residential. The one-year analysis shows a net monthly subsidy, a failure to pass the price-floor test, for business service of \$16.14 in urban, \$19.20 in suburban, and \$25.87 in rural areas.

It follows from our review of the record and decisions based thereon that the proposed tariff is unacceptable. The tariff must require customers to acquire service for periods of time sufficient to ensure that no subsidy occurs, or the services a customer is required to purchase must be grouped sufficiently to obtain the same result. Alternatively, the same result (passing the price-floor test) might easily be obtained from a reduction in the nonrecurring charges for essential elements.

NOW, THEREFORE, IT IS HEREBY ORDERED, that:

1. The proposed tariff is denied without prejudice.

2. Pursuant to U.C.A. §63-46b-13, an aggrieved party may file, within 20 days after the date of this Report and Order, a written request for rehearing/reconsideration by the Commission. Pursuant to U.C.A. §54-7-15, failure to file such a request precludes judicial review of the Report and Order. If the Commission fails to issue an order within 20 days after the filing of such request, the request shall be considered denied. Judicial review of this Report and Order may be sought pursuant to the Utah Administrative Procedures Act (U.C.A. §§63-46b-1 et seq.).

DATED at Salt Lake City, Utah this 28th day of July, 2000.

/s/ Stephen F. Mecham, Chairman

/s/ Constance B. White, Commissioner

/s/ Clark D. Jones, Commissioner

Attest:

/s/ Julie Orchard

Commission Secretary



The cell numbering within the formulas is in standard spreadsheet format the letter refers to the column and the number refers to a line,

hence C6 refers to column C and row 6. A \$ sign preceding a letter or number reference within a cell reference simply means that reference will be frozen or fixed if the formula is copied. Within a given section of the worksheet once the formula has been entered into the uppermost lefthand cell it can be copied to all other cells within the section.

The @AMPMT formula is the amortization formula used to spread the effects of the nonrecurring charges and credits over the time horizon. Specifically the function calculates the (monthly) payment needed to complete amortize a fixed amount over time accounting for the interest. The arguments within the function are as follows: @AMPMT(Principal, Interest Rate, Term of Amortization).

For example, the formula in cell C37 is as follows:

$(@AMPMT((B\$16+B\$19+B\$22),I\$1/12,$A36))+(B\$10+B\$15+B\$18+B\$21)$.

The explanation of the formula is as follows:

First argument (Principal) = $(B\$16+B\$19+B\$22)$ = All nonrecurring charges incurred by the CLECs.

Second argument (Interest) = $I/12$ = Stated interest rate, contained in cell I1, divided by 12 to correspond with the monthly analysis.

Third argument (Term) = $A36$ = The number of months in the analysis.

Remainder of the formula (recurring monthly charges) = $+(B10+B15+B18+B21)$.