ORAL ARGUMENT – 9/29/04
03-0789
AT&T V. PUC

LAVALLE: The primary issue before the court is whether the PUC has jurisdiction to hear AT&T's complaint that SW Bell and its long distance affiliate have engaged in an unlawful, discriminatory, preferential price squeeze. A price squeeze supported by improper, intra company cross subsidization, a price squeeze harmful to the health of competition in the Texas in-state long distance market.

The second issue is whether the commission can by way of remedy order a reduction in the wholesale switched access rates that Bell charges to Texas long distance carriers. If it finds that the complaint of price squeeze is enabled, is funded by the above cost in states which access charges that SW Bell charges to nonaffiliate long distance carriers.

O'NEILL: So you would amend §58.025(a) to say, instead of not under any circumstances to be only if anti-competitive?

LAVALLE: No. In fact there's no such amendment necessary or appropriate. We have in (b), which immediately follows subsection (a), in fact the same effect perhaps even more sweeping when the legislature said that regardless of subsection (a) and its under any circumstances and prohibition against hearing on the reasonableness of rates, that nonetheless this section does not prohibit a complaint that comes under chapter 60, the competitive safeguards provisions of PURA. And in fact, the legislature was so firm on its point that this savings clause should operate to preserve the jurisdiction of the commission to hear and investigate anti-competitive allegations, that it put in a counterpart in chapter 60. Under 60.002 it said that §58.025, the very provision J. O'Neill that you just referred to, that §58.025 does not prevent the commission from enforcing this chapter.

O'NEILL: But wouldn't you say as long as rates are not affected pursuant to subsection (a)?

LAVALLE: Absolutely not. And in fact, what subsection (a) does it really puts into place the restriction against having a traditional rate of return hearing. And AT&T agrees that what subsection (a) means is that the commission cannot on any given day decide in response to a complaint from a consumer or a customer decide on its own whim that it's a good day for a traditional ratemaking hearing. That's what subsection (a) of 58.025 presents. That's what it restricts. And it deals only with the reasonableness of the rates. A term used traditionally in the jurisprudence of this state and others to talk about the traditional kind of rate design and rate regulation, rate of return kind of ratemaking and design. It does not go the further step of saying that under no circumstances can a rate that is otherwise unlawful come under review if it is part of a plan and a scheme to affect anti competitive behavior.

HECHT: But you concede I take it that that would give the commission considerable latitude in adjusting switched access rates or not?

LAVALLE: I don't know that it gives it considerable latitude. It certainly does give it some latitude. The fact that the legislature wanted the commission to have that latitude, I think is driven home by the fact that the only statutory provision that directly restricted the ability of the commission to order such a reduction is 58.062. 58.062 was repealed in 1999. Section 58.062 said that notwithstanding any other provision the commission may not reduce an electing company's rate for switched access services before the expiration of the cap...

HECHT: But the briefs indicate that at some point not long ago the rate was 11 cents a minute. Is that right? Now it's something like 5 or 6 cents a minute.

LAVALLE: I think it is closer to 6.

HECHT: So that's quite a bit of latitude there. 50%. And I guess your view of it is that the commission could come in and make a substantial reduction in the rate.

LAVALLE: Not because the commission thinks that the rate is simply too high. What it can do as a remedy in response to an allegation and finding of anti competitive activity. And the reason it can do that is not just because §58.062 was repealed and thus it has to be considered not to be a statement of current Texas law. But because the jurisdiction was already there before and after 58.062. The prohibition against reduction of access rates was already there in chapter 60 before and after that repeal.

The provisions of ch. 60 and specifically on page 1, 60.003 directly addressed what the commission's authority is, what it's jurisdiction is. And provides under subsection (a)(2) that the commission has authority to resolve any dispute that arises under the policies of this chapter, that being chapter 60. Those polices include any of those as indicated in (a)(1), not just subchapters (b) and (h), but also subchapter (a). And the very, very first competitive safeguard that's listed by the legislature in subchapter (a) of ch. 60 is one dealing with fair competition in which the commission is charged with effecting rates that are fair to each participant that are not unreasonably preferential, prejudicial or discriminatory and that are applied equitably. That is the essence of a price squeeze claim.

