STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER, *Governor*

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
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**F I L E D**
08-03-07
01:14 PM

August 3, 2007

Agenda ID #6867
Quasi-Legislative

TO PARTIES OF RECORD IN RULEMAKING 06-06-028

This is the proposed decision of Commissioner Chong. It will not appear on the Commission's agenda for at least 30 days after the date it is mailed. The Commission may act then, or it may postpone action until later.

When the Commission acts on the proposed decision, it may adopt all or part of it as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the proposed decision as provided in Article 14 of the Commission's Rules of Practice and Procedure (Rules), accessible on the Commission's website at www.cpuc.ca.gov. Pursuant to Rule 14.3, opening comments shall not exceed 25 pages.

Comments must be filed either electronically pursuant to Resolution ALJ-188 or with the Commission's Docket Office. Comments should be served on parties to this proceeding in accordance with Rules 1.9 and 1.10. Electronic and hard copies of comments should be sent to ALJ Pulsifer at trp@cpuc.ca.gov and Commissioner Chong's advisor, Lynn Carew, at ltc@cpuc.ca.gov. The current service list for this proceeding is available on the Commission's website at www.cpuc.ca.gov.

/s/ ANGELA K. MINKIN
Angela K. Minkin, Chief
Administrative Law Judge

ANG:hl2

Attachment

Decision **PROPOSED DECISION OF COMMISSIONER CHONG**
**(Mailed 8/03/2007)**

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

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| Order Instituting Rulemaking into the Review of the California High Cost Fund B Program. | Rulemaking 06-06-028 (Filed June 29, 2006) |

# INTERIM OPINION ADOPTING REFORMS TO THE HIGH COST FUND–B MECHANISM

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# INTERIM OPINION ADOPTING REFORMS TO THE HIGH COST FUND–B MECHANISM

## 1. Introduction

By this decision, we adopt essential preliminary reforms to the California High Cost Fund–B (CHCF-B or B-Fund) program. Pursuant to Public Utilities Code § 739.3, the CHCF-B program was established in 1996 as part of a broader policy framework to ensure that universal telephone service goals are met throughout California. The CHCF-B program was designed to support "universal service" goals by ensuring that basic telephone service remains affordable in high cost areas within the service territories of the major incumbent local exchange carriers (ILECs).

As a result of the preliminary reforms implemented in this order, we estimate that the B-Fund (currently at $434.6 million) will decline by approximately $315.4 million by January 1, 2009, representing a 74% reduction in subsidy expenditures. As explained below, we thus reduce the B-Fund retail surcharge from 1.3% to 0.5% effective January 1, 2009. Also, in the next phase of this proceeding, we expect to institute further reforms designed to target any remaining price supports in a more efficient manner consistent with our universal service obligations. In adopting the reforms herein, we uphold our obligation to meet universal service goals while recognizing the dramatic changes in the competitive landscape of voice services that have occurred over the past decade. Our adopted reforms are consistent with the uniform regulatory framework (URF) for the telecommunications industry that we initiated in D.06-08-030 in which the Commission found that:

> "the ubiquity of the FCC unbundling policies limits the market power of AT&T, Verizon, SureWest, and Frontier. Cross-platform competition, particularly that from wireless and VoIP technologies, provides an additional check that reduces market power of each carrier. Also Verizon and SureWest have demonstrated the presence of competitors throughout their entire service territories. Thus, a geographically specific analysis of policy and competitors makes clear that the ILECs no longer possess market power."[1]

We are also guided by governing federal and state statutes regarding universal service principles as well as legislative and Commission mandates for review of the B-Fund.

Under the B-Fund program, a Carrier of Last Resort (COLR) must offer basic residential service to all customers within a designated service area, and receives funding to subsidize affordable basic rates in high cost areas. Prior to the B-Fund program, a system based on implicit cross-subsidies had kept basic rates affordable.[2] By replacing these implicit cross-subsidies with a separate explicit subsidy fund, the CHCF-B was designed to facilitate competitive cost-based pricing for services other than basic service, while supporting the affordability of basic service. Thus, historic pricing structures that would price business services higher than comparable residential services or price intrastate long distance service higher than cost could be reduced or eliminated with the creation of the B-Fund.

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[1] See D.06-08-030, at 132.

[2] Because the ILEC basic rates were set based upon an average between high and low cost areas, including profitable and less-profitable areas, basic residential rates in High Cost areas were internally subsidized by revenues from more profitable exchanges, subsidies between product lines, and from other sources of revenues. (See Decision (D.) 95-07-050; 60 CPUC 2d, 536, 546.)

The reforms adopted herein address the significant market and regulatory changes since the B-Fund program was initiated in 1996, and focus on (a) the criteria for eligibility to draw subsidy support and (b) the updating of the high cost proxy used to derive the level of subsidy disbursements. Our goal is to enable the forces of competition to set appropriate prices while preserving access to affordable telecommunications services in high cost areas of California.[3]

This decision completes the review required by the legislature in Senate Bill (SB) 1276 (Chapter 847, Statutes of 2004) to update the B-Fund and evaluate reducing the size of the B-Fund. Our review revealed that the existing level of the B-Fund benchmark threshold is overly inclusive and results in subsidies to basic lines beyond the level that is required to meet the Commission's universal service goal of a 95% penetration rate for basic service.

In crafting of reforms to the B-Fund program, we note reforms being considered at the federal level,[4] and shared concerns regarding the need to rein in the growth in subsidy levels paid to support universal service goals.[5] In this

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[3] Cal. Pub. Util. Code §§ 709(a), 709.5(a).

[4] On May 1, 2007, the Federal-State Joint Board on Universal Service released a Public Notice seeking comment on several proposals for possible reforms including reverse auctions, GIS technology and network cost modeling, disaggregation of support, support for competitive carriers, and broadband support. *Federal-State Joint Board on Universal Service Seeks Comment on Long Term, Comprehensive High Cost Universal Service Reform*, WC Docket No. 05-337, CC Docket No. 96-45, Public Notice, FCC 07J-2 (Fed.-State Jt. Bd., rel. May 1, 2007) (*Public Notice*).

[5] In its Recommended Decision released the same day as the *Public Notice* seeking further comment, the Federal-State Joint Board expressed concern that High Cost support at the federal level has been rapidly increasing in recent years, and found that immediate action is needed to restrain growth in the funding of eligible carriers by imposing an interim cap on high cost support. *Federal-State Joint Board on Universal*

*Footnote continued on next page*

interim order, we scale back B-Fund subsidy levels by raising the threshold benchmark for defining "high cost" areas. We will thereby target support levels more efficiently to cover only those "high cost" areas where funding is necessary to meet universal service goals. The act of updating the benchmark threshold will reduce the overall amount of high cost support provided to COLRs, and will produce a significant consumer benefit as the surcharge on all California consumer bills will be reduced going forward.

In order to facilitate a smoother transition, the changes in the threshold benchmark adopted herein shall be phased in gradually beginning October 1, 2007, and concluding by January 1, 2009. We likewise reduce the B-Fund retail surcharge from 1.3% to 0.5% effective January 1, 2009. There is no reason to delay implementing reductions to the B-Fund subsidy draw until the rate freeze expires January 1, 2009. We did not change the level of basic rates when the CHCF-B support levels were first established, and likewise need not change basic rate levels as a result of the revisions in B-Fund support levels implemented herein.[6]

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*Service*, WC Docket No. 05-337, CC Docket No. 96-45, Recommended Decision, FCC 07J-1 (Fed.-State Jt. Bd., rel. May 1, 2007) *(Recommended Decision*).

[6] The Commission began updating its telecommunications policies in the late 1980s to respond to significant changes in the telecommunications marketplace resulting in adopting the New Regulatory Framework (NRF) for the companies now known as Verizon and AT&T. Re Alternative Regulatory Frameworks for Local Exchange Carriers, D.89-10-031, 33 CPUC 2d 43, 61 (1989). The Commission authorized the NRF for Frontier and SureWest in Re Citizens Utilities Company of California, D.95-11-024, 62 CPUC 2d 244 (1995), and Re Roseville Telephone Company, D.96-12-074, 70 CPUC 2d 88 (1996), respectively. In the second triennial review of NRF, the Commission effectively suspended the price-cap index and capped the basic service prices the companies could charge. Re Incentive-Based Regulatory Framework for Local

*Footnote continued on next page*

We note that in retaining the high cost fund, California remains on the vanguard of states with an explicit high cost program. Twenty-two other states have created high cost funds since California created the second state high cost fund more than a decade ago. With this decision we reaffirm our commitment to ensuring affordable telecommunication services are available to all Californians, and that the best means of achieving this goal is to ensure all telecommunication carriers in the state contribute in an equitable and explicit manner.

With these reforms, we will rely more upon competitive market forces, rather than regulatory subsidies that favor only one technology, to keep basic rates affordable. We conclude, however, that complete elimination of the B-Fund program is not feasible at this time or in the interests of consumers. We are concerned that the cost for basic service at least in certain high cost areas still exceeds reasonably affordable levels, thus requiring some continued subsidy. We thus permit the B-Fund program to continue on a more limited basis, at least for the present time.

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Exchange Carriers, D.95-12-052, 63 CPUC 2d 377, 381 (1995). At that time, the basic rate was established to recover half of the companies' costs, and other rate elements were established to recover the remaining half of the costs. In D.96-10-066, the Commission created the B-Fund and ordered the companies to reduce many of those other non-basic rate elements. For example, D.98-07-033 adopted $305.2 million in rate reductions in toll, switched access, ZUM/local usage, and custom calling features for Pacific Bell to offset explicit subsidy support provided by the B-Fund. Companies that did not reduce non-basic rates were directed to surcredit the B-Fund support to their customers. In D.06-08-030 the Commission removed most remaining price constraints on rates other than that for basic service, which remained capped until at least January 1, 2009. D.06-08-030 thus has the effect of removing the constraints on prices that were reduced by the creation of the B-Fund.

The B-Fund was to be reviewed every three years, but this is the first comprehensive review conducted by the Commission since the creation of the B-Fund in 1996, more than ten years ago. In response to legislative directives, our review of the B-Fund shows that there is a continuing need for high cost support; however, as noted above, updates to the B-Fund should be undertaken. Much has changed since 1996, and while the process selected by the Commission has performed well, in this phase of the proceeding we will perform some ministerial updates to important parts of the methodology. Since qualifying "high cost" areas were last identified in 1996, California has experienced dramatic changes both in demographics as well as technological innovations in the market for voice services. As a result, continuing to rely on such data to support B-Fund subsidies has become increasingly untenable. Because the cost data underlying existing B-Fund subsidy support levels is significantly outdated, cost proxies for high cost areas must be revised.

In the next phase of the proceeding, we shall complete the long overdue update of the relevant cost proxies for deriving subsidy draws, as explained below. Our goal shall be to complete this update expeditiously. As a longer term goal, in the next phase of this proceeding, we intend to institute a market-driven reverse auction process to determine high cost support levels.

The existing rate freeze applicable to basic exchange services for URF ILECs is scheduled to remain in place until January 1, 2009. Effective on January 1, 2009, the freeze on basic exchange services that are not supported by the CHCF-B automatically expires. Pursuant to this order, we also direct that the rate freeze on any remaining basic exchange services that continue to be supported by the CHCF-B be lifted effective January 1, 2009.

We will also phase in any rate increases for basic residential service after January 1, 2009, to prevent dramatic price increases. In the next phase of this proceeding, we shall consider the appropriate time frame and amount of allowable increases for each COLR to transition gradually to full pricing flexibility.

As a basis to receive B-Fund support after full pricing flexibility takes effect, however, we shall require that a COLR certify that it is not charging rates for basic service in excess of the benchmark levels that we establish herein. If a COLR sets charges for basic service in excess of the benchmark amounts adopted herein, the COLR shall no longer receive B-Fund support. A COLR that does not make the required annual certification will be required to provide a detailed showing as to why they are unable to comply with the Commission's Rules. The Commission will evaluate the evidence and determine what, if any, action is required.

## 2. Procedural Background

On June 29, 2006, we opened this rulemaking regarding the B-Fund, setting forth the issues to be addressed and providing opportunity to file comments. Prior to this proceeding, no formal review of the B-Fund program had been undertaken since its inception in 1996. We opened this proceeding to (1) satisfy the requirements for review of the B-Fund program; (2) institute urgently-needed reforms; and (3) respond to concerns of the Legislature, consumer groups, and DRA as to the size of the B-Fund. The review of the B-Fund, as initiated by this proceeding, is required by legislative mandate as well as Commission directives. The California Legislature enacted SB 1276

(Chapter 847, Statutes of 2004),[7] requiring Commission review of the CHCF-B program, with a report due to the legislature by January 1, 2006. This review was to (a) consider adjusting CHCF-B support levels to reflect updated operating costs, and (b) evaluate whether universal service support levels could be reduced while still meeting the goals of the program. D.96-10-066 also determined that the B-Fund should be reviewed once every three years.[8]

This review is further prompted by the pending expiration of provisions of Pub. Util. Code § 739.3 which mandated the establishment of a high cost support fund. The statutory provisions of § 739.3 are scheduled to sunset effective January 1, 2009.[9] Moreover, § 739.3(e) expressly requires the Commission to consider eliminating explicit support funding "in service areas with demonstrated competition."

As identified in the Order Instituting Rulemaking (OIR), the scope of this proceeding includes the following issues: (1) adjusting universal service rate support payments to reflect updated operating costs, (2) evaluating whether B-Fund support levels can be reduced and made more predictable while meeting the goals of the program, (3) ensuring it is competitively neutral, (4) reducing

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[7] See SB 1276 (Chapter 847, Statutes of 2004) states:

> SEC. 4. The Public Utilities Commission shall by January 1, 2006, conduct a review of the program established pursuant to subdivision (c) of Section 739.3 of the Public Utilities Code and of the California High Cost Fund-B Administrative Committee Fund, to accomplish both of the following: (a) adjust universal service rate support payments to reflect updated operating costs, and (b) evaluate whether universal service rate support levels can be reduced while still meeting the goals of this program.

[8] D.96-10-066, Appendix B, Rule 6.C.4.

[9] See Pub. Util. Code § 739.3 (f).

rate disparity in residential basic service between urban and rural areas in the state, and (5) making the current administration of the program more efficient.

Parties filed opening comments on September 1, 2006, and reply comments on October 16, 2006. A Supplemental Ruling, dated February 23, 2007, solicited additional information on selected issues. Parties filed responsive comments on April 27, 2007, on issues identified in the Ruling. No party has requested evidentiary hearings, and we conclude that no hearings are necessary to resolve issues identified in this order. The record of written comments provides a sufficient basis for the reforms that we adopt. This proceeding has been categorized as quasi-legislative.

Comments were filed by the incumbent LECs: Pacific Bell Telephone Company d/b/a AT&T California (AT&T), Verizon California Inc. (Verizon), SureWest Telephone (SureWest), and Citizens Telecommunications Company of California Inc, d/b/a Frontier Communications Company of California (Frontier). Comments were also filed by Sprint Nextel (Sprint), Time Warner Telecom of California, L.P (Time Warner), the California Cable and Telecommunications Association (CCTA), Cox California Telecom LLC (Cox), Omnipoint Communications, Inc. (dba T-Mobile), The Division of Ratepayer Advocates (DRA), and The Utility Reform Network (TURN).

Given the complexity and extent of the issues in the OIR, and the need to begin to institute reform expeditiously, we shall address the relevant issues in sequential phases. In this manner, we can begin implementing needed reforms to the B-Fund without waiting until all issues in the proceeding have been decided. The instant decision addresses issues resolved in the first phase of this proceeding, in which we adopt measures to:

- Raise the threshold benchmark to qualify for B-Fund support;

- Reduce B-Fund surcharges from 1.3% to 0.5% to reflect the revised benchmark;
- Maintain the basic rate freeze until January 1, 2009;
- Adopt a cost model to update the high cost proxy;
- Lift the basic rate freeze on all lines effective January 1, 2009; and
- Determine that any rate increases for basic residential service should be phased in after January 1, 2009.

The remaining issues identified in the OIR which are not resolved in this decision shall be addressed in a second phase of the proceeding in which, among other things, we shall conduct cost studies to update the applicable high cost proxies utilized for subsidy draws. We shall also pursue measures to implement a reverse auction as a longer term solution whereby competitive market forces can be relied upon to a greater degree to set any necessary support levels to keep basic rates affordable.

### 3. Overview of the B-Fund Mechanism: Its Function and Current Status

As a framework for the reforms in the B-Fund program adopted in this order, we affirm the long-standing public policy goals of universal service, as articulated by statute and implemented in previous Commission decisions. In this respect, D.96-10-066 states:

> Universal service has over the years developed a twofold meaning with respect to telecommunications services. The first is that a certain minimum level of telecommunications services must be made available to virtually everywhere in the state. The second meaning of universal service is that the rates for such services remain affordable. By making affordable telephone service

> ubiquitous in California, all Californians can share in the social and business benefits of the telephone network.[10]

Prior to the opening of telecommunications markets to competition, universal service goals were met through regulation of rates charged by an incumbent monopoly provider of telephone service. In the interests of promoting universal service, rates for basic services were kept at a uniform level throughout the ILEC service territory. To the extent that rates for basic service did not recover the actual cost of service, the rates were cross-subsidized by other services priced above cost. In this manner, the regulated utility was able to earn a reasonable return while keeping basic service affordable in order to meet universal service goals.

This traditional approach to meeting universal service goals became increasingly anachronistic as telecommunications markets opened to competition beginning in the 1980s, with the break up of AT&T into eight regional Bell Operating Companies and a long-distance entity. The introduction of competition for long-distance calling led to the entry of new competitors such as MCI and Sprint. In 1996, Congress enacted the landmark Telecommunications Act of 1996 (the Act) which introduced local exchange competition. With the advent of competition for local service from multiple providers, the traditional ILEC pricing mechanisms for preserving universal service needed reform.

While instituting competition, the Act also codified the Federal Communications Commission's (FCC) longstanding policy of providing universal service support for "telecommunications services" in high cost and low

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[10] D.96-10-066, *mimeo*. at p. 16.

income areas. Section 254 of the Act identified various principles underlying the preservation and advancement of universal service, of which we are mindful.[11]

With respect to the state's authority to regulate the provision of universal service, the Act maintained the longstanding federal-state compact, stating:

> (b) State Regulatory Authority — Nothing in this section shall affect the ability of a State to impose, on a competitively neutral basis and consistent with Section 254, requirements necessary to preserve and advance universal service, protect the public safety and welfare, ensure the continued quality of telecommunications services, and safeguard the rights of consumers.[12]

The Act expanded upon the long-standing state and federal roles in ensuring communication services were available and affordable.[13] Specifically, Section 254(b)(3) requires "sufficient Federal *and State* mechanisms to preserve and advance universal service,"[14] while Section 254(f) requires state policies to be

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[11] 47 U.S.C. § 254(b)(1)-(7). The principles are: (1) Quality services should be available at just, reasonable, and affordable rates; (2) Access to advanced telecommunications and information services should be provided in all regions of the Nation; (3) Consumers in all regions should have access to telecommunications and information services, including advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and reasonably comparable to rates charged for similar services in urban areas; (4) All providers of telecommunications services should contribute in an equitable and nondiscriminatory manner; (5) Federal and State support mechanisms must be specific, predictable and sufficient to preserve and advance universal service; (6) Schools, libraries, and rural health care providers should have discounted access to advanced telecommunication services; and (7) Any other principles as the Joint Board and the FCC determine are necessary and appropriate – which the FCC used to add a competitive neutrality requirement.

[12] 47 U.S.C. § 253 (b).

[13] 47 U.S.C. § 151; Pub. Util. Code §§ 709(a), 709.5(a).

[14] 47 U.S.C. § 254(b)(3) (emphasis added).

consistent with those of the Federal Communications Commission and delineates state authority to preserve and advance universal service.[15] While California does have an intrastate high cost fund, as part of its universal service program, 26 states do not. Of course, California's universal service policies predate the Telecommunications Act of 1996. Section 709 of the Public Utilities Code "declares that the policies for telecommunications in California" include a continuation of "our universal service commitment by assuring continued affordability and widespread availability of high-quality telecommunications services to all Californians."[16] Further, Section 709.5 of the Public Utilities Code reiterates that even in opening "all telecommunications markets" to competition, the Commission must ensure that "the state's universal service policy is observed."[17]

In December 1994, the Commission instituted a multi-proceeding "roadmap" for facilitating local competition,[18] including proceedings to address universal service goals within a competitive environment.[19] We developed a preliminary framework for keeping basic service affordable in high cost areas in D.95-07-050 and D.95-12-021.

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[15] 47 U.S.C. § 254(f).

[16] Pub. Util. Code § 709(a).

[17] Pub. Util. Code § 709.5(a).

[18] See D.94-12-053, adopting an initial procedural plan to facilitate opening local exchange telecommunications markets to competition. 58 CPUC 2d, 393,395.

[19] AB 3643 (Statutes 1994 Chapter 278). See also D.95-12-021, initiating proceedings to establish a proxy cost study in the universal service proceeding (R.95-01-020/ I.95-01-021) 62 CPUC 2d 690-698.

After the Commission established its universal service framework, the California Legislature codified it in Pub. Util. Code § 739.3 to require a "competitively neutral" program to meet universal service goals as local markets began to be opened to competition by new competitors. Pub Util. Code § 739.3 subsections (c) through (f) are of primary relevance to the CHCF-B.[20] Under § 739.3(c), the Commission must maintain a program "to promote the goals of universal telephone service and to reduce any disparity in the rates charged by" providers offering service in high cost areas except (per subsection (e)) in areas with demonstrated competition.

In D.96-10-066, we finalized the CHCF-B program to meet legislative mandates for universal service as competitive market structures evolved. The CHCF-B Program applied within the service territories of the four largest California ILECs.[21] The CHCF-B program recognized the change to a competitive market structure by designating a COLR in each ILEC service territory. The four largest California ILECs currently serve as COLRs.[22] In

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[20] The Commission was to "develop, implement, and maintain a suitable, competitively neutral, and broad-based program to establish a fair and equitable local rate support structure aided by universal service rate support to telephone corporations serving areas where the cost of providing service exceeds rates charged by providers, as determined by the Commission" See Pub. Util. Code § 739.3(c), pursuant to SB 207 (Stats. 1996, Ch. 750).

[21] We concurrently changed the name of the fund previously established for the Small LECs to the California High Cost Fund-A (CHCF-A), and created the separate fund (i.e., CHCH-B) to provide universal service support for the major ILECs. The CHCF-A is designed to support affordable basic exchange rates for small ILECs serving High Cost areas.

[22] The four largest ILECs in California which are covered by the B-Fund are: AT&T, Verizon, SureWest, and Frontier.

addition, Cox, a cable provider, serves as COLR in certain portions of the AT&T and Verizon service territory.

The regulatory concept of a COLR is rooted in the idea that by accepting the franchise obligation from the state to serve a designated area, the COLR is obligated to serve *all* customers in the area that request service. By contrast, though multiple providers compete for customers, competitors may target specific market niches that are profitable. Consequently, the requirement for a COLR helps achieve universal service goals, ensuring that customers in high cost areas have access to basic telecommunications services at rates that are reasonably comparable to rates for similar services in urban areas, supported by B-Fund subsidy draws.

As prescribed in D.96-10-066, the following steps are performed in determining the B-Fund requirements:

1. Define what constitutes "basic service" subject to cost support under the B-Fund subsidy;
2. Calculate the costs by designated high cost areas applicable to the residential basic service elements identified in Step 1. The geographic area is delineated by "Census Block Groups;"
3. Determine a benchmark threshold as a cut off point for access lines considered to be "high cost" eligible for subsidy support;
4. Determine whether other sources of funding should be considered as offsets to the subsidy calculation;
5. Determine the type of funding mechanism to use. The current mechanism is an all-end-user surcharge assessed on retail customers of telecommunications carriers;[23]

[23] The following services are exempt from paying into the B-Fund: Universal Lifeline Telephone Service, coin-operated paid calls, debit cards messages, one-way radio

*Footnote continued on next page*

6. Decide whether specific services or entities should be excluded from having to pay into the fund; and
7. Determine what rates should be reduced in light of implicit subsidies being made explicit.

The explicit subsidy provided by the B-Fund applies only to the cost of the first (or primary) residential line that the COLR provides to each household in designated "high cost" areas.

The subsidy is intended to compensate the COLR for costs related to eligible high cost lines in excess of the amount recovered in rates, thereby keeping rates affordable. The underlying principle of universal service is that a certain minimum level of "basic service" should be available to everyone,[24] providing a gateway or connection to the telephone network.[25] Without such connection, a person has limited ability to participate in society.[26]

As a measure of universal service, we have applied the longstanding goal of a 95% penetration rate for phone service among low-income, nonwhite, and non-English-speaking households.[27] We specifically adopted the 95% penetration rate for phone service as a statewide goal to ensure universal service in D.95-07-050.[28]

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paging, customer-owned pay telephone usage, directory advertising and pre-existing customer contracts executed on or before September 15, 2004. (See D.96-10-066, p. 191.)

[24] *See* D.94-09-065, pp. 6-7. *See also* D.95-07-050, p. 548.

[25] The adopted list of "basic service" elements covered under the B-Fund subsidy is set forth in D.96-10-066, Appendix B, Rule 4B.

[26] *See* D.95-07-050, p. 549.

[27] D.94-09-065, pp. 6-7.

[28] D.95-07-050, p. 548.

To offset the subsidy paid to the COLR, the Commission ordered reductions in certain rates (other than for residential services) equivalent to the B-Fund subsidy. In this manner, the B-Fund explicit subsidies replaced the implicit subsidies that had previously been built into rates for various services priced above cost. By making implicit subsidies explicit, the B-Fund program was intended to provide a competitively neutral funding mechanism applicable to all service providers in the ILECs' service territories. Prices for services other than basic residential service could thereby be aligned more closely with actual costs. Cost-based pricing for such service sends a more economically efficient price signal and is conducive to a competitive market.

The CHCF-B program began in 1996 at an initial funding level of about $350 million per year. The California Budget Act of 2002 transferred $250 million to the State's general fund. The B Fund budget for fiscal year 2005-06 budget was $447.1 million and for fiscal year 2006-07 budget was $434.6 million[29] with actual expenses for the 2005-2006 budget year exceeding $419 million.[30]

Over the past 10 years, the CHCF-B surcharge has fluctuated between 1.42% and 3.80%.[31]

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[29] R.06-05-028 at 4-6.

[30] Any funds in excess of directed expenditures are used to reduce future collections.

[31] See OIR 06-06-028, filed June 29, 2006, in Appendix A, Table 4. The current program budget was established in Resolution T-17028 dated July 20, 2006. Resolution T-17078, dated March 1, 2007, reduced the surcharge rate from 2.00% to 1.30% effective April 1, 2007. Appendix A of the resolution shows that by June 30, 2008, the fund balance was estimated to be approximately $46.3 million.

## 4. Phase I Reforms to the B-Fund Program

### 4.1 Should the B-Fund Program Continue?

#### 4.1.1 Introduction

In D.06-08-030 (the URF Phase I Decision), we found the California telecommunications market to be competitive given the major changes wrought at the federal level with the Act. As an initial issue, we consider whether, in light of the competitiveness of the telecommunications industry, the B-Fund program is still necessary in order to meet universal service goals. In D.06-08-030, we found that AT&T, Frontier, SureWest, and Verizon lack market power because competitive alternatives exist throughout their service territories.[32] We also found that competition is present throughout the four ILEC service territories with no meaningful difference between high cost and low-cost areas.[33] Therefore, various parties contend that the B-Fund support may no longer be necessary as a result of competitive industry forces, and in view of the sunset provisions of § 739.3. Some parties argue that the B-Fund works to skew competition in favor of the ILECs. Alternatively, to the extent that continuation of high cost support remains necessary, we must consider how the B-Fund should be reformed, while preserving the goals of universal service.

#### 4.1.2 Parties' Positions

Parties express differing views as to whether the B-Fund has helped to keep basic rates affordable, and whether it needs to continue to ensure universal service. Parties do not dispute that universal service goals in California have been achieved. They disagree, however, as to whether, or to what extent, the

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[32] D.06-08-030, *mimeo.* at 117.

[33] D.06-08-030, *mimeo.* at 118-133.

success of universal service is attributable to the B-Fund program. AT&T and SureWest support the continuation of the B-Fund program, arguing that it is "indisputably promoting universal service." AT&T argues, however, that the Fund "has not fully compensated all carriers for the associated costs."[34] AT&T claims that not only have the engineering principles underlying an efficient network changed since 1996 but, also, cost inputs relating to the network. While certain costs, such as for equipment, have decreased over that period, AT&T claims that other costs, such as for labor and copper, have increased. AT&T contends that the CHCF-B has contributed to preserving service in high cost areas because California's high service penetration rates are partially attributable to AT&T's current statewide basic service rates, which it asserts are below cost. AT&T contends that those below cost rates are, in turn, "partially attributable" to the CHCF-B.

SureWest likewise contends that the B-Fund promotes universal service by keeping residential basic service rates "lower than they would have been." SureWest further claims that, without the CHCF-B, the COLR ILECs "would have to consider raising residential basic service rates to ensure cost recovery."[35] SureWest notes, however, that at current funding levels, its customers are required to pay more in B-Fund surcharges than they receive in subsidy support for basic service. SureWest argues that such an imbalance is unfair and SureWest is entitled to higher levels of B-Fund support than what is currently received.

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[34] AT&T Opening Comments at 27.

[35] SureWest Opening Comments at 14.

Verizon argues that the B-Fund should be reduced by raising the threshold for eligibility to draw a subsidy, with serious consideration to eliminating the fund entirely over time.[36] Verizon believes that complete elimination now may be premature, however, particularly in light of the FCC's pending proceeding to reform the federal universal service program. Verizon also argues that the failure of new intermodal competitors to participate in the fund is undermining the fund's sustainability as well as the requirement for competitive neutrality.

Frontier believes that, in the present competitive environment for telecommunications services, the B-Fund program has become "outdated," and should be discontinued. If the B-Fund program is continued, however, Frontier argues that each ILEC should be permitted to elect to withdraw and no longer participate. Frontier argues that its own residential customers subscribing to basic residential service receive no direct benefit from the B-Fund.

Parties representing competitors, as well as DRA, argue that the B-Fund program should be eliminated now. Sprint argues that there is no logical basis or necessity for the CHCF-B program to continue. Since competitors are already serving throughout California without the benefit of CHCF-B subsidies, as affirmed in D.06-08-030, Sprint argues, such competitors already offer access to affordable basic service. Sprint further argues that the CHCF-B program is unfair and has an anticompetitive impact on non-ILEC-affiliated wireless and cable telephony providers. All of the CHCF-B funds generated by surcharges on their customers' bills have served to fund reductions in ILEC non-basic service prices.

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[36] Verizon Opening Comments at 8.

DRA likewise claims that the CHCF-B program does not promote universal service, noting that residential basic service rates in high cost areas did not change when the CHCF-B was instituted.[37] The direct effect of the CHCF-B has been to effectively *increase* basic residential rates slightly (through the CHCF-B surcharge) and to *decrease* the ILECs' business and non-basic residential rates. Moreover, Section 254(e) of the Act mandates that carriers receiving the high cost support "shall use that support only for the provision, maintenance, and upgrading of facilities and services for which the support is intended." DRA notes, however, that the ILECs have no data confirming that they use the CHCF-B funds for such designated purposes.[38]

As another basis for advocating elimination of the B-Fund program, certain parties (e.g., Sprint and DRA) argue that ILECs get an unfair competitive advantage by continuing to receive B-Fund subsidies. Pursuant to D.06-08-030, the ILECs no longer have restrictions on the pricing of services other than basic service. Frequently, such services are bundled with residential access lines provided in high cost areas. The ILECs are now free to price such bundles on a geographically deaveraged basis.[39] Since the ILECs now have the freedom to increase the prices of services that were previously required to be lowered to offset B-Fund subsidies, Sprint and DRA contend that surcharges to "support" lines provided as part of a service bundle violate Pub. Util. Code § 739.3(d). This

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[37] Verizon reports a limited exception. MCI's California rates are set by zone and the CHCF-B funding MCI receives was used in a calculation to offset higher than average costs and to reduce rates in some zones. Verizon Response to DRA Data Request 1-7.

[38] DRA Opening Comments at 20-21.

[39] D.06-08-030, *mimeo*. at 138-143, 192-193 and 255.

provision requires that the surcharge "reasonably equals the value of the benefits of universal service to contributing entities and their subscribers." DRA argues that the Commission must eliminate universal service support wherever the CHCF-B surcharges for such support exceed any value that telecommunications subscribers receive from the program.[40] DRA argues, consequently, that any continued B-Fund support should be limited to primary residential lines in high cost areas provided at á la carte, price-capped rates.

DRA further argues that the CHCF-B has no direct effect on reducing rate disparities between urban and rural areas since the CHCF-B subsidies go to carriers, but do not directly affect retail rates. Both before and after the institution of the CHCF-B, each ILEC was required to provide basic residential local exchange service at a single price throughout its service territory, with no geographic deaveraging and no disparity between urban and rural area rates.[41] The Commission has retained this requirement for primary residential lines through January 1, 2009.[42] Thus, *within* the ILECs' respective territories, there are no urban-rural residential primary-line rate disparities.