OWEN: But looking at the way this is set up. It talks about unreasonably preferential, prejudicial or discriminatory which to me implies some difference between what you are charging yourself or your affiliate as opposed to someone else. And then you go to section 60.003 and it gives specifically what the commission has authority to do. It says it can establish procedures for subchapters (b) through (h). It doesn't say (a) through (h). It says also you can adopt procedures for (b) through (c). It doesn't say (a). It also talks in terms of ch. 58, competitive safeguards that the company puts into effect. And that's not 60.001. So I'm having trouble linking up the language the way you want us to.

LAVALLE: First, when you look at 60.003, it's not limited to (b) through (h). In fact it says explicitly establish procedures with respect to a policy stated in this subchapter. That's subchapter (a), or subchapters (b) and (h). And it authorizes the commission, really commands them to enforce the policies that are set forth throughout chapter 60. The first one deals with those rates that are unreasonably preferential, prejudicial or discriminatory. A price squeeze is a type of preferential rate, because even on its face, although it may appear that these are out of pocket expenses both to the affiliated and the nonaffiliated long distance carriers, in fact under the price squeeze as we believe and have alleged occurred, the charge comes out of one pocket and goes back into the other.

OWEN: Why isn't that a problem with imputation and not so much the rate per se. As long as the same rate is charged across the board to everyone it's not preferential. There may be another problem on how you calculate on imputation internally. Why isn't that an imputation problem as opposed to looking at the rate itself?

LAVALLE: Because if it's funded by cross subsidization then it's unlawful. It's a form of preferential pricing.

OWEN: But isn't cross subsidization covered under imputation? Isn't that how you get at that?

LAVALLE: The question is whether - regardless of whether it is also covered under imputation, a price squeeze is a form of preferential, prejudicial pricing. Because the effective rate being charged to your affiliate is different than the rate being charged to the nonaffiliated carriers. In other words, and on top of that the profits that's made from the above cost rate charged to the nonaffiliated carriers actually funding the ability of the affiliated long distance carrier to charge rates with which other carriers simply cannot compete.

* * *

ATTORNEY GENERAL

LAWYER: The principal reason the commission is here today is to ask this court to recognize the commission's authority to ensure fair competition as authorized by the legislature under ch. 60...

HECHT: I'm a little unclear from your brief whether you think you can grant relief or not and, if so, what it would be?

LAWYER: The commission does believe it has authority to grant relief. Specifically the commission could grant injunctive relief that would compel the two Bell companies, the long distance affiliate and the local company, to comply with the statute.

HECHT: Charge a different rate?

LAWYER: No. Not charge a different rate, but comply with this statute that is not cross subsidized between the two affiliated companies. And the commission could also impose civil penalties if it found a violation of the statute. In addition, the commission does believe it has authority to reduce switched access rates if it finds a violation. But the premise here would be that the commission first has to find a violation of the statute. The commission has yet to be given the opportunity to even investigate the allegations.

O'NEILL: Here's where I am confused. Are there a class of remedies that can be imposed that don't affect the rate? You said they could prohibit cross subsidization but wouldn't that affect the rate?

LAWYER: No. The remedy - well AT&T's allegation is that by charging above cost switched access rates, the local company is subsidizing the below cost long distance rates that the long distance affiliate charges to consumers. And basically you've got one company that earns all the profits and another company that operates at a loss. And the commission could by way of injunctive relief command the long distance company to charge a price that would recover the full switched access rate that is being charged to all long distance competitors by the local company.

O'NEILL: They would have to then raise their price.

LAWYER: The long distance company would have to raise its price. It would not affect the switched access rates.

BRISTER: That's going to be an on going process because their cost of doing business changed month to month, week to week, so you are going to have to change that price. Can't you just prohibit the cross subsidization?

LAWYER: Yes. The commission could do that as well.

BRISTER: You wouldn't have to get involved in pricing at all to do that.

LAWYER: No.

BRISTER: Is there such a claim in this case?

LAWYER: The remedies sought by AT&T is a reduction of switched access rates or any other relief to which it may be entitled.

BRISTER: But if what you are aiming at is the wrong imputation as J. Owen said, you are going to have to keep doing that, you are going to have to keep adjusting that rate and we're going to be back to the old system where we are just adjusting the rates. Right?

LAWYER: No. I don't think so.

BRISTER: If the cost of electricity or whatever it is the costs that go into this go up, then you are going to have to change that rate because now the rate you imposed on them is too low. It's going to have to be raised and then have to be lowered.

LAWYER: No. Because what we have here is an allegation of anti-competitive conduct. If the court recognizes the commission's authority to address that anti-competitive conduct, then it may result in only a one time change to the switched access rates. The commission is not engaging in traditional rate making principles as this court found in Cities of Austin. That involves principles of rate design such as looking at the overall revenues of a company, the net income, and setting a rate that would be just and reasonable allocated across all consumer levels. And that's not what the commission is trying to do here. The commission is simply trying to investigate allegations of anti-competitive conduct made by AT&T. And the CA's opinion is actually wrong in that it says the commission is seeking to actively reduce the switched access rates. That's not what the commission is after at all in this hearing. The commission has bifurcated the hearing process and phase one will investigate simply whether there has been a violation of the law.

HECHT: But you don't have hearings for no reason. The only reason you are going to have a hearing is either to decide to do something or not to do anything. But if there's nothing you can do there is no reason to have a hearing.

LAWYER: That's true. But ch. 60 does give the commission authority to ensure fair competition. And §60.011 commands the commission to ensure that the rates and rules of an incumbent, like SWB, are not unreasonably preferential, prejudicial, or discriminatory. So the commission has authority to hold a hearing to at least investigate those allegations of AT&T. The commission may well find that there is no violation, that the rates are not preferential, prejudicial, or discriminatory, and that may be the end of this case. But the commission must be allowed to carry forth the legislative mandate of ensuring fair competition. You can't just halt the administrative process before it even gets started.

HECHT: There is some argument that that position was advanced in the legislature and did not get traction. What's your response to that?

LAWYER: The legislature did address that argument in the 1999 amendments to PURA. The legislature did three things in the 1999 amendments. First, it mandated specific reductions to switched access rates. There was a 1 cent reduction followed by a 2 cent reduction. And second, the legislature repealed the only statutory prohibition against further commission reduction of switched access rates. And finally, third, the legislature preserved ch. 60, which authorized the commission to ensure fair competition. And by doing so the legislature addressed AT&T's argument at the legislature that heah, there might not be a price squeeze right now, but if events develop we want the commission to be able to address that.

* * * * * * * * * *

RESPONDENT

LAWYER: I would like to begin with a brief review of the history of switched access rates, which are a product of rate design.

O'NEILL: The PUC does have a function to oversee the industry and to make sure that anti-competitive behavior doesn't happen. That's part of the mandate. Would you agree with that?

LAWYER: I agree.

O'NEILL: How do they do that here? Is there a way they can have a bifurcated hearing to determine whether there has been any competitive behavior and then craft a remedy that would not affect switched access rates like she said enjoin any cross subsidization?

LAWYER: The judgement of the DC in this case enjoins a hearing only as to reduction. It specifically states that the commission can consider competitive safeguards under ch. 60 involving matters other than the reasonableness of the rates. I think there are two statutory reasons why the commission has no authority to consider the level of the rates. First of those incentive regulation 58.025(a), the commission cannot under any circumstances reduce the rates or hold a hearing concerning the costs of services. Secondly, and this hasn't been properly emphasized, switched access rates became kind of a political issue. You remember the ads: it cost more to make calls from Midland to Marfa than it does from Midland to Honolulu. That was AT&T's complaint over the years about switched access rates. The reason for that is that the Honolulu call is not intrastate. The FCC took a different approach and they imposed a per line charge. Whether somebody made long distance calls or not it's $3-$4 a month on every line.