TURN disagrees with those parties advocating elimination of the CHCF-B. TURN argues that there is not sufficient information to conclude that universal

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[40] Pub. Util. Code § 739.3(d).

[41] A limited exception applies in Verizon's California service territory as an artifact of the merger between the former GTE and Contel. Verizon provides residential basic exchange service at a single "statewide-average" price in the former GTE California service territory and at a different (and lower) "statewide-average" price in the former Contel California service territory.

[42] D.06-08-030, *mimeo*. at 151-156.

service goals could be met without continuation of some form of subsidy program.[43]

#### 4.1.3 Discussion

Given the statutory mandates of § 739.3(f), the B-Fund must continue at least until the expiration of the statute scheduled for January 1, 2009.[44] Moreover, even after the mandate of § 739.3 expires, the Commission will continue to have independent authority to ensure that universal service goals are met, and that customers can have access to basic service at affordable rates. Ongoing mandates to provide for universal service are independently set forth in Pub. Util. Code § 709 requiring that we "ensure that competition in telecommunications markets is fair and that the state's universal service policy is observed."[45] Thus, even assuming § 739.3 expires with no legislative extension or

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[43] TURN Reply Comments at 3-4.

[44] § 739.3(f) states: "This section shall remain in effect until January 1, 2009, and as of that date is repealed, unless a later enacted statute that becomes effective on or before January 1, 2009, deletes or extends that date."

[45] Pub. Util. Code § 709 states:

> The Legislature hereby finds and declares that the policies for telecommunications in California are as follows: (a) To continue our universal service commitment by assuring the continued affordability and widespread availability of high-quality telecommunications services to all Californians; (b) To focus efforts on providing educational institutions, health care institutions, community-based organizations, and governmental institutions with access to advanced telecommunications services in recognition of their economic and societal impact; (c) To encourage the development and deployment of new technologies and the equitable provision of services in a way that efficiently meets consumer need and encourages the ubiquitous availability of a wide choice of state-of-the-art services; (d) To assist in bridging the "digital divide" by encouraging expanded access to state-of-the-art technologies for rural, inner-city, low-income, and disabled Californians; (e) To

*Footnote continued on next page*

enactment of new legislation, independent statutory authority exists providing the Commission discretion to continue the B-Fund beyond January 1, 2009, as necessary to meet universal service goals.

In addition to such state law requirements, federal statutes also identify the preservation and advancement of universal service support as important continuing goals. Specifically, as noted earlier, Sec. 254(b)(3) of the Act requires "sufficient federal and state mechanisms to preserve universal service"[46] Likewise, Sec. 254(f) delineates state authority to preserve and advance universal service. Therefore, we find strong support in both federal and state statutory law for the continuation of the B-Fund program beyond January 1, 2009, as an essential requirement to ensure that universal service goals continue to be met within California.

Parties disagree as to how much the achievement of universal service goals may be attributed to the B-Fund program. Although, as noted by DRA, the ILECs have not provided any data confirming that they have used CHCF-B funds only to pay for facilities serving high cost areas, there is no requirement

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promote economic growth, job creation, and the substantial social benefits that will result from the rapid implementation of advanced information and communications technologies by adequate long-term investment in the necessary infrastructure; (f) To promote lower prices, broader consumer choice, and avoidance of anticompetitive conduct; (g) To remove the barriers to open and competitive markets and promote fair product and price competition in a way that encourages greater efficiency, lower prices, and more consumer choice; and (h) To encourage fair treatment of consumers through provision of sufficient information for making informed choices, establishment of reasonable service quality standards, and establishment of processes for equitable resolution of billing and service problems.

[46] 47 U.S.C. § 254(b)(3).

under our rules for the production of such data. Moreover, it would be inconsistent with URF policies, as adopted in D.06-08-030, to engage in such a review of how a particular carrier has spent money on specific facilities. We are persuaded, however, that at least in reference to providing service in truly high cost areas, the availability of B-Fund support has played a key role in keeping rates affordable in such areas. We draw this conclusion by observing how well universal service goals have been realized since the B-Fund was implemented. We adopted a 95% penetration rate as a reasonable representation of universal service in D.96-10-066 (p. 563). Over 95% of California households have basic telephone service today.[47] Such robust subscribership figures places California tied for thirteenth among U.S. states and territories.[48]

As discussed below, we conclude that the B-Fund program should continue beyond January 1, 2009, albeit in more limited and targeted form, to ensure customers continued access to affordable basic service in high cost areas. In view of the dramatic technological, competitive, and regulatory changes in the telecommunications landscape over the past decade, however, we conclude that competitive market forces can be relied upon to a greater degree than in the past to meet universal service goals, when coupled with a more technology-neutral Lifeline low-income program.

Ten years ago, competition for local residential voice service was in its infancy. Today, ILECs vigorously compete with wireless, cable video providers,

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[47] See AT&T Comments of April 27, 2007, referencing FCC Reference Book of Rates, Prices Indices, and Household Expenditures for Telephone Service, Table 1.1 (rel. Aug. 11, 2006).

[48] FCC Telephone Subscribership in the United States, Table 2 (rel. Jun. 29, 2007).

and Voice over Internet Protocol providers in both the local and long distance communications markets. Subscribers to wireless service in California now number more than 27.5 million, exceeding wireline phone subscribers by over five million.[49] Customers can obtain an array of services over their wireless phones, plus mobility, at rates competitive with those offered by the ILEC. Although there is competition for long distance services, "long distance" is disappearing as a stand-alone service as more consumers opt for bundled service packages[50] or use internet protocol-based networks.[51] Thus, consumers increasingly communicate in ways that bypass the traditional public switched telephone networks entirely. It is in this vastly different voice market that we look at a
B-Fund program whose roots lie in a vastly different monopoly regulatory environment.

Our preference, therefore, is to minimize interference with competitive market forces in meeting universal service goals. As observed in D.06-08-030, CHCF-B subsidies are "market distorting."[52] Further, we conclude that continuing to rely on system average cost as the benchmark is the primary cause of any market distorting effects. Accordingly, we seek to appropriately target

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[49] See Sprint Nextel Comments of 4/27/07, p. 10.

[50] Local Exchange Carriers offer both local and long distance calling in one package, and compete against wireless providers that offer "bucket plans" of minutes in interstate calling areas.

[51] Voice over Internet Protocol service is national or international in scope. Vonage Holdings Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission, WC Docket No. 03-211, Memorandum Opinion and Order, 19 FCC Rcd 22404 (2004).

subsidy levels under the B-Fund program to minimize the potential to distort competitive market forces through regulatory subsidies to one market player.

In this regard, the CHCF-B has provided greater subsidies to AT&T more than any other carrier, whose customers in 2005 contributed about $110 million into the B Fund but AT&T received a payout of $341 million, a net gain of $231 million for the year.[53] SureWest "currently receives less than $500,000 annually from the CHCF-B…" but its "customers paid over $1,300,000 into the CHCF-B in 2005."[54] While Frontier's residential customers subscribing to basic service (other than Lifeline) are assessed a 1.3% B-Fund surcharge, they also receive surcredit offsetting the support received by Frontier for service to areas designated as high cost. The 3.63% surcredit to offset the B-Fund subsidy applies only to services other than residential service.

Only three competitors (Cox and the pre-merger interexchange carriers AT&T and MCI) obtained COLR status (entitling them to make claims on the CHCF-B) over the past ten years. Since the acquisition of the former AT&T and MCI by the parent companies of the two largest California ILECs, Cox is the only remaining unaffiliated competitor to seek and obtain eligibility to draw high cost support from the CHCF-B.[55] Except for these three carriers, access to the B-Fund has not led any other actual or potential competitor to seek COLR status in any high cost service area.

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[52] D.06-08-030, p. 143.

[53] AT&T Responses to DRA Data Requests 1-6 and 1-17.

[54] SureWest Opening Comments at 4.

[55] OIR at 12-13.

The customers of the pre-merger AT&T and MCI paid more surcharge revenues to support price reductions in ILEC non-basic services than AT&T and MCI ever drew from the CHCF-B.[56] Thus, for non-COLR telecommunications providers generally, the CHCF-B may actually discourage competition to the extent that it subsidizes prices beyond what is necessary to achieve universal service goals.

Another way to promote competitive neutrality in access to B-Fund support is to consider modifications to the applicable standards to qualify as a COLR. As noted above, Verizon raises the concern that the failure of intermodal competitors to participate in the Fund under current rules undermines principles of competitive neutrality. Sprint likewise argues that the Commission should consider permitting wireless carriers to become eligible to draw B-Fund subsidies when they serve customers in designated "high cost" areas. [57]

We recognize that under current definitions of "basic service" qualifying for B-Fund support, Lifeline Service must be included as a component thereof. Since wireless carriers cannot presently provide Lifeline Service, they are precluded, by definition, from being a COLR.[58] We believe, however, that the issues raised by Verizon and Sprint warrant further consideration regarding the possible modification of existing rules to accommodate a broader base of eligibility for B-Fund support to include wireless and other intermodal carriers.

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[56] AT&T Responses to DRA Data Requests 1-6 and 1-17; Verizon **PROPRIETARY** Responses to DRA Data Requests 1-6 and 1-17 (including attachments thereto).

[57] Sprint Comments of 4/27/07, at 18.

[58] See D.96-10-066, Appendix B, Adopted Universal Service Rules §§ 1 (Definitions), 4 (Basic Service).

We shall solicit further comments on the merits of this issue in the next phase of this proceeding as a basis for considering further reforms to promote competitive neutrality, consistent with other public policy goals.

We also recognize that the CHCF-B has not reduced or eliminated rate disparities *between* ILECs. For example, although AT&T and SureWest share adjacent service territory boundaries, AT&T's residential customers pay only $10.69 per month for basic service while SureWest's residential customers pay $18.90. Verizon's and Frontiers' residential customers pay about the same, though slightly less than SureWest's customers.

Therefore, it is in the interests of a competitive market to minimize the market-distorting effects of B-Fund subsidies by ensuring that subsidized lines are in truly high cost areas.[59] While the levels of B-Fund support should be scaled back, however, we find that complete elimination of B-Fund support at this time would not be prudent and could jeopardize universal service goals in high cost areas.

We disagree with parties that argue that the fund is not needed since competition exists for ILEC wireline service ubiquitously, including within high cost areas. While competitors have the *capability* to serve high cost areas without B-Fund support, however, competitors also reasonably expect to recover their costs. Until we update the relevant proxy associated with providing basic service in high cost areas (scheduled for the next phase of this OIR), we cannot confirm that ubiquitous cost-based pricing for basic service would remain affordable without the B-Fund. Because the record has not yet been updated to

reflect revised cost proxies, moreover, there is no evidence to support AT&T's claim that its basic residential service rates are necessarily below cost, or that it has not been adequately compensated through the B-Fund. Thus, while we have serious questions about continuing the current levels of B-Fund support, we still believe that some ongoing level of support remains necessary. Further, to the extent the ubiquity of the UNE-L unbundling scheme throughout the service territories of each of the four COLRs relies on B-Fund support to ensure wholesale service is provided in high cost areas, elimination of the B-Fund would harm the competitive landscape of California.

The B-Fund must continue, at least for now, to ensure that customers in designated high cost areas continue to have access to basic service at affordable rates. Excessively high rates for basic service would conflict with the statutory mandate to preserve universal service. Unaffordable rates that undermined universal service goals would not be considered "just and reasonable" as required by Pub. Util. Code § 451.[60] In this regard, the Commission is obligated pursuant to Pub. Util. Code § 451 to ensure that "[a]ll charges demanded or received by any public utility…for any service rendered…be just and reasonable." Likewise, continuation of the B-Fund is consistent with Pub. Util. Code § 709(a), which calls for "the continued affordability and widespread availability of high-quality telecommunications services to all Californians."

By raising the threshold and reducing the number of lines eligible for subsidized support, however, we will minimize any dampening effects that the

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[59] As discussed supra, the Commission should update the High Cost proxy model, and ensure only truly high cost areas are subsidized.

[60] Pub. Util. Code § 739.3(c).

B-Fund may have on competition while ensuring service is affordable in truly high cost areas. We discuss how the threshold should be revised in the following section.

### 5. Revisions to the High Cost Threshold Level

As a matter of high priority for reform, we turn to the issue of the whether, or in what manner, to revise the threshold level for "high cost" lines eligible for B-Fund support. As prescribed under current rules, only those lines served by a COLR in areas with costs above a designated "high cost" threshold qualify for B-Fund support. The threshold governs the number of lines eligible for subsidy support. Only those primary residential lines in service areas in which the adopted proxy costs exceed the threshold qualify for B-Fund subsidy. To the extent that we can revise the threshold to focus more effectively on applying subsidy funds only to those lines that are located in genuinely high cost areas, the required level of B-Fund subsidies can be targeted more efficiently.

In D.96-10-066, we adopted a benchmark threshold equal to the higher of either (a) the statewide average cost of basic service (set at $20.30 per line), or (b) the basic flat rate plus End-User Common Line (EUCL) charge.[61] Because AT&T California's rate, including the EUCL, is $15.07 per line, its high cost threshold is $20.30 per line. AT&T draws additional subsidy on qualifying high cost lines equal to the difference between its $15.07 rate and the $20.30 benchmark. Verizon California's basic rate, including the EUCL is $23.75, which constitutes its threshold. The corresponding threshold for SureWest is $25.40.

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[61] In D.96-10-066, we applied the EUCL charge as an offset to the fund because it covers a large share of the interstate portion of the LECs' nontraffic-sensitive embedded loop costs.

For Frontier, the threshold is $24.35. In this interim decision, we revise the threshold for high cost support funding to limit the number of lines qualifying for a subsidy to a more reasonable level, as discussed below.

### 5.1 Parties' Positions

Parties generally support revising the high cost threshold, but disagree about the extent and methodology by which to do so.[62] AT&T argues that the existing threshold formula based on system-average costs should continue to apply, and that $20.30 system-average figure should merely be updated to reflect more recent data. [63]

Various parties argue that the existing threshold overstates the level of subsidy required to support universal service by ignoring revenues from services which are bundled with the residential access line in high cost areas. The ILECs and many intermodal competitors (e.g., cable and wireless) offer service bundles and features that include not only basic exchange service, but also broadband, wireless, caller ID, voicemail, and video services, among others. In the URF proceeding, the ILECs claimed that two-thirds or more of their customers subscribe to service bundles (the proportion depends in part on the definition of bundles). AT&T estimated that, as of July 2006, only 10.8% of its billed residential revenues were for basic service only without additional bundled services from AT&T or its affiliate.[64] Thus, for example, the current CHCF-B arrangement may provide a $10 per month subsidy to support a line which, in

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[62] *See, e.g.,* Cox Opening Comments at 10; CCTA Opening Comments at 9; Sprint Opening Comments at 2, and; Verizon Opening Comments at 10-11.

[63] AT&T Comments of 4/27/07 at 3.

[64] AT&T Response to DRA Data Request 1-19, part f.

addition to basic service, generates an additional $40 per month for the ILEC and its affiliates from voice mail, a feature package, and DSL – none of which are allocated any part of the "high cost" line.

Since the COLR is receiving compensation through bundled services being offered to residential customers, various parties argue that the threshold should be revised to recognize such revenues. DRA argues that the ILECs may actually require no subsidy to provide lines in a particular high cost area where the full range of revenues that already provide full compensation to the ILECs and their affiliates for such lines. Time Warner argues that a conservative estimate for 2006 of the average revenue per line for bundled services for Verizon and AT&T California operations is $33.35.[65]

Verizon advocates setting the B-Fund benchmark equal to the benchmark used by the FCC for evaluating funding requirements under the federal universal service program. The FCC applies this benchmark as the basis for each state to certify whether rural rates charged within the state are "reasonably comparable" to urban rates in order to qualify for federal universal service funds. For purposes of determining if such rates are "reasonably comparable," the FCC adopted a benchmark based on national urban residential rate data, set at two standard deviations above the average urban rate.

The FCC characterized this benchmark as establishing a "safe harbor," or presumption, that rates in high cost areas that do not exceed this benchmark are

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[65] Source Time Warner Comments dated 4/27/07, p. 4, citing 2006 ARMIS 43-03 (Revenues) and ARMIS 43-01 (Billable Access Lines). Revenue is the total of: Basic Area Revenue (Row 5001), Other Basic Area Revenue (Row 5060), End User Revenue (Row 5081), and Switched Access Revenue (Row 5100).