The Texas commission said no. We don't want to design our intrastate rates that way. We want to impose access charges on long distance carriers for their use of the local network. It started out as J. Hecht pointed out somewhere around 13 cents. I think it got down over the years and in 1995 when the legislature adopted incentive regulation, those rates in existence at that point were capped. But the controversy continued. And in their 1999 report to the legislature, the commission said to the legislature that these rates have been frozen at this higher level for some years, the legislature may wish to address them. The legislature did. It required in 58.301 and .302 reductions in switched access rates. One of them was key to the very time when SBCS, the long distance affiliate, entered into business. Those reductions have now taken place. And Sen. Sibley, said Look, the legislature has set these rates and that the commission has no power to do anything about it, certainly not to decrease them.

BRISTER: The legislature didn't set the long distance rates.

LAWYER: No. Set the access rates.

BRISTER: And if some local telephone company is subsidizing its long distance affiliate, does the PUC have jurisdiction to do something about it?

LAWYER: Subsidization is something that happens all the time in the sense that some rates recover costs, other rates do not. In Texas, local service rates do not cover all the costs. And for that reason, you have to have other rates that are higher in order to recover the costs. That's the situation when rates were frozen in 1995.

So rate design is something that is prohibited when you have an electing company. You can't go in and say SWBT, you need to lower your switched access rates, without as your honor pointed out earlier, also considering whether you have to compensate for that by raising the rates of local service that are below cost.

HECHT: But to refine the question a little bit. Is anti-competitive, cross subsidization something the PUC ought to concern itself with and try to remedy?

LAWYER: Anti-competitive but not in the sense of reducing rates.

HECHT: And you think they can do that under the TC's order?

LAWYER: Yes.

JEFFERSON: What remedy could the TC impose in a separate hearing that doesn't involve ____?

LAWYER: I think the TC could decide that the switched access or the commission could hear a hearing as to determine whether these switched access rates are being applied reasonably, consistently. But let me point to one thing under 60.001 that hasn't been mentioned. When the legislature set these rates, the legislature said SW Bell is free of course to reduce them further, but if they are reduced further, 60.001 applies. The legislature did not say that 60.001 applied to the rates it set.

OWEN: What if you don't reduce. You stick with the cap that's in effect, let's say 5 to 10 years, but over time the long run incremental cost of service is more than that cap. What happens then?

LAWYER: I'm troubled by any proceeding before the commission that would have to do with the level of rates because that gets us back in to what costs are. And we're returning then from incentive regulation to regulation or re-regulation. I don't know what the commission could do. I think in many respect, I would say they can't do anything on the basis of these facts, because SW Bell is charging the rate authorized by the legislature.

OWEN: SW Bell is statutorily authorized to decrease their rates. And if they do, then the commission can look into whether that rate is above the long run incremental cost of service.

LAWYER: They can reduce them down to long run incremental costs.

OWEN: So the commission has to determine what long run incremental costs are to determine whether that rate is above or below.

LAWYER: You are correct.

OWEN: But if they don't decrease, if they stay at the cap, is it important or not under the statute for somebody to look at out of the 5, 10 or 15 years down the line whether that rate is above long run incremental costs of service?

LAWYER: I think my first answer would be that the remedy is at the legislature as to switched access rates. That's exactly what the legislature did when they set them. You have another report, a 2001 report to the legislature which the commission says will you please give us the authority to reduce switched access rates further. The commission not only in that session but in the subsequent session did not act.

O'NEILL: And you're saying they could do that here? You're not complaining that they could have a hearing, they could have the hearing, the TC could enjoin cross subsidization if it found anti-competitive pricing. And the commission could we would like to reduce the _________ but we can't by the statute, but legislature you please do it.

LAWYER: In this case we have not an investigation or a hearing to develop the facts. Everybody knows the facts. In this case we have a complaint by AT&T which the commission has no jurisdiction to consider, the essence of which is we are requiring you to reduce switched access rates. We're not talking here about some investigatory power the commission may have, or some remedy to support its request to the legislature for reductions or that type of thing. We're talking about a lack of jurisdiction on this complaint by AT&T, the essence of which is to require a reduction.

OWEN: What if there is a price squeeze. Can you be specific about how the commission could remedy that.

LAWYER: I don't really understand the price squeeze in this sense. There are plenty of protections in federal law as well against cross subsidies. The FCC has accounting rules that would reflect whether a cross subsidy is taking place. It's controlled by federal law. Of course, when you have a business operation it's going to make profit on some and not make profit on others, and it uses that to run its business. That's what SWBT is doing. There isn't any problem about having a holding company in which some units are providing one service and other units are providing a different one. And that's how business operates. This is not a regulated question. It's competition. And under competition...

BRISTER: But one of these is a monopoly.

LAWYER: No. I would disagree with you. Both the local and the long distance market

have been open to competition. That was the purpose not only in setting regulation but of the federal act. And here we have complete competition in the long distance market.

HECHT: And do you say then that 58.302(b), which allows the electing company to switch access rates further subject to not reducing them below long run incremental costs, the ability of the commission to come in and look at fair competition under that provision, it's your view that protects the local telephone market? It certainly doesn't protect the long distance market.

LAWYER: No.

HECHT: So this prevents unfair competition in the local market. Is that the purpose...

LAWYER: You need to understand the price squeeze argument that AT&T is making.

HECHT: I understand that argument. You mentioned earlier that the electing company can reduce the rates at its own initiative subject to limits and subject to review under ch. 60. Why would you review it under ch 60? To prevent unfair competition in the local market?

LAWYER: Whether it be the local market or not, I think what the legislature intended is that under ch. 60.001 if SW Bell reduced it they could not reduce it for everybody accept AT&T for example.

HECHT: But if they reduced it to below their costs, then what?

LAWYER: The commission could say you don't have any authority to reduce it below your cost.

Let me address the 4 arguments that I understand AT&T and the commission are making here. I've talked about 60.001. It seems to me that's answered clearly by the fact the legislature was aware of that. They said 60.001 applies if SW Bell reduces. But the legislature did not subject its own rates that we are setting to commission review. And that is in addition to the prohibition against any hearing concerning the rates of an electing company. And this court in Cities of Austin rejected the same argument that's made here, that 58.025 does not simply apply to traditional rate cases, but it prohibits commission's review of rate design issues. That's what Cities of Austin plainly held.

Third, the repeal of 58.062. That was a provision in the statute before the legislature acted that said the commission is prohibited from reducing switched access rates. I think that's been in there all along because of the controversy about switched access rates.

That was repealed. Why? Because the legislature required reduction of switched access rates. So 58.062 would have been in conflict with .301 and .302. That's why it was repealed.

HECHT: But not if .301 and .302 just sort of set caps. If they just cap the rates. They can go lower. Perhaps you should go lower.

LAWYER: They can go lower but only at the initiatives of SW Bell. The 60.001 argument that I understand the commission is making goes too far. What they are saying is that we've always had this authority under 60.001 to reduce rates if we found that that was unfair to competition. Now that would lead as the CA said to the absurd result that despite the legislature setting the rates, despite incentive to competition instead of regulation, that the commission has always had this authority. And that would send us right back to rate regulations. So the repeal of 58.062 didn't remove a barrier. The commission has never had any jurisdiction under 60.001.

What the CA correctly did was to consider the statute as a whole. And while 60.001 doesn't grant authority to the commission to reduce rates, it does give the commission authority to assure that any rate reductions that SW Bell might make are not discriminatory.

OWEN: Can you help me understand what the legislature is getting at in 58.302(b). It says notwithstanding ch. 60(f), which deals with pricing, what does that got to do with all of this?

LAWYER: Notwithstanding (f) is something that's been in the statute all along. That refers to a pricing rule that is one of the competitive safeguards. And I think the legislature is saying that that doesn't apply either. That's my understanding of what that language means.

OWEN: What does (f) pricing apply to? Does it apply to switched access rates?

LAWYER: It applies to all local exchange companies, not whether they've elected incentive regulation or not. Ch. 60 is a universal application in that sense. But the great bulk of ch. 60 can still be enforced. That's what the reference to ch. 60 safeguards meant. Look at what it covers: unbundling; resale; imputation; the pricing rule in (f); interconnection; infrastructure sharing; joint marketing; affiliate rules. That is the great body of jurisdiction that the commission has under ch. 60, not rate setting authority.