"reasonably comparable" to national urban rates. Verizon identified the safe harbor rate as $34.21 per line.[66] The FCC permitted states with rates below the benchmark to certify that their rates are "reasonably comparable" without requiring additional information, or to rebut the presumption by demonstrating that other factors beside basic service rates affect comparability.[67]

Verizon argues that a necessary implication of resetting the B-Fund benchmark to the "safe harbor" level is that basic rate freeze would be lifted and subject to upward adjustment. Based on Verizon's logic, rate increases up to the level of the "safe harbor" rate would be considered "reasonably comparable" consistent with universal service goals.

Cox suggests that the Commission could consider use of the FCC's safe harbor rate as a starting point, and then evaluate the need for modifications to make the threshold more applicable to California circumstances. For example, the FCC rate could be adapted to reflect average urban rates for California, with the threshold calculated at two standard deviations above that average. SureWest recalculated the FCC "safe harbor" rate to be $26.43 per line, adjusted

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[66] This benchmark adjusts annually, and Verizon proposes that the B-Fund benchmark should likewise adjust annually to match updates in the FCC safe harbor benchmark. (See In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45 (rel. Oct. 27, 2003) ¶ 41.

[67] The FCC Order states that: "…standard deviation analysis of the relevant cost data supports the determination that the cost benchmark rejected by the court does in fact provide an appropriate level of non-rural High Cost support.[footnote omitted]. Standard deviation analysis is a commonly used statistical analysis that measures the dispersion of data points from the mean of those data points. [footnote omitted]. Both the [FCC] and state commissions have employed standard deviation analysis as a statistical standard for determining parity or comparability [footnote omitted]." See FCC Order on Universal Service (FCC 03-249) released October 27, 2003, page 38, ¶ 62.

for California-specific rates for AT&T and Verizon. The B-Fund benchmark is based on the costs to provide basic service consistent with the Commission's Universal Service goals, whereas the FCC safe harbor rate includes other taxes and fees that do not relate to the provision of universal service. SureWest thus also recalculated the "safe harbor" rate to remove costs to customers that are not revenue to the carrier, resulting in a rate of $17.98 (incorporating California-specific rates).

Other parties (Sprint and Time-Warner) argue that the threshold should be based upon the level of expenditures that a customer residing in a high cost area can reasonably afford, consistent with the overall goal of a 95% penetration rate for basic service. Parties sponsoring this approach offered data from the U.S. Census and the FCC regarding the level of expenditures that consumers devote to basic telecommunications services. Based on demographic data regarding average household expenditure levels for telecommunications services, Sprint proposes the benchmark be raised to between $36 and $41 per line.

### 5.2 Discussion

We conclude that the current threshold is overly inclusive and allows subsidy support in areas where it is not needed to meet universal service goals. Moreover, even if system average cost was still an appropriate basis for a high cost benchmark threshold, the currently adopted figure for system average cost of $20.30 is extremely stale, and an updated cost study would be necessary to derive a more current figure. Reliance on the system average cost as a high cost benchmark is no longer appropriate, however, given current market and regulatory conditions. The criteria underlying the benchmark needs to be revised to reflect more accurately the goal of limiting subsidies to what is required to ensure that basic service remains affordable in high cost areas.

We should have looked at the B-Fund every three years, and the current benchmark and threshold data should have been updated pursuant to an earlier review. As articulated in D.96-10-066,[68] such periodic review was intended to ensure that the overall size of the Fund stayed within reason, subject to adjustment as competition and technology evolved. By conducting such period reviews, we anticipated that the need for ongoing high cost support may be reduced over time. The three-year review interval was expected also to provide time to determine whether new entrants were willing to serve high cost areas with the subsidies provided. We also anticipated that an auction mechanism could be a possible vehicle for subsequent determination of subsidy amounts instead of conducting resource-intensive updates of cost proxy inputs.

Since the periodic three-year review process has not been performed as originally intended, the task before us now is to move forward expeditiously with long-overdue reforms. Our priority in this first phase of the proceeding is to revise the benchmark threshold, as discussed below. Next, we shall address subsequent reform measures for Phase II of the proceeding.

By resetting the threshold to a more reasonable level as an initial reform, we will limit the number of lines that qualify for support and reduce the size of the B-Fund. As a result, we expect the balance in the B-Fund to decline by approximately 74%, assuming no change in the high cost proxy per line. After we complete the update of the high cost proxy per line, we will implement further revisions in the level of the Fund. Likewise, the B-Fund surcharge will be reduced to reflect a lower level of support payments.

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[68] See D.96-10-066, 68 CPUC 2d, 524, 632-633.

The currently adopted B-Fund threshold levels do not effectively serve the purpose of limiting subsidies to areas that are truly "high cost." The current threshold levels are based on the premise that any cost in excess of the statewide average (presumed to be $20.30 per line) constitutes "high cost." By providing subsidy support wherever costs exceed $20.30 or the flat rate plus EUCL (whichever is higher), the fund subsidizes prices in excess of what is required to meet universal service goals.

The benchmark should no longer be based upon system average costs, even assuming updated underlying data. A benchmark based upon a utility's system average costs is a poor surrogate to measure what amount a customer can reasonably afford to pay for basic service. The definition of "high cost" therefore should not be defined simply as anything above a system average figure. Instead, the benchmark should be revised based on a standard of affordability by customers rather than system average costs of the utility.

Merely updating the system average cost will not inform us concerning the level of cost support actually needed to keep basic rates affordable in high cost areas. The proper focus of a benchmark should be the affordability by the customer and reasonable comparability of rates between rural and urban areas. Universal service goals are attained when rates charged for basic service are affordable for up to at least 95% of customers within California.[69] There is no justification to subsidize lines based on a designation as "high cost" where such costs are already within an affordable range.

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[69] *See* D.95-07-050, p. 548.

The goal of universal service "affordability" does not necessarily require the exact same rates be charged to rural and urban customers, but is based on the principle of "reasonable comparability." As a standard of affordability in rural high cost areas, Section 254 of the Act requires access in rural and high cost areas based on a "reasonably comparable" standard, as follows:

> Consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.[70]

The principle of "reasonable comparability" allows for more flexibility in deriving an appropriate high cost benchmark than is reflected in the current B-Fund methodology based on system average costs. Setting the B-Fund threshold level based on "reasonable comparability" will more effectively delineate truly high cost areas, and limit subsidy support only to areas where costs exceed a reasonably affordable rate level. We find such an approach to be more in step with the statute's "affordability" standard.

We decline to adopt the use of the FCC "safe harbor" rate as a basis for revising or indexing the B-Fund benchmark. While we find merit in such an approach, the B-Fund benchmark is intended to provide a demarcation of "high cost" regions eligible for B-Fund subsidies based upon affordability of *California-*

[70] 47 U.S.C. §254(b)(3).

*specific costs.* By contrast, the FCC "safe harbor" rate is based upon *nationwide revenues* and other charges (such as 911 fees and sales taxes).

Even though SureWest offered certain refinements to the FCC "safe harbor" rate to reflect more California-specific data, we still find the resulting figures are inappropriate as a basis to set a high cost threshold for B-Fund purposes. Even with these refinements, the resulting rate still represents a measure that is not directly relevant to the issue at hand, namely, affordability of basic service costs by customers.[71] Moreover, the figure as recalculated by SureWest is distorted by the use of regulated and capped rates, and is therefore not the best surrogate of actual average cost of service.

We likewise reject parties' proposals to set the revised high cost threshold based upon the average revenues that the ILEC recovers for packages that it markets on a bundled service basis. The high cost subsidy is designed to provide support only for basic service. It would be improper to index the threshold based on prices for other services marketed on a bundled basis in addition to basic service. We no longer regulate the prices for such nonbasic services, and attempting to index the B-Fund threshold based on such prices would be an improper reversal of procompetitive policies adopted in URF in D.06-08-030. Moreover, proponents of this approach focus only on the *revenue* from other services but ignore offsetting *costs* of such services. Since we no longer apply cost-based regulation to such services, however, there would be no basis to

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[71] The Tenth Circuit approved the methodology chosen by the FCC, but remanded the matter for a better justification. S*ee Qwest Communications International Inc. v. Federal Communications Commission* (10th Cir. 2005) 398 F.3d 1222, 1237 (*Qwest II)*. Since the Tenth Circuit's decision, the FCC has not dealt with the remanded justification. It is not clear when or if, it will do so, and what changes, if any, may occur.

quantify the costs for such services. Any attempt to quantify such costs would conflict with URF as adopted in D.06-08-030 which favors the competitive discipline of the marketplace rather than cost-of-service regulation. Therefore, there is no basis to set a threshold level based upon total revenues associated with a service bundle.

As a basis for revising the benchmark to reflect a more relevant measure of affordability and reasonable comparability with rates in urban areas, we conclude that the most appropriate criteria relates to customers' ability to afford basic service. For this purpose, we shall consider relevant demographic data regarding consumer expenditures on telecommunications services. In this regard, Time Warner/CCTA provided the results of the FCC's annual survey of residential monthly phone rates for flat-rate residential service (2006) which show a range from $16.01 per line in Anaheim to $25.38 per line in Long Beach.[72] The same survey reports substantially higher rates in other cities (including cities served by AT&T and Verizon) without any reported universal service concerns. For example, residential flat rates of $34.33 were reported in West Memphis, Arkansas and 33.82 in Racine, Wisconsin. Of the 95 cities surveyed by the FCC, AT&T's California rates were the lowest in the nation.[73]

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[72] The flat-rate for residential service includes the subscriber line charge, surcharges and taxes. (See Reference Book of Rates, Price Indices and Household Expenditures for Telephone Service, Industry Analysis and Technology Division, Wireline Competition Bureau, FCC, 2006, Tale 1.3, as cited in Time Warner/CCTA comments dated April 27, 2007, pp. 4-5.)

[73] This comparative rate survey lends some credence to AT&T's claims that its basic residential rate in California is below cost. After the rate freeze expires on January 1, 2009, AT&T will have flexibility to raise its basic residential rate to cover costs, subject

*Footnote continued on next page*

Sprint provided similar data from the FCC and the U.S. Census Bureau. Based on this data, Sprint argues that an average household could realistically spend well over $30 per month on telecommunications services. The FCC reports that: "About 2% of all consumers expenditures are devoted to telephone service. This percentage has remained virtually unchanged over the past 20 years, despite major changes in the telephone industry and telephone usage." The stability in the percentage of household expenditures devoted to telephone usage over the past 20 years provides a solid basis upon which to establish an affordability benchmark. These FCC and Census Bureau data sources reveal that the national average household expense for wireline local exchange service remained at about $36 per month between 2000 and 2005.[74]

As an alternative measure of affordability, Sprint suggests that the high cost benchmark could be set equal to 50% of consumers' average expenditures for all telecommunications services (currently equal to approximately $82 per month).[75] Such an approach would produce a benchmark of $41 (=$82 * 50%).

We conclude that the bounds of what constitutes affordable basic service may cover a range of demographic data. For purposes of a high cost benchmark,

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to the phase-in process to be addressed in the next phase of this proceeding, and within the constraints of the competitive marketplace.

[74] See Sprint Comments of 4/27/07, footnote 25, citing Table 3.2, Average Monthly Household Telecommunications Expenditures by Type of Provider (Average are for only those households billed for service) at 3-4, in *Trends in Telephone Service,* February 2007 (*Trends Report*), published by the Industry Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Division.

[75] *Id.* Sprint Comments, citing *Trends Report,* at 3-1, Table 3-1, Household Expenditures for Telephone Service at 3-3, showing that average annual expenditures on telephone

*Footnote continued on next page*

however, we require a specific figure. We conclude that the figure of $36 per month, representing average household expenditures on basic service, provides a reasonable threshold benchmark and is within the range of affordability for basic service. Given the range of report data regarding household expenditures for telecommunications services as presented by Sprint, we consider the $36 figure to provide a conservative proxy of basic service costs that a consumer may reasonably afford. This figure is at the lower end of the range suggested by Sprint. We shall thus authorize the revised B-Fund "high cost" benchmark to be increased to $36 per line by January 1, 2009.

The use of the $36 revised benchmark will limit subsidy payments only to those lines in Census Block Groups (CBG) with a basic service cost proxy in excess of $36 per month. We shall order that subsidy support be phased out for those lines whose cost is equal to or less than the revised benchmark based on the timetable discussed below. As an interim measure, the revised benchmark levels shall be applied against existing High Cost CBG proxies. Once we complete the updating of CBG high cost proxies in the next phase of this proceeding, as discussed below, we shall further revise the applicable per-line subsidy disbursements accordingly.

We also shall authorize a B-Fund surcharge of 0.5%, which represents a reduction from the current 1.3% surcharge. We believe that this reduction is appropriate given the diminishing levels of claims we anticipate going forward as a result of the revised threshold we are adopting. We direct the Communications Division Staff to prepare a resolution for the Commission's

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service increased to $990 per household by 2004, equal to $82.50 per household per

*Footnote continued on next page*

consideration to implement the revised 0.5% surcharge, to become effective by January 1, 2009.[76]

Although the B-Fund surcharge could be reduced immediately to reflect the effects of the revised high cost benchmark threshold, we elect instead to retain the surcharge at its existing level until January 1, 2009. In this manner, we preserve the flexibility to redirect B-Fund collections to support additional broadband deployment through an important new program, described below.

In the identification of issues for comment in the OIR, we raised the issue of whether the Commission should reconsider the definition of basic residential service and include enhanced services like broadband, etc.[77] As part of this proceeding, we also sought additional comments on the need for reporting on broadband services.[78] In its comments, SureWest states that because the deployment of broadband services encompasses a mixture of regulated and non-regulated entities, the Commission should allow the market to operate to deliver broadband services. SureWest further states that if, after a sufficient period of time, the Commission determines that the market has failed to deliver on the promise of broadband services, the Commission can begin the complex analysis of determining which people are not receiving broadband services, why they are

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month.

[76] Since the resolution implementing the 0.5% surcharge will merely be a ministerial act, we shall not require the Communications Division to circulate the draft resolution for public comment prior to Commission action to adopt it.

[77] See OIR at 48 (Sec. V.G. 6.

[78] Assigned Commissioner's and Administrative Law Judge's Ruling Soliciting Further Comments regarding reform of the California High Cost Fund-B Program, February 23, 2007.

not receiving broadband services, and a solution within the Commission's jurisdiction to help alleviate any such problem.[79] Citizens also states that the B-Fund balance could be used for statewide broadband deployment initiatives and/or service to underserved areas in the state.[80] Promoting deployment of additional broadband services within areas of California that are underserved or not served at all is consistent with our universal service policies aimed at bridging the "digital divide" as articulated in Pub. Util. Code § 709 (c) and (d).[81] We have previously taken steps to promote the ubiquitous availability of broadband and advanced services in California, and to enhance broadband connectivity, by establishing the California Emerging Technologies Fund (CETF) in conjunction with approval of the mergers of SBC/AT&T and Verizon/MCI.[82] This rulemaking provides an opportunity to take a further important step toward realizing this goal through the creation of a California Advanced Services

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[79] Surewest Reply Comments of 10/16/06 at 10.

[80] Citizens Telecommunications Company of California Comments on the Assigned Commissioner's Ruling at 6.

[81] Pub. Util. Code § 709 (c) identifies as one of the policies for telecommunications in California, the following: "To encourage the development and deployment of new technologies and the equitable provision of services in a way that efficiently meets consumer need and encourages the ubiquitous availability of a wide choice of state-of-the-art services." § 709 (d) further identifies as a goal: "To assist in bridging the "digital divide" by encouraging expanded access to state-of-the-art technologies for rural, inner-city, low-income, and disabled Californians."

[82] See D.05-11-028 (Ordering Paragraph 1(c)) and D.05-11-029 (Ordering Paragraph 3(c)), respectively. The CETF was established for the purpose of achieving ubiquitous access to broadband and advanced services in California, particularly in underserved communities through the use of emerging technologies by 2010.

Fund (CASF) to promote additional broadband services in California.[83] Accordingly, effective with this order, we hereby authorize the establishment of the CASF to promote this goal. In order to provide an initial funding source for the CASF, we conclude that it may be appropriate to redirect at least a portion of the B-Fund contributions for this purpose.

Although we could lower the B-Fund surcharge now to reflect the reduced level of subsidy draw that will result from raising the high cost threshold, we believe that maintaining an increased B-Fund contribution surcharge until January 1, 2009 may be desirable as a means of initially funding the CASF. Therefore, we will refrain from lowering the B-Fund surcharge at this time, and will instead consider whether, or to what extent, B-Fund contributions should be redirected to the CASF. We shall solicit comments on the merits of such an approach in the next phase of this proceeding.

In Phase II of this proceeding, we shall consider the design of a procedure whereby applicants may qualify for funding under the CASF for purposes of deploying broadband in areas that are not currently being served or that are underserved. Under the CASF, we envision that an application process would be used for qualifying for funding of broadband deployment based on a showing that a proposed area is either not being served or is underserved by broadband services at less than 3MBPS. Under such a process, applicants would be required to: (1) voluntarily submit data to the Commission, under appropriate confidentiality provisions, of its broadband infrastructure by census block group, and (2) commit to complete build within 18 months. We envision a process

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[83] See e.g., Broadband for All? Gaps in California's Broadband Adoption and

*Footnote continued on next page*

whereby priority would be directed first to areas not served by facilities capable of providing 3MBPS download and 1MBPS upload speeds, then potentially to areas with one or two facilities-based providers capable of providing those speeds to all customers.

As the CASF would be a limited one-time-only source of funds to build infrastructure in California and would work in conjunction with the California Emerging Technology Fund, we seek input on the overall size and funding of the CASF. We also shall also seek input as to whether an application should open a sixty day window for other applications for substantially the same geographic area. CASF applicants need not be COLRs, but would have to meet specific audit, verification, and other requirements with respect to the use of the funds. Funding not directed for use by January 1, 2010, will be used to reduce the B-Fund surcharge in the 2010-2011 funding year. We shall pursue further development of these issues in the next phase of this proceeding.

As a result of the revisions in the benchmark authorized in this order, a significant number of CBGs that were previously considered "high cost" will now be excluded in computing B-Fund draws. To facilitate Commission staff review and monitoring of B-Fund subsidy draws submitted by COLRs for payment subsequent to this order, we direct that any new claims for B-Fund support clearly identify the specific CBGs, and associated proxy costs, that have been eliminated and that are no longer eligible for B-Fund support due to revisions in the threshold benchmark. COLRs shall provide this documentation

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Availability, Public Policy Institute of California, rel. July 10, 2007.

separately for each successive change in the benchmark level, as set forth in the Appendix Table 1 schedule of this order.

## 6. Timing for Implementing Revisions to the Benchmark

We next consider the question of timing of the implementation of the revised benchmark threshold of $36. Since the rate freeze on basic service will continue until January 1, 2009, as discussed below, we must determine whether it is appropriate to implement changes to the B-Fund benchmark threshold *prior to* lifting the rate freeze. Alternatively, we consider to what extent, if any, changes to the B-Fund benchmark or surcharge should be deferred to coincide with the lifting of the rate freeze.

### 6.1 Parties' Positions

AT&T, Verizon, and SureWest argue that any changes to the benchmark should be implemented concurrently with lifting the freeze on basic rates, scheduled for January 1, 2009. AT&T argues that raising the benchmark (thereby reducing subsidy) while the rate freeze remains in place would be "disjointed" and impede the ILECs' continued ability to serve high cost areas, putting rural customers at greater risk. AT&T argues that any reduction in subsidy support while the basic rate freeze remains in effect would mean either (1) carriers lose money serving high cost customers, or (2) any shortfalls would have to be funded by raising prices for services other than basic service. AT&T contends that neither of these alternatives is appropriate.

AT&T argues that if it was forced make up reduced subsidies by raising rates for services other than basic service, the result would be to restore the very cross-subsidies that the B-Fund was designed to eliminate. AT&T argues that such cross-subsidization would conflict with the Commission's policy to

promote competition by eliminating implicit price subsidies and encouraging carriers to price services in relation to actual costs.

The ILECs assert that if the funds provided to the COLR to subsidize high cost lines is reduced, then the Commission would be required to authorize an offsetting increase in basic rates to maintain revenue neutrality. The ILECs argue that principles of revenue neutrality must be enforced as long as there are basic rates which are not subject to full pricing flexibility.[84] AT&T argues that without a revenue-neutral rate increase to offset a Commission-mandated reduction in B-Fund support, a justified "taking" would occur. At least for the duration of the rate freeze on basic service through January 1, 2009, the ILECs could not make up for a reduction in the authorized level of B-Fund support by increasing basic rates without Commission approval.

AT&T asserts that the Commission "recently agreed that when revenues are taken away from AT&T California by the Commission's actions, it is appropriate to provide for an offsetting revenue source."[85] AT&T cites the Commission's action to lower intrastate access charges for the large ILECs, finding that "in past instances in which the Commission has ordered rates to be reduced [the Commission has] provided for revenue neutrality." The Commission stated that it "could only depart from the established policy with a compelling showing."[86]

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[84] AT&T Opening Comments at 21-22; SureWest Opening Comments at 12; Verizon Opening Comments at 14-15. Frontier Opening Comments at 9.

[85] AT&T Opening Comments at 20.

[86] AT&T Opening Comments at 20-21 (citing *Re Intrastate Carrier Access Charges*, Decision No. 04-12-022, *Interim Opinion Resolving Intrastate Access Charge Policy Questions in Phase I, mimeo.*, p. 10 (Dec. 2, 2004)).

Cox, Sprint, Time-Warner, DRA and TURN dispute the ILECs' claims concerning revenue neutrality. They argue that changes to the threshold should be implemented now without waiting for the freeze on basic rates to be lifted on January 1, 2009. TURN favors the possibility of "downward revenue neutrality" if ILECs would gain a "windfall" by being allowed to keep subsidies without offsetting rate reductions.[87] These parties believe that Commission-mandated rate adjustments to compensate for reduced B-Fund support levels are unwarranted, and that revenue neutrality has no relevance in a competitive environment, even with a basic service rate freeze.[88] They argue that the COLR is able to adjust prices for all services except for basic services subsidized by the CHCF-B, and thereby to offset any reductions in CHCF-B draws.[89]

DRA believes that the benchmark could be increased, without lifting the residential rate freeze (other than the effect of eliminating the CHCF-B surcharge and, where applicable, surcredits). DRA argues that any increased cost-threshold should *only* be used to reduce B Fund subsidy support, but not as a basis for increasing *retail* rates. DRA calculates that an increase in retail rates up to the FCC $34.21 "safe harbor" threshold, as Verizon contemplates,[90] would

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[87] Cox Opening Comments at 14; Sprint Nextel Opening Comments at 2; Time-Warner Opening Comments at 15-17; and TURN Opening Comments at 9-11.

[88] DRA Opening Comments at 27-29; Cox Opening Comments at 14; Sprint Nextel Opening Comments at 2; Time-Warner Opening Comments at 15-17, and TURN Opening Comments at 9-11.

[89] As a limited exception, AT&T does not have the freedom to raise switched access prices. Switched access was one of the services receiving price reductions as a result of the revenue-neutral rate rebalancing adopted for AT&T in D.98-07-033.

[90] Verizon Opening Comments at 10-11.

nearly double retail rates in the Verizon, Frontier and SureWest territories and more than double them in the AT&T territory.

### 6.2 Discussion

We find no valid reason why the benchmark cannot be revised, and subsidies reduced, prior to January 1, 2009 when the basic residential rate freeze will expire. Consumers are entitled to relief from excessive burdens of B-Fund subsidies (as reflected in B-Fund surcharges) without undue delay. Reform in the B-Fund should proceed expeditiously and revisions to the threshold need not be delayed until January 1, 2009.

We strongly disagree with the ILECs' claim that the subsidy level can only be adjusted concurrently with the lifting of the rate freeze. We did not change the level of basic rates when the CHCF-B support levels were first established, and likewise need not change basic rate levels as a result of the revisions in B-Fund support levels implemented herein. Universal Service support is not an entitlement, and the relevant statutes do not automatically entitle designated COLRs to receive universal service support. Simply because the Commission has not varied in its determination of the fund since its inception does not create an entitlement for such support to carriers on a prospective basis.

In order to provide a smoother interim transition to the new benchmark level, however, we shall phase-in implementation of the new benchmark in stages. The first stage of implementation shall begin effective October 1, 2007. Subsequent adjustments in the threshold shall be implemented in three-month increments. The full implementation of the $36 benchmark shall take effect on January 1, 2009. Appendix Table 1 shows the estimated reductions in subsidy levels for each COLR associated with each successive adjustment, culminating in

the $36 threshold. The Appendix Table 1 shows a cumulative reduction in subsidy support of approximately 74% from existing levels.

We further conclude that there is no necessity to authorize any offsetting rate increases to preserve revenue neutrality as a result of reducing B-Fund support levels as implemented in this order. In D.06-08-030, we identified only one remaining area where revenue neutrality principles would apply during the transition period until January 1, 2009, when full pricing flexibility takes effect. Specifically, we stated: "the ILECs may apply the revenue neutrality principle during the transition period in order to offset Commission-mandated price changes in services still subject to price controls." As a result of the changes to the B-Fund threshold in this order, however, we are not mandating any price changes for basic services "still subject to price controls." The rate freeze on basic services, as authorized in D.06-08-030, continues in effect at least until January 1, 2009. Therefore, consistent with D.06-08-030, there is no basis to invoke revenue neutrality in response to any changes being implemented in this order, and consequently, there is no need to delay implementation of the revised benchmark.

We find inapplicable AT&T's argument that "[t]he principle of revenue neutrality should be applied, as it has been applied to other Commission-ordered changes in rates since the inception of NRF."[91] AT&T references the Commission's "consistent" and "repeated" historical rate rebalancing under NRF

[91] AT&T Opening Comments at 21.

(our pre-URF price cap regime) as a model to apply in this proceeding.[92] In this regard, AT&T references D.04-12-022 which states:

> We find in past instances in which the Commission has ordered rates to be reduced we have provided for revenue neutrality. We are wary of midstream changes to our regulatory programs, which have been crafted with an eye toward balancing competing interests. We could only depart from the established policy with a compelling showing.[93]

This quotation was in the context of the now defunct regulatory framework under NRF. The "regulatory programs" from which a "midstream change" was suspect, as referenced in D.04-12-022, however, are now virtually nonexistent with the adoption of URF in D.06-08-030.

We concluded in D.06-08-030 that "[t]here is no longer a need for the NRF regulatory apparatus of price caps, annual price cap filings, productivity factors, and all residual elements of rate-of-return regulation, including the calculation of shareable earnings."[94] The concept of "revenue neutrality" was a residual element of the era of rate-of-return and NRF regulation, to ensure that regulatory changes did not adversely affect the ILEC's financial viability or cause unwarranted windfalls.

When the B-Fund was established in 1996, we determined that "in order to make subsidies for high cost areas explicit, there must be a correlating downward adjustment of rates or price caps through a surcredit or reduction in tariffed rates or price caps so as to prevent the ILECs from recovering implicit

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[92] AT&T Opening Comments at 19-20.

[93] D.04-12-022, *mimeo.* at 10.

[94] D.06-08-030, *mimeo.* at 272, COL 115.

subsidy support as well."[95] We initially implemented this downward adjustment as a billing surcredit as an equal percentage rate reduction on all services except residential service and contract rates. Pacific Bell filed an application to replace the surcredits with specific reductions directly to different services, which we approved in D.98-07-033.[96]

In D.98-07-033, in reducing price ceilings to offset the explicit B-Fund subsidies, we stated: "By reducing Pacific's authorized price ceilings for these services, we ensure that Pacific cannot unilaterally raise these prices, thereby negating or redirecting our adopted offset; Pacific must file an application to raise its service price ceilings." D.98-07-033 made no changes to basic service rates.

With the adoption of URF in D.06-08-030, however, price ceilings (other than for basic service) have been completely eliminated. The URF ILECs are no longer required to file an application to raise prices for these services. URF ILECs may now simply file one-day effective advice letters but must give consumers 30 days' notice of rate increases and more restrictive terms and conditions. Those tariffs may be challenged. Other previous restrictions on the ILECs' ability to adjust rates for services other than basic residential service, however, have been eliminated.[97] The opportunity to adjust rate levels based

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[95] D.96-10-066 at 207.

[96] D.98-07-033 adopted $305.2 million in rate reductions in toll, switched access, ZUM/local usage, and custom calling features for Pacific Bell to offset explicit subsidy support provided by the B-Fund.

[97] The limited exception is that AT&T does not have the freedom to raise switched access prices. Switched access was one of the services receiving price reductions as a result of the revenue-neutral rate rebalancing adopted for AT&T in D.98-07-033.

upon competitive market forces provides a ready vehicle through which reduced B-Fund subsidies can be offset. The ILECs could in fact have already "rebalanced" their rates, at least partially, in anticipation of a reduction in B-Fund support levels. In this regard, we note that since September 2006, the ILECs have already implemented significant price increases for various residential services which are not subject to the basic residential rate freeze. These increases are summarized in Appendix Table 2 of this Decision. To the extent that these price increases have already compensated the COLR for higher costs, any additional "revenue neutrality" adjustment, even if not otherwise unjustified, would be a windfall.[98] In the environment under URF as adopted in D.06-08-030 where the COLR is subject to competitive market forces, the principles that once justified revenue neutrality are moot.

At the time CHCF-B program was established, residential telecommunications services consisted largely of basic service, vertical features, and toll. Since then, additional services such as all distance, VoIP, high-speed internet, wireless services, and multi-channel video services are typically offered as a "bundle." Although the rate freeze continues on basic service through January 1, 2009, the COLR can still adjust the price of service bundles which include provision of a primary residential line. As previously noted, the ILECs claim that two-thirds or more of their customers subscribed to service bundles (the proportion depends in part on the definition of bundles). AT&T estimated that, as of July 2006, only 10.8% of its billed residential figures were exclusively

[98] A Commission-enforced rate rebalancing, imposed on the ILECs' customers who are most likely to be vulnerable to price increases, could be used by the ILECs to underprice competitive services.

for basic service only without some additional bundled AT&T or AT&T affiliate service.[99] In many cases, these services are offered to customers in high cost areas as part of a bundle which includes basic service.

Therefore, the COLR may be able to compensate for reductions in subsidy support from the customer in the high cost areas by adjusting the prices of service bundles. The ILECs argue that such an approach would conflict with our policy against implicit cross-subsidization of services. There is no evidence in the record that any cross-subsidization would occur in the short-term until January 1, 2009, or at any point thereafter. To the extent that a carrier may increase prices for service bundles to offset the loss of subsidy support, such prices increases could not apply to the basic service component. Further, any such restrictions will only be transitory, however, until the rate freeze is lifted and carriers have the first opportunity to exercise full pricing flexibility for basic services. Moreover, as noted above, a large majority of residential customers subscribe to bundles of services delivered over the primary access line. To the extent that the customer pays a single bill for the entire package of bundled services, any price increase would apply to the total bundle. Irrespective of which particular services were attributed with any increase within the bundle, therefore, the customer's total charge would be the same.

We also reject AT&T's argument that it could not succeed in reflecting the true cost of lines in high cost areas through bundled service offerings because the bundled price would not be competitive.[100] AT&T offers no empirical data

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[99] AT&T Response to DRA Data Request 1-19, part f.

[100] AT&T Comments, p. 8.

concerning how, or at what point, its overall price for service bundles become uncompetitive. On the other hand, in D.06-08-030, we found that competition exists throughout the ILECs' service territory. Therefore, while competitors that offer basic service as part of a bundle receive no B-Fund support, they recover sufficient revenues to induce them to compete with the ILECs. Moreover, we have already concluded that basic service costs up to a threshold of $36 per line would be affordable so as to meet universal service goals. Of course, any actual price increase for a service bundle that AT&T might charge would be constrained by features and prices for service bundles offered by competitors.

In any event, the COLR will not be competitively disadvantaged relative to other service providers who already have to compete against the COLR's allegedly subsidized basic rate, but without any B-Fund subsidy. Given these considerations, we conclude that the approach we adopt herein is fair and consistent with our overall procompetitive framework adopted in D.06-08-030.

Another reason why revenue neutrality is an inappropriate policy is because there would be no practical way to determine specific rate adjustments to ensure a truly revenue-neutral result.

AT&T acknowledges that it would be virtually impossible to account for all revenue differences attributable to rates that have changed for competitive reasons since rate rebalancing was instituted in 1998, given the different discount plans that have been put in place and replaced since then. Also, competition radically affected AT&T's customer base, both in access lines and minutes of use.

AT&T concedes that whether its rates actually decreased or increased and what revenue effects resulted are, at best, not simple questions to answer.[101]

The Commission has not required revenue neutrality and rate rebalancing when revenues increased because AT&T raised prices. It would be untenable to order rate increases in the name of revenue neutrality without reconciling changes in rates over the past eight years. Such an approach would run the risk of implicitly compensating the ILEC for competitively motivated revenue decreases, which would be unfair and detrimental to consumers. The COLRs have utterly failed to provide any detail that would even allow us to consider such an approach. Mere allegations that changes to carrier costs have occurred since the most recent review are not enough. Under the regulatory frameworks in place over the past eight years, carriers have had ample opportunity make a case for changes to the basic service rates, and to the extent any pricing limitations continue, existing processes are available for them to present information that would merit a change.

In addition, trying to impose revenue neutrality would create an unequal competitive advantage, contrary to URF as adopted in D.06-08-030. Competitors other than ILECs already have price flexibility for all services, including basic residential lines, and revenue neutrality has no applicability or relevance.[102]

We also disagree with AT&T's claim that "[f]ederal law also requires revenue neutrality."[103] AT&T argues that Section 254 of the 1996 Act requires

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[101] AT&T Opening Comments at 24.

[102] *See* Cox Opening Comments at 14-15; Sprint Nextel Opening Comments at 2; Time-Warner Opening Comments at 15-17.

[103] AT&T Opening Comments at 21.

"specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service." AT&T argues that reducing the CHCF-B Fund without also providing for an alternative revenue offset contravenes the Act because it would reduce a revenue source that was specifically created to preserve universal service.[104] Contrary to AT&T's claims, we find nothing in Section 254 that requires "revenue neutrality." The reforms that we adopt are fully consistent with the goals of Section 254 to "preserve and advance universal service."

We also reject AT&T's argument that it would constitute an impermissible "takings" to reduce subsidy support levels without providing an offsetting increase in basic rates. As previously explained, AT&T has ample opportunities to exercise price flexibility under URF through the offering of bundled services which include provision of a basic residential line. Moreover, to the extent that we reduce the level of B-Fund support available to AT&T to cover the cost of residential basic service, such funds are not an entitlement. AT&T and the other COLRs have no entitlement to continue receiving high cost support. AT&T fails to provide any justification as to how a "takings" would result from any actions we adopt in this order to reform the B-Fund program and to target support in a more efficient manner.

### 7. Per-Capita Income Test as a Criterion to Limit Subsidy Funds

As another possible tool to target subsidy support only to those lines where necessary to meet the goals of universal service, we solicited comments concerning the merits of targeting subsidy funds more narrowly by excluding

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[104] AT&T Opening Comments at 21.

high-income households from eligibility for B-Fund support through a "means test" applied to individual customers. As noted in the OIR, residents in a number of California counties have per-capita income in excess of the statewide median value.

### 7.1 Parties' Positions

Sprint and Time Warner Telecom favor the use of a means test for customers whose lines are subject to CHCF-B funding. Sprint offers no suggestion, however, as to how such a means test would be implemented.[105] Time Warner Telecom argues that a means test is appropriate because the system for assessing the CHCF-B is regressive and a means test would enable the Commission to ensure that telephone lines to vacation homes would not be subsidized.

Other parties who commented upon the concept of a means test opposed it.[106] AT&T, Verizon, SureWest and Cox argue that a means test would add unnecessary complexity to calculating the CHCF-B. AT&T characterizes a means test as creating an "administrative nightmare" where different customers, in the same street or neighborhood, could be charged different rates. A means test would involve modifications to billing systems and the implementation of income verification processes.

### 7.2 Discussion

We agree that a test based upon per-capita income is not a practical tool for limiting the size of the B-Fund, and that the administrative difficulties of

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[105] Sprint, p. 2.

[106] Verizon, p. 14; AT&T, p.18; SureWest, p. 9-10; Cox, p. 9.

establishing one would outweigh any benefits. We conclude that the revised threshold that we have adopted herein provides for a more simplified and practical tool to target subsidies to truly high cost areas in a more streamlined manner. The use of average household expenditures, as we discussed above, offers a more feasible basis to set affordability criteria in order to meet universal service goals.

### 8. Disposition of Rate Freeze on Basic Residential Service

In crafting changes to the B-Fund, and the associated implementation time table, we must consider when and how the existing freeze on basic rates shall be lifted. We granted pricing flexibility for all services in D.06-08-030 in the URF proceeding, except for basic residential local exchange service. We set an automatic expiration date of January 1, 2009, for the freeze on basic residential local exchange rates not subject to a B-Fund subsidy, coinciding with the scheduled sunset of the provisions of § 739.3.[107]

D.06-08-030 (p. 2) states: [W]e cap the price of basic residential service until January 1, 2009 in order to address the statutorily-mandated link between the LifeLine rate and basic residential service rates."[108] We further stated that:

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[107] D.06-08-030 (Conclusion of Law (COL) 30) states: "The Commission should maintain price caps on basic residential flat service, basic residential measured service, LifeLine basic residential service and Lifeline connection service until January 1, 2009 as discussed herein."

[108] The relationship between the basic residential rates and funding needed to support LifeLine is being addressed in the Universal Service, Public Policy Programs Rulemaking (R.06-05-028). LifeLine is a critical element in our universal service program to bring local telephone service at affordable rates to low income Californians, and any changes to basic residential rates must be consistent with LifeLine policies being addressed in R.06-05-028. We intend to resolve relevant LifeLine issues in R.06-05-028 in time to permit the lifting of the basic rate freeze effective January 1, 2009.

"After January 1, 2009, the cap on basic residential service rates that are not subsidized by CHCF-B will no longer serve the public interest, and accordingly, the cap will sunset automatically with no further Commission action required." (D.06-08-030 at 152.)

We deferred to this proceeding, however, the disposition of the rate freeze for residential services, if any, that remain subject to CHCF-B subsidies. In this respect, we ordered that "basic residential services receiving a CHCF-B subsidy shall be frozen at a level equal to the current rate, which will be reevaluated in our upcoming CHCF-B review in R.06-06-028." (D.06-08-030 at 143.) By ruling dated February 23, 2007, we provided notice and opportunity for comment as to whether, in what manner, or to what extent, the rate freeze applicable to basic residential services should be lifted and/or modified as a function of revisions to the B-Fund mechanism contemplated in this OIR. We consider this issue below.

### 8.1 Parties' Positions

AT&T supports the lifting of the freeze on all basic rates effective January 1, 2009, but argues that both the B-Fund subsidies and revenue neutrality would still be warranted even after full pricing flexibility takes effect. AT&T asserts that if the support for high cost lines is reduced while the COLR obligation remains, any changes to the support level would have to be made up on a revenue neutral basis. AT&T does not believe that full pricing flexibility for basic would eliminate the need for support. Rather, the subsidy level would merely be adjusted to reflect whatever rate level was set for basic service.[109]

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[109] AT&T Opening Comments at 22.

AT&T proposes that any reduction in B-Fund support levels associated with changes in the benchmark or "presumed rate" be phased in over an extended period. AT&T states that the precise time period for such a phase-in would depend on the magnitude of the total increase in the benchmark threshold adopted by the Commission, but suggests that a phase-in limited to a $2 per year would be manageable.[110] AT&T argues that the Commission cannot set a presumed rate two or three times higher than what a carrier has been allowed to charge because "rate shock" would result with negative consequences for consumers.

SureWest advocates a multi-year transition period for purposes of implementing increases to basic rates to a level closer to the actual cost of service, with a corresponding gradual reduction in B-Fund draws. SureWest agrees with AT&T that given the current disparity between costs of service and basic rate levels, any rate increase implemented on a "flash cut" basis to recover full costs could result in "rate shock."

Sprint argues, however, that any risk of sudden rate increases to make up for reductions in B-Fund subsidies would be significantly moderated by competition. Rather than sudden rate increases, Sprint/Nextel argues that the more likely scenario is that given competitive market forces, the ILEC would continue to price basic service at a level that would induce the customer to remain with the ILEC.

DRA argues that if the B-Fund program is to continue beyond January 1, 2009, in some form, the Commission should require the COLR to

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[110] AT&T Comments of 4/27/07 at 18.

maintain price caps as a condition of receiving subsidy funds. DRA argues that absent price caps on basic service, there would be no assurance that customers benefited from B-Fund subsidies because the COLR could negate any benefits by raising prices for basic service. As an alternative to immediate elimination of the B-Fund, DRA proposes a multi-year phase-out period, with a "stepping down" of the current per-line subsidy each year until the full subsidy is eliminated. DRA specifically recommends a three-year period for phasing in any permitted rate increases for AT&T's basic residential service before establishing a single statewide benchmark for affordable service.[111]

TURN argues that pursuant to Pub. Util. Code § 454, the rates for rural customers cannot be increased absent a showing that such increase would be "just and reasonable." TURN thus argues that continuation of a rate cap should be required until the Commission conducts an appropriate investigation. As an additional reason to continue the rate freeze, TURN argues that Pub. Util. Code § 5940, prohibits cross-subsidies between stand-alone residential primary lines and deployment of a video service network. TURN argues that if the rate freeze is lifted, the Commission would have no way to assure itself that rate increases to rural residential primary lines were not being used to finance the video network. TURN argues that an extended rate freeze would be warranted to ensure that the provisions of § 5940 are being enforced.

### 8.2 Discussion

We first consider whether the existing rate freeze can or should be lifted prior to January 1, 2009. As a matter of law, the Digital Infrastructure and Video

[111] DRA Comments of 4/27/07 at 10.

Competition Act (DIVCA) permits only inflation-related adjustments, at most, to basic rates prior to January 1, 2009.[112] Since we have concluded, as discussed above, that the rate freeze does not preclude revision to the threshold for eligibility to draw subsidy funds, the freeze should continue until January 1, 2009.

We conclude that effective January 1, 2009, however, the rate freeze should be lifted on all basic access lines, including any that continue to be subsidized by the CHCF-B. Although the basic rate freeze will end on January 1, 2009, we conclude that it would be premature to grant full pricing flexibility for all basic rates immediately upon the lifting of the freeze. While we recognize the need to start the process to enable basic rates to move closer to costs, we also share the concerns of certain parties as to the potential for retail "rate shock" if full pricing flexibility for basic rates were granted immediately on January 1, 2009. We believe that cost-based rates for basic service should be implemented gradually to provide for a smoother transition for customers. Therefore, we shall adopt a phased-in schedule to take effect beginning January 1, 2009, to begin transitioning from the current basic rate levels toward the goal of cost-based rates, as disciplined by competitive market forces. During this phase-in period, we shall impose caps on the maximum level that the COLR may charge for basic service, subject to gradual step increases over a prescribed time period until the rate cap rises to a level equal to the benchmark threshold of $36 per line, as adopted herein. In this manner, any potential "rate shock" will be avoided.

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[112] This provision of DIVCA applies only to carriers that obtain a statewide video franchise. AT&T, Verizon, and Cox have all sought such franchises. AT&T and Verizon's applications have been granted.

We shall develop a further record in the next phase of this proceeding concerning the appropriate time period and magnitude of step increases that should be authorized after January 1, 2009, for COLRs to transition from the current subsidized basic rate levels up to the revised benchmark of $36. We shall adopt a specific schedule for the phase-in of step increases in basic rate levels to take effect by the time that the rate freeze expires on January 1, 2009. After the phase-in period has concluded, we shall authorize full pricing flexibility for basic rates.

After full pricing flexibility takes effect, all carriers, including the COLR will be free to adjust prices for residential rates based on competitive market forces rather than based upon whether a subsidy is available to support prices below their cost. Carriers will be able to price residential service to reflect costs in a particular geographic location rather than applying a uniform system average price. A requirement of geographically averaged prices could encourage the provision of services by high costing but subsidized technologies, while discouraging service by competitors offering lower-costing but unsubsidized services. As an example, in many rural areas, it may prove less expensive to provide basic telephone service via wireless technologies than by subsidizing the construction of long copper wire traditional telephone service connections.

AT&T offset its B-Fund subsidy by directly reducing services other than for basic rates. To offset their B-Fund subsidies, Frontier and Verizon each apply a B-Fund surcredit to their customers' bills for all intrastate services except basic residential service.[113] Frontier and Verizon propose that any reduction in

[113] Frontier Opening Comments at 3; Verizon Opening Comments at 15.

subsidies be offset by a reduction in the B-Fund surcredit.[114] DRA recommends that the "permanent" surcredits adopted for Frontier and Verizon in Resolutions T-17008 and T-17009, respectively, be eliminated.[115] We shall phase out these surcredits concurrent with the lifting of the freeze on basic rates effective January 1, 2009. The phase-out of the surcredits will be conducive to the goal of moving more toward reliance on competitive forces rather than subsidies to meet universal service goals.

The lifting of the rate freeze is consistent with the URF policies adopted in D.06-08-030, and will facilitate the goal of moving rates for basic service toward a level that reflects actual costs. Particularly considering the extended period that has transpired without adjusting basic rates to respond to changing costs, the freeze should be lifted effective January 1, 2009. In that manner, basic rates can begin to move closer to their true costs, consistent with a competitive market.

California's basic residential telephone service rates are priced among the lowest in the nation. Consistent with a competitive market, increases in the price of basic service to align more closely with actual costs would send a more economically efficient price signal to customers. We disagree with Sprint's observation, however, that the forces of competition should act as a constraint to mitigate concerns regarding any claimed "rate shock" as a result of immediately lifting the freeze on basic residential rates. Although the voice market is competitive, basic residential rates have not been priced based upon competitive market forces but have remained frozen for an extended time. Therefore, we

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[114] Frontier Opening Comments at 8; Verizon Opening Comments at 15.

[115] DRA Opening Comments at 6.

believe that a transitional period is needed to move smoothly from the current price freeze to a pricing structure more reflective of a competitive environment.

TURN raises concerns that lifting the freeze on basic rates could result in cross-subsidization between basic local exchange service and video services in violation of § 5940. To the extent that any such cross-subsidization theoretically could occur, the rates for basic exchange service would have to increase to a level in excess of cost. Considering the current disparity between basic rate levels and the actual costs of basic service, particularly in high cost areas, we do not consider it realistic to expect that rates would rise to the point where cross-subsidization was an issue, at least in the near term. As to the longer term, we shall consider in the next phase of this proceeding if additional reporting requirements or other safeguards should be imposed to guard against cross-subsidization of video services as prohibited under § 5940.

We disagree with TURN's argument that the requirements of Pub. Util. Code § 454 require formal Commission approval based on a separate showing that the increase is "just and reasonable." Pursuant to D.06-08-030, we have determined that competitive market forces will assure that rate levels are "just and reasonable." No separate showing will be required as a basis to adjust basic rates.

We also note that, to the extent that basic service rates change due to the lifting of the freeze, the rates that Small Local Exchange Carriers (LECs) charge would likewise be affected as a result. Small LECs' rates would be affected because the average local exchange rates of the Small LECs are not to exceed 150% of comparable California urban rates. The 150% level constitutes a benchmark against which specific company rate designs are measured than a rigid requirement that each rate design element be set at 150% of the underlying

urban rate. Small LECs that cannot meet their revenue requirement as a result of the 150% rate level limitation are eligible to draw from the CHCF-A. The lifting of the rate freeze on January 1, 2009 will cause changes in the comparable California urban rate levels for purposes of the 150% cap. We shall consider any applicable implications for the CHCF-A as a result of the lifting of the rate freeze, along with more general review of the CHCF-A program, in a separate proceeding.[116]

As noted in D.06-08-030: "We emphasize that application of the revenue neutrality measure will end on January 1, 2009, when we lift the basic residential rate price cap on services not subsidized by CHCF-B." Therefore, with the lifting of any remaining price freeze on January 1, 2009, there will no longer be a basis for the Commission to maintain revenue neutrality or to mandate price adjustments associated with reductions in B-Fund support levels.

Although we shall lift the freeze on all basic rates effective January 1, 2009, we conclude that the B-Fund subsidy program should continue beyond January 1, 2009, albeit at a reduced level of support for certain high cost lines in more targeted high cost areas. In the interests of ensuring that universal service goals continue to be met, certain truly high cost areas will still require some level of B-Fund support to keep rates at reasonably comparable levels with those of urban areas. The COLR needs to offer service to such areas even though the costs of service remain high. Targeted support from the B-Fund will provide a continuing vehicle to fund the gap between rate levels and service costs in such areas.

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[116] See D.91-09-042, Appendix, 41 CPUC 2d, 326, 330.

We shall conduct a cost study, as explained below, to update the proxies for high cost areas so that the level of support is set at a reasonable level. Subject to the rate cap phase-in, to be determined in the next phase of this proceeding, the COLR will have the flexibility to charge rates subject to competitive market forces.

As a basis to receive B-Fund support after full pricing flexibility takes effect, however, we shall require that a COLR certify annually that it is not charging rates for basic service in excess of the benchmark levels that we establish herein. A COLR that does not make the required annual certification will be required to provide a detailed showing as to why it is unable to comply with the Commission's Orders. The Commission will evaluate the evidence and determine what, if any, action is required.

## 9. Phase II Reforms to the B-Fund Program

## 10. Cost Updating of High Cost Proxy

### 10.1 Introduction

As noted above, we conclude that the CHCF-B program needs to continue after January 1, 2009, albeit on a more limited and better-targeted basis applicable to those areas where cost levels may still warrant some level of subsidized support. As a basis for continuing to provide support in high cost areas on a more limited basis after January 1, 2009, we conclude that the most immediate priority is to update the cost proxies to derive a reasonable level of support due for high cost lines.

In D.96-10-066, we defined high costs based on a "Census Block Group" (CBG) where the cost of basic telephone service exceeded the system average in the territories of the state's four large and mid-sized LECs. Since the adoption of

CBG costs in 1996, over a decade ago, the makeup of the state's population demographics, technology and costs of providing service have changed considerably. As a result, the applicable level of costs included in the support calculation require updating accordingly.

Although raising the high cost benchmark to $36 per line will significantly reduce the number of lines to be subsidized, as shown on Appendix Table 1, certain areas will still reflect costs above the $36 threshold, at least based upon existing cost proxy levels. In the OIR, we tentatively concluded that we should still update the estimated cost of providing basic service to Californians to reflect current conditions. Based on our review of parties' comments, we affirm that conclusion.

By updating the cost data utilized for determining the support levels, we will have greater assurance that support is limited to reasonable cost levels needed to meet the goal of universal service. The cost updating process involves two primary determinations: (1) selection of a cost model to use in deriving high costs by region and (2) determination of the appropriate input values to reflect the applicable high costs to be modeled. As noted in the OIR, the original "Cost Proxy Model" (CPM) utilized to derive high cost proxies in D.96-10-066 is no longer available for use. As discussed below, we adopt an alternative model in this order for developing updated proxy costs for purposes of determining the appropriate level of support. In view of the limitations underlying the cost-updating approach that we adopt, however, we shall also pursue a longer term solution in the form of a reverse auction for determining applicable support levels.

### 10.2 Parties' Positions

As a basis for conducting updated studies of high cost proxies, the first step is to adopt an appropriate model to be used. AT&T identified various models that could possibly be used to perform updated calculations of cost proxies for purposes of setting the level of subsidy support in designated high cost areas. Such models include "CostPro" (originated by the developers of the original CPM) used to establish B-Fund support levels in 1996, the "Synthesis Model" (approved by the FCC, but not previously used within California), the Hatfield Model (HM 5.3) (previously used for modeling UNE costs for AT&T and Verizon, but not previously used for deriving universal service funds).

AT&T argues that while none of the available models is ideal, the HM 5.3 model offers the best choice for use in updating proxy costs for deriving high cost support levels. The advantage of the HM 5.3 model is that the Commission has already approved it for use in the UNE proceeding. The HM 5.3 model has the capability to compute costs for universal service. Although the universal service calculations in the HM 5.3 model are based on federal definitions, adjustments can be made to reflect California-specific costs.

Verizon proposes to utilize adopted UNE loop costs as a basis for updating basic retail service costs for deriving B-Fund subsidies. Verizon argues that UNE costs can be updated without the need to perform comprehensive cost studies. For Verizon, UNE costs were most recently adopted in D.06-03-025.[117] The adopted UNE costs would require the addition of the port, usage and retail costs. Although UNE costs are identified only on a wire center (rather than a CBG)

[117] See D.06-03-025, Appendix C, "Wire Centers by Zone."

basis, Verizon argues that the wire center provides a sufficient level of granularity.

DRA argues that the current method for determining which areas are high cost and the amount of support required per area tends to overstate the amount of support required. DRA claims that the existing methodology for high cost support which is based on forward-looking costs to serve high cost areas produce estimates that are systematically overstated. DRA claims that the ILEC is likely to incur relatively minor costs to extend existing facilities short distances. DRA argues that forward-looking costs are meaningful only with respect to a new wireline competitor entering an area to serve customers. DRA argues that such costs are not relevant in the context of an incumbent carrier extending service using its preexisting facilities. DRA argues that the annual operating expense of the line is more relevant than the total service long-run cost to replace the line, and that the ILECs only need to cover any gap between ongoing incremental costs and revenues. DRA notes that the available models focus primarily on plant layouts and associated capital costs of a new plant, but provide little information as to relationship of ongoing operating costs in relation to population and geographic differences.

AT&T claims that DRA's position constitutes a repudiation of the "Consensus Costing Principles" which were previously adopted for use in developing wholesale rates.[118] AT&T argues that these principles have been used in many subsequent proceedings including the proceeding that established the B-

[118] See D.95-12-016, Interim Opinion Adopting Cost Methodology Principles and List of Basic Network Functions for which Cost Studies are to be Performed, 62 CPUC 2d 575, Appendix C (Dec. 6, 1995).

Fund, and that DRA arguments for changes to that standard are without any sound basis. Among other disagreements, AT&T disputes DRA's assumption that once facilities have been deployed to serve a new area, the only relevant costs applicable to determining B-Fund support levels are short-run incremental costs. AT&T argues that facilities periodically must be replaced, and depreciation of those facilities is a necessary part of service costs.

SureWest agrees with DRA that the currently applied costing methodology for B-Fund support levels fails to capture SureWest's true cost applicable to serving customers in high cost areas. In contradiction to DRA, however, SureWest claims that incremental cost *understates* the actual costs involved in serving high cost lines. SureWest contends that "actual" cost of service data is preferred, rather than theoretical assumptions underlying "forward-looking" cost approaches, at least for purposes of a SureWest cost model to revise B-Fund support levels.

SureWest supports the creation of an entirely new model that is tailored to its specific costs of providing basic retail service in its territory, rather than relying on a model focused on the costs of a larger ILEC. In D.05-08-004, SureWest was previously directed to develop and submit a cost model for purposes of producing a cost proxy of its operations as a basis to derive B-Fund subsidy levels. The cost model was intended to be used to justify SureWest's interim annual draw of $11.5 million from the CHCF-B. SureWest subsequently filed a Petition for Modification of D.05-08-004, proposing to phase down the interim draw. SureWest was also granted an extension of time to submit the cost model required under D.05-08-004. SureWest argues that a company-specific model is no longer needed to resolve the interim draw, but that a revised

statewide model is needed so that SureWest can receive an accurate level of B-Fund support.

Time Warner suggests that the updating of the cost proxy raises questions concerning what is the appropriate technology to be modeled for purposes of setting a cost proxy. Another question is who should pay for any higher quality or greater reliability features that may be associated with a wireline technology. Time Warner argues that any quality or reliability differences of wireline may be less important to customers in more remote service areas subject to high cost. As an alternative, Time Warner suggests merely capping the cost proxy at the rate level for basic wireless service.[119] In this way, any incremental cost differences associated with a wireline network would be born only by those customers willing to pay more for the higher level of reliability. Time Warner argues that it would be unfair to require all consumers to subsidize the incremental improvement in reliability of wireline service if the recipients of that reliability are unwilling to pay for it themselves.

If the Commission chooses to utilize the ILEC network as a model for updating high cost proxies, however, Time-Warner proposes an approach based on comparing UNE Platform cost changes over distinct time periods. Specifically Time Warner proposes (1) calculating the percentage change in UNE costs between the mid-1990s and those adopted in D.04-09-063 (for SBC) and D.06-03-025 (for Verizon) and (2) applying the percentage change by zone to the previously adopted costs for each CBG that exists within each respective zone.

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[119] Time-Warner Comments of 4/27/07 at 20.

TURN proposes a variation of the Time-Warner approach intended to produce a more accurate cost adjustment. As explained in the Declaration of Dr. Roycroft, attached to TURN's comments, TURN suggests that a similar scaling using a publicly available model such as the FCC Synthesis Model or Hatfield Model 5.3, with updated information provided by carriers to reflect forward-looking input prices. The updated model runs would then be compared with runs using input values from earlier periods, and a scaling ratio would be generated. Since these models generate cost estimates at the wire center level, a matching of wire centers and census block groups would be required to correlate cost model results with the CPM estimates.

### 10.3 Discussion

In weighing the various factors involved, we conclude that the cost proxy for B-Fund support must be updated given the passage of more than a decade since the costs were previously reviewed. The updating of costs raises a number of difficult questions. For example, given the competitiveness of the industry through intermodal technologies (i.e., wireline, wireless, VoIP, and cable networks), it is unclear as to what technology would be most relevant for purposes of modeling a competitively-neutral cost proxy. For example, wireless or broadband technology may be able to provide comparable local service to an area at a lower cost than the traditional copper-loop circuit-switched architecture as generally utilized by the ILEC. Yet, our current standards for basic service requirements and the associated existing cost models for identifying high cost areas are grounded in the traditional wireline network architecture. Thus, given current standards, we cannot rely upon basic wireless rate levels (as suggested by Time-Warner) as the basis for capping high cost proxy levels. None of the identified models, moreover, is capable of calculating the cost of a wireless or

cable-based network, or voice service based on Internet Protocol. It would not be feasible to undertake a cost study based on data from intermodal providers, or to modify cost data to factor in service quality differences among different intermodal technologies.

While the ideal solution would be to identify costs based on the most competitive technology currently available, the resources are not currently available to identify and measure such costs. Since the ILECs currently serve the function of COLR, we conclude that the costs of the ILEC network continue to be acceptable, at least in the near term, as a basis for updating the high cost proxy. As discussed below, we intend to institute a reverse auction process whereby all competitors will be able to bid on obtaining rights to receive B-Fund subsidies. In this manner, the ultimate goal will be to let the marketplace determine the least-cost technology and COLR that can most efficiently offer universal service access in a given area.

Given the limitations involved, we conclude that the HM 5.3 model offers the best choice among the available options for purposes of updating the B-Fund high cost proxies. In previous Commission proceedings, we have acknowledged that the HM 5.3 model is not ideal as a cost estimating tool, but contains certain flaws. Nonetheless, we previously concluded that HM 5.3 model results were sufficiently acceptable to use in the most recent UNE cost proceedings for AT&T and Verizon (see D.04-09-063 and D.06-03-025). As stated in D.06-03-025, we concluded that adoption of the HM 5.3 model for determining Verizon's UNE rates was "reasonable given the enormous complexity involved in TELRIC modeling exercises. It is reasonable to use a model with some flaws when the alternative is another model with more significant flaws that is also difficult to operate and modify." (P. 56.)

We therefore adopt the HM 5.3 model for use in this proceeding for purposes of the development of updated cost proxies to derive B-Fund support levels prospectively. The HM 5.3 model offers a relatively current customer location database and model inputs that have already been reviewed by the Commission for AT&T and Verizon. In the next phase of the proceeding, we shall conduct additional inquiry concerning whether or how the cost data for AT&T and Verizon may serve, or be adapted, as proxies for B-Fund support in the SureWest and/or Frontier service areas.

Although some code changes are required, HM 5.3 does include CBG-level cost data that may be extracted. We conclude that costs should be disaggregated at the CBG level in order to provide a sufficient level of granularity for identifying high cost lines. Using the adopted version of the HM 5.3 model is superior to updating the 1996 cost study for year 2000 U.S. Census data because the HM 5.3 model contains actual customer location inputs that are more current. Since the rights to the model are controlled jointly by the model developers and the former stand-alone AT&T and MCI, however, provisions will have to be made for appropriate access for third-party review.

The other potential modeling sources suggested by parties do not provide as useful a basis for deriving a cost proxy as does the HM 5.3 model. The Cost Pro model is not suitable in view of the fact that no party, including AT&T appears to have any working knowledge of the model's capabilities in estimating retail costs. Likewise, the Synthesis Model is not a suitable choice. As noted by DRA, this model is aging, not regularly maintained, and is cumbersome to use. The Synthesis Model also requires a proprietary third-party input database which is not publicly available. The existing database is over a decade old and numerous new company-specific inputs would need to be obtained and

processed through the third-party database developer. As another disadvantage, the Synthesis Model only calculates costs at the wire center, rather than at the CBG level.

We decline to adopt the modeling approach suggested by Verizon using UNE-P – based loop costs as the basis for updating high cost support levels. The UNE model only calculates costs at the wire center level, and thus would not provide sufficiently granular delineation of costs at the CBG level. As a result of such an approach, costs would be averaged across broad geographic areas rather than being targeted to the specific CBG areas where high costs exist. Moreover, the model only provides costs for AT&T and Verizon (which would still require some updating), but no recent cost data for either SureWest or Frontier.

We also decline to adopt the Time-Warner/TURN proposals for scaling the costs from the original Cost Proxy Model using the zone-wide shifts in the Commission-adopted UNE results. These proposed approaches would be unnecessarily complex without yielding meaningful projections to reflect real population and demographic changes, or technology and market changes that have affected costs since 1996.

DRA argues that it would involve a major undertaking to litigate and adjudicate the appropriate level of updated costs for each of the COLRs. TURN, however, believes that the inputs to the model can be updated relatively easily. AT&T proposes that the principal changes for cost proxy updating be limited to:

(a) Updating the locations of customers and CBGs;

(b) Adjusting the model to calculate costs per CBG rather than per wire center;

(c) Reflecting geographical and political obstacles to the construction of networks;

(d) Updating inputs for costs of labor and equipment; and

(e) Incorporating retail cost inputs not previously derived.

Our intent is to avoid relitigation over the previously adopted methodology or sources used to calculate input prices, such as depreciation rates or costs of capital. Rather, our goal is to limit the updating process merely to reflect the cost inputs to that were used in the most recent UNE cost proceedings for AT&T and Verizon. We shall set as an initial priority that cost updates and model runs be performed for AT&T and Verizon. We recognize that no previous costs have been adopted for SureWest or Frontier utilizing the HM 5.3 model. We shall separately consider the process for updating of cost proxies for SureWest and Frontier to follow after costs are updated for AT&T and Verizon. We shall schedule a workshop in the next phase of this proceeding for the parties to meet and confer with the goal of reaching consensus, or at least minimizing, disputes concerning the manner in which cost inputs should be updated for the limited purpose of computing the high cost proxy to derive subsidy levels in accordance with the approach adopted herein.

## 11. Future Disposition of B-Fund Eligibility and COLR Responsibilities

After the rate freeze is lifted, carriers will no longer be restricted on the level that can be charged for basic service. Accordingly, we must determine how B-Fund subsidy requirements will be measured in an environment where there is no longer a freeze on basic rates.

DRA proposes that the ILECs retain their COLR obligation, and that the Commission hold additional proceedings to determine how to guarantee affordable service throughout the state thereafter through other means. DRA argues, however, that if a CHCF-B subsidy program is to continue after January 1, 2009, while allowing detariffing or geographic deaveraging, there would need to be rate reporting and monitoring reports. DRA believes that such

reports should be location-specific, at least as granular as a Census Block Group. DRA argues that such reports would be vital to ensure that ratepayers are not providing funding to COLRs that yields little or not benefit.

We agree with DRA that the COLR obligation should continue. We shall develop an additional record in the next phase of this proceeding to address how the COLR obligation shall be administered after January 1, 2009. We recognize that the level of retail prices ultimately determines whether basic service is affordable in high cost areas consistent with universal service goals. We shall consider what alternative measures would be appropriate as an alternative to the current B-Fund program thereafter.

To the extent that a COLR seeks to continue to qualify for B-Fund support after full pricing flexibility takes effect, we shall consider whether, or through what process the COLR should certify that its rates for basic service do not exceed the adopted benchmark. In this manner, the carrier would be free to charge less than the benchmark, but any rate reductions will have no effect on the level of B-Fund support. If the carrier charges basic rates in excess of the benchmark, the carrier would not receive B-Fund support.

In the next phase of this proceeding, we shall also consider what processes should be adopted for subsequent evaluation of the B-Fund program viability and justification for its longer-term continuation. As part of this process, we shall consider what processes may be applied to periodically review, refine, or update the $36 per line benchmark threshold adopted in this order. Also, as explained below, we shall pursue implementation of a reverse auction to establish high cost funding levels.

### 12. Auction Mechanism to Establish High Cost Funding Levels

As various parties have observed, we recognize the limitations of relying on updated cost modeling to serve as the basis for B-Fund support levels. Not only is the cost modeling process time consuming and resource intensive, but it also requires the selection of a particular technology that is to be modeled. In the last decade, advances in communications technology have brought consumers many choices of voice providers using many technologies. It may not be in consumers' interests for government to select the technology for consumers through funding of B-Fund support. Rather than rely on a technology-specific cost proxy as a basis to determine high cost funding levels, we conclude that the superior long term solution is to move toward more market-based approaches that are not biased toward a particular carrier or technology. In particular, we intend to pursue implementation of a reverse auction as a means of determining the appropriate level of high cost support to meet universal service goals on a technology-neutral basis.

We determined in D.96-10-066 that, "if little or no [local phone] competition develops, then we may reconsider whether the use of an auction mechanism is appropriate for reviewing the subsidy amounts."[120] After holding a workshop in 1997 to investigate development of an auction mechanism, we found that existing legal and market conditions at that time were not suitable for an effectively functioning auction mechanism.[121] Commission staff concluded

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[120] D.96-10-066, *mimeo. a*t 216.

[121] CPUC Staff Report, "Universal Service Report to the Governor and the Legislature: In Response to Pub. Util. Code § 739.3(e) and (f)" (Rel. December 1, 1999) at 8.

that conditions continued to be unsuitable in 1999.[122] Legal concerns identified in 1997, and persisting in 1999, included the Commission's ability to restrict subsidy to the winning bidders, the ability to relieve incumbent LECs of their interconnection obligations, and the ability of the Commission to require exiting COLRs to sell facilities according to a specific pricing method.[123]

The competitive concerns identified in 1997, and persisting in 1999, involved the lack of potentially interested bidders for less desirable service areas and lack of facilities-based local exchange competition at that time, with the expectation that such competition would arrive to remote areas at a much later time. Commission staff concluded in the Telecommunications Division 1997 Workshop Report that, without competition, an auctioning mechanism would not serve the public interest, and could enable ILECs' to "ratchet-up" the level of subsidy in those areas with the least amount of competition, which would result in an artificial inflation of the subsidy.[124]

In comments in this proceeding, various parties suggest that the Commission take no action to implement a reverse auction until the FCC issues its own set of revised universal service rules which may provide guidance on this issue. We acknowledge that proposals for reverse auctions are currently being considered by the FCC as a vehicle to determine high cost support for the federal

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[122] *Id.* at 9.

[123] *Id.* at 9.

[124] CPUC Staff Report "Universal Service Report to the Governor and the Legislature: In Response to Pub. Util. Code § 739.3(e) and (f)" (Rel. December 1, 1999) at 9.

universal service program.[125] We intend to take into account any relevant ideas or proposals that may be developed by the FCC proceeding as we craft a reverse auction for use in our state B-Fund program.

Given the range and extent of competitive options that have developed over the past decade, however, we cannot simply delay moving forward to develop our own auction mechanism. California has not been afraid to innovate ahead of the federal government and other states. We believe that the time is right to revisit the concept of an auction as a superior means of determining the value of a high cost subsidy.

The purpose of an auction mechanism has been stated as allowing "a marketplace of competitive bidders to determine the economically efficient level of subsidy required to compensate a carrier for serving a high cost area."[126] In many contexts, "auctions have been used as a way to introduce market forces into the allocation of scarce resources."[127] A properly structured auction mechanism could drive down the cost of the subsidy for high cost areas to the extent that a competitor is more efficient than the current COLR in offering service to such areas. An auction mechanism would eliminate the need to revisit the issue of whether one particular cost proxy model is better than another, or to

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[125] The Federal-State Joint Board on Universal Service issued a public notice (FCC 07J-2) seeking comment on the use of reverse auctions.

[126] CPUC Staff Report "Universal Service Report to the Governor and the Legislature: In Response to Pub. Util. Code § 739.3(e) and (f)" (Rel. December 1, 1999) at 8.

[127] FCC Public Notice, "Federal-State Joint Board on Universal Service Seeks Comment on the Merits of Using Auctions to Determine High Cost Universal Service Support," WC Docket No. 05-337, at 2. *See* http://www.neca.org/wawatch/wwpdf/081406_1.pdf#search=%22auction%20mechanism%20telecommunications%22.

litigate updated cost studies, and would avoid the time and resource consuming aspects of litigating cost models. The auction mechanism also eliminates debates over what type of technology should be modeled since the bidder will take that factor into account in making a bid. Bidders will also have to consider all sources of revenues expected to be realized when they make their bids, not just basic service revenues. In this manner, a reverse auction will reflect more realistically all of the revenue sources associated with providing service over a basic access line in high cost areas.

In the next phase of this proceeding, we shall develop the record as a basis for implementing an auction mechanism to replace the current system based upon modeling of cost proxies of high cost support requirements. The auction mechanism will require development of a bidding process predicated upon appropriate parameters of acceptable COLR service. For example, we will consider if there is some minimum standard of reliable 911 service necessary for a carrier to qualify as a COLR. Does a competitor that requires end users to furnish terminating equipment other than a standard telephone qualify as a COLR? We also will consider whether, if the ILEC loses the COLR bid, the ILEC must then make its existing facilities in the designated area available to a new COLR. As one possible preliminary approach, we may consider selecting a limited area for a pilot project to test the operation of a reverse auction.

### 13. Program Administration Issues

In 1999, the Legislature created the CHCF-B Administrative Committee Fund within the State Treasury.[128] This legislation provided that the funding

[128] Government Code Section 270(a)(2), pursuant to SB 669.

would be in rates, while the funds collection would be submitted first to the Commission, and then deposited with the Controller for deposit in the California High Cost Fund-B Administrative Committee Fund.[129] The COLR's claims are paid after being reviewed by Commission staff.

In 2001, the Legislature allowed funds to be transferred between various telephone funds in the annual budget act.[130] The Legislature also expressed its concern with stale data underlying the B-Fund. Section 270(b) restricted the transfer of funds until the service costs from the Commission's 1996 decision were recalculated.[131] Subsequently, the Budget Act of 2002 transferred nearly $251 million of High Cost Fund-B money to the state general fund.[132]

In 2004, Pub. Util. Code 739.3 was further amended to: (a) provide that money in Commission-regulated telecommunications related funds are the proceeds of rates, and therefore, are held in trust for the benefit of ratepayers and to compensate telephone corporations for their costs of providing universal service; (b) extend funding for the various universal service programs including the B-Fund program until January 1, 2009;[133] and (c) further require the

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[129] Government Code Section 276(b).

[130] Pub. Util. Code § 276, pursuant to Section 20 of SB 742 (2001), as amended by Stats. 2001, Ch. 903 § 5.

[131] Pub. Util. Code § 270(b)(2), pursuant to AB 140 (Statutes of 2001). The Legislature restricted fund transfers from the B-Fund to the other high cost fund until statewide data was recalculated.

[132] AB 425 Provision 8660-011-047.0 (Stats. 2002, Ch. 379).

[133] Pub. Util. Code § 739.3, pursuant to SB 1276 (Stats. 2004, Ch. 847, enrolled September 28, 2004).

Commission to conduct by January 1, 2006, a review of the B-Fund.[134] The purpose of the review was "to accomplish an adjustment of subsidy payments to reflect updated operating costs and an evaluation of whether subsidy levels can be reduced while maintaining the goals of the program."[135]

We solicited comments on program implementation issues, including issues associated with an automated claims process.[136] Two parties presented proposals regarding program processing issues. Cox suggested an automated claims review that would include electronic submission of monthly claims via secured connection, standardization of a monthly claims format for all carriers, electronic notification with a date that the monthly claim was submitted, and the opportunity for all carriers to elect to receive payments via an automatic clearinghouse.[137] AT&T recommended that the Commission employ a Third-Party Administrator that would be responsible for processing new participant applications, processing claims for compensation from the fund, distributing subsidies from the fund, and provide staff support to the CHCF-B Administrative Committee, including preparation of financial statements and management reports. If such a Third-Party Administrator were employed, the Commission's role would be reduced to drafting the annual budget, overseeing audits of program, and periodically setting the level of the CHCF-B surcharge.[138]

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[134] SB 1276 § 4 (Stats. 2004, Ch. 847).

[135] *Ibid*.

[136] OIR at 47.

[137] Cox Opening Comments at 15.

[138] AT&T Opening Comments at 26-27.

DRA expressed concerned that these proposals lack specificity, and provide no supporting data as to the likely cost of such programs. AT&T provided no basis – such as an undue burden on the Commission – for the management of the fund to be outsourced to a Third-Party Administrator. DRA argues that Third-Party Administrators can add an unnecessary layer of expense and administrative complexity for programs such as the CHCF-B. DRA recommends that, if the Commission elects not to eliminate the B fund, workshops should be held to determine the need for and cost of program implementation changes, with evidence (including evidence of anticipated costs) provided by those claiming needed changes.

We shall direct that a workshop be convened in the next phase of this proceeding for parties to seek consensus on how B-Fund program administration can best be improved, automated, and streamlined. We shall consider the need for further development of the record on this issue after parties report back on the results of the workshop in seeking consensus solutions regarding program administration.

## 14. Comments on the Proposed Decision

The proposed decision of Commissioner Rachelle Chong in this proceeding was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on _____ and reply comments were filed on _____ by _____.

## 15. Assignment of Proceeding

Rachelle B. Chong is the assigned Commissioner and Thomas R. Pulsifer is the assigned ALJ in this proceeding.

## Findings of Fact

1. In D.96-10-066, the Commission instituted the B-Fund as an explicit subsidy program to ensure basic universal telephone service in high cost regions served by the major Incumbent Local Exchange Carriers within a competitive market environment.

2. The review of the B-Fund, as initiated by this proceeding, is required by legislative mandate as well as Commission directives in D.96-10-066.

3. The Commission adopted a uniform regulatory framework in D.06-08-030, generally eliminating restrictions on pricing of services, but specifically maintained the rate freeze on basic service until January 1, 2009.

4. After January 1, 2009, as directed in D.06-08-030, the cap on basic residential service rates that are not subsidized by CHCF-B will sunset automatically with no further Commission action required.

5. D.06-08-030 directed that basic residential services receiving a CHCF-B subsidy remain frozen at a level equal to the current rate, to be reevaluated as part of the CHCF-B review in R.06-06-028.

6. The level of basic residential rates did not change when the B-Fund was adopted in 1996, but rate reductions or surcredits were applied to other services to offset the explicit subsidies provided for through the B-Fund.

7. The existing level of the B-Fund benchmark threshold is overly inclusive and results in subsidies to basic lines beyond the level that is required to meet the Commission's universal service goal of a 95% penetration rate for basic service.

8. The current B-Fund benchmark is equal to the higher of system average cost (assumed to be $20.30 per line) or the basic rate plus End-User Common Line Charge.

9. A benchmark threshold based on affordability of basic service by customers provides a more meaningful criterion for setting B-Fund support levels instead of the current benchmark.

10. A test based upon per-capita income is not a practical tool for limiting the size of the B-Fund, and the administrative difficulties of establishing such a screening process would outweigh any benefits.

11. As a benchmark of affordability of basic service in rural high cost areas, Section 254 of the Act requires access in rural and high cost areas based on a "reasonably comparable" standard.

12. The FCC and Census Bureau data sources reveal that the national average household expense for wireline local exchange service remained at about $36 per month between 2000 and 2005.

13. A benchmark set at $36 per line provides a reasonable proxy of customer affordability of basic service based on relevant demographic data.

14. Based on current data concerning B-Fund claims, annual claims for B-Fund subsidies total approximately $422 million.

15. A revision in the high cost benchmark to $36 per line would result in a reduction in claims applicable to the four COLRs of approximately 74%.

16. A corresponding reduction in the surcharge will produce a significant consumer benefit as the surcharge on all California consumer bills will be less going forward.

17. A reduction in the B-Fund surcharge from 1.3% to 0.5%, to take effect January 1, 2009, is reasonable in view of the revision in the high cost benchmark to $36 per line.

18. Although an increase in the benchmark threshold to $36 would reduce the level of subsidy available to the COLRs, competitive opportunities exist to offset

lost subsidy by adjusting the price of other services, particularly through the marketing of bundles in conjunction with the provision of the basic line.

19. As indicated by the price increases for services other than basic residential rates implemented by the ILECs since September 2006, as illustrated in Appendix Table 2 of this decision, there is evidence that the ILECs have the capability to rebalance their rates in anticipation of possible reduced subsidies.

20. During the era of cost-of-service and NRF price regulation, the Commission applied principles of revenue neutrality by authorizing rate offsets to give the ILEC an opportunity to earn a reasonable return while avoiding windfalls.

21. The Commission is not obligated to ensure revenue neutrality as a result of changes in the threshold benchmark since the ILEC is no longer subject to the pricing constraints that existed during the NRF era.

22. Although the Commission stated that revenue neutrality would continue to apply during the transition until January 1, 2009 for any mandated changes in the basic rate, no such changes in basic rates are being mandated in this order.

23. Since there is no obligation to ensure revenue neutrality, there is no reason to delay implementing reductions in subsidy support levels even though the basic rate freeze remains in effect until January 1, 2009.

24. An implementation schedule for the gradual phase-in of the $36 benchmark revision would provide for a smoother transition and result in the schedule of subsidy revisions shown in Appendix Table 1.

25. There is no basis for the Commission to maintain revenue neutrality or to mandate price adjustments to insulate the ILECs from risks associated with reductions in B-Fund support levels.

26. Although the freeze on all basic rates expires effective January 1, 2009, the B-Fund subsidy program is still needed continue beyond January 1, 2009, albeit at a reduced level, to support certain high cost lines at affordable levels.

27. Although the basic rate freeze will be lifted effective January 1, 2009, it would be premature to authorize full pricing flexibility for basic rates immediately upon expiration of the rate freeze, given the potential for dramatic price increases.

28. A gradual phase-in of increases to move basic rates toward cost-based levels with full pricing flexibility will avoid the risk of dramatic retail rate increases.

29. To the extent that basic service rates change due to the lifting of the freeze, the rates that Small LECs charge would likewise be affected as a result because the average local exchange rates of the Small LECs are not to exceed 150% of comparable California urban rates under current Commission policy.

30. The cost proxy for B-Fund support needs to be updated given the significant passage of time since the costs were previously reviewed in 1996 in order to limit subsidy levels funded by customers only to truly high cost areas to meet universal service goals.

31. While the ideal solution would be to identify costs based on the most competitive technology currently available, the resources are not currently available to identify and model such costs.

32. While the HM 5.3 model is not ideal as a cost estimating tool, it represents the best available overall cost model for updating high cost areas considering the disadvantages of the other possible model choices, and other alternatives.

33. The HM 5.3 model results were sufficiently acceptable to use in the most recent UNE cost proceedings for AT&T and Verizon.

34. Rather than rely on a technology-specific cost proxy to determine high cost funding levels, the superior longer term solution is to move toward more market-based solutions that are not biased toward a particular carrier or technology. A reverse auction mechanism could offer a means of determining the appropriate level of high cost support to meet universal service goals on a technology-neutral basis.

35. Subject to further inquiry in Phase II of this proceeding, the potential exists to allocate B-Fund support in a more competitively neutral manner by considering modifications in current rules that would expand the base of intermodal carriers that may become eligible for B-Fund support.

36. Promoting deployment of additional broadband services within areas of California that are underserved or not served at all is consistent with universal service policies aimed at enhancing deployment of advanced services and bridging the "digital divide" as articulated in Pub. Util. Code § 709(c) and (d).

37. The creation of a California Advanced Services Fund would provide an effective tool to promote additional broadband services in regions that are not served or are underserved consistent with Pub. Util. Code § 709(c) and (d).

38. Maintaining an increased B-Fund surcharge contribution until January 1, 2009 may be desirable as a source of funding the CASF.

39. An application process would be an appropriate procedural vehicle for seeking funding support for a proposed area that is currently unserved or underserved by broadband services.

## Conclusions of Law

1. The Commission will continue to have an obligation to ensure that universal service goals are met even after § 739.3 expires, as scheduled for January 1, 2009.

2. The Commission's review and reform of the B-Fund in this proceeding is undertaken to comply with applicable legislative and Commission-ordered mandates.

3. Reforms to the B-Fund should account for the changes in the competitiveness of the marketplace that have transpired since 1996, while balancing the goals of the URF with the obligations to preserve universal service.

4. Pub. Util. Code § 739.3(d) requires that the Commission eliminate universal service support wherever the CHCF-B surcharges for such support exceed any value that telecommunications subscribers receive from the program.

5. The reforms adopted in this order conform with Pub. Util. Code § 739.3(d).

6. The raising of the benchmark to $36 per line and related reduction in subsidy support should be implemented as set forth in the ordering paragraphs below in order to target support more effectively to truly high cost lines.

7. The use of the FCC "safe harbor" rate as a basis for indexing the B-Fund benchmark would not produce the best measurement for defining high cost regions to be eligible for B-Fund subsidy support at this time.

8. There is no basis to delay implementation of the revised benchmark threshold until the basic rate freeze is lifted, nor is there any basis to ensure revenue neutrality given the pricing flexibility available to the ILEC under the URF.

9. In the environment under URF as adopted in D.06-08-030 where the COLR is subject to competitive market forces, the principles that once justified revenue neutrality are moot.

10. The basic rate freeze should remain in effect until January 1, 2009 for all basic lines, and should correspondingly be lifted for all basic lines effective thereafter.

11. Upon expiration of the rate freeze on January 1, 2009, a phased-in implementation of rate cap increases should take effect to move from current levels up to the revised level of the benchmark threshold. The specific timing