Let me address the complaint against SBCS here, the long distance affiliate. Separate company, required by federal law to be separate, safeguards under the federal act to be sure that it operates separately. All of that. And as I said earlier, the long distance market has been fully competitive since 1993. We all know that from the number of calls we get about shifting from this carrier to another. And the commission's jurisdiction over long distance is very limited. It's essentially insofar as it involves this case, involves two things. First, the complaint that AT&T originally filed is under 52.107. And it alleged predatory pricing. We're not saying the commission doesn't have jurisdiction over that. But what happened? When the proceeding got to the point where AT&T was going to have to answer some discovery, they took a non-suit on .107 so they wouldn't have to do that.

So the only basis for defending now the complaint against SBCS is .108 that

has to do with discrimination among customers. But if you look at the AT&T complaint it doesn't have anything to do with discrimination among customers. In fact, AT&T says we don't want the commission to do anything that would deprive customers of low prices. What we want is a reduction in switched access rates.

I think that any of these competitive safeguards would be available for the commission.

* * * * * * * * * *

REBUTTAL

LAVALLE: I will try to respond to many of the questions that came up in the argument of SWB. The most pressing issue, I believe that was addressed is whether or not the judgment of the DC as affirmed by the CA does or does not enjoin a hearing from taking place? does or does not enjoin investigation into anti-competitive activity? AT&T and the commission take no consolation in the generalization that well of course you can have a hearing on anti-competitive activities. Because when you look at the actual language in the judgment, it says in fact the opposite. When you get into the specific issues it prohibits the commission from looking at. Those specific issues that prohibits the commission from looking at include the allegation of cross subsidization. They include the allegation of setting rates in a way that is anti-competitive. They include each and every one of the unlawful practices that is spelled out in the complaint of AT&T. So a generalization gives us no comfort. And in fact what they say is, because the cross subsidization and the price squeeze is affected by, because AT&T alleges that the means and method through which the price squeeze occurs is through the charging of this above cost switched access rate that from that allegation as to the means and methods by which the improper act occurs and is allowed to occur profitably...

OWEN: It seems like the legislature consciously decided to allow the ____ to charge an above cost ______ switched access rate. That much seems clear.

HOGAN: Absolutely and there's no question and there's no disagreement among the parties that it is an above cost rate and that it was acknowledged to be an above cost rate. The issue is, an unlawful practice. What do you do with that margin? If your cost is ½ cent, and you are charging your competitors 6 cents, then the corporate family of SBC is incurring a cost of ½ cent for its long distance minute. We're having to recover in our charges to end users 6 cents. It's that margin, that price squeeze that ultimately for the long distance of the instate long distance market is particularly harmful.

HECHT: Why isn't that predatory pricing?

HOGAN: It can be predatory pricing if it is below cost. In a sense if the standards that the commission identified, it could be a species of predatory pricing. But I really think what is going on here is that it is a function of the cross subsidization. We actually disagree that this is a simple matter of everybody recovers costs differently depending on what products they are offering, what

services are being provided. It is recognized in fact that the market for in state switched access is one dominated.

HECHT: But you've abandoned the predatory pricing claim. It's hard to see a difference between that and the claim that you are still advancing.

HOGAN: The predatory pricing claim was dropped through amendment. There's no question. The cross subsidization absolutely was not. And it's that cross subsidization and the ability...

HECHT: If there is cross subsidization as you say, why wouldn't that be predatory pricing?

HOGAN: You could have cross subsidization and still not be charging a rate that's below your cost. And in fact, we believe that the standard for proving an unlawful cross subsidization frankly is less onerous than proving predatory pricing. And the commission is charged we believe with ensuring that neither one occurs. So in answer to the basic question about what the injunction prohibits, there's no question that it prohibits an investigation because it links any consideration that might take into account how those excess rents(?) that above cost amount is being used to fuel improper conduct because that is the means and method alleged that therefore no hearing occurs.

The next question that came up was whether or not this issue had already been tried in some political sense before the legislature? I think it's critical to note that in the 1999 legislature when these particular issues were addressed, SW Bell was not in the long distance market. It had not yet obtained authority to offer out of territory long distance. And so in fact the price squeeze was raised as a concern. The fact that that fear has come to fruition does not make the claim any less viable and does not in fact limit the court's jurisdiction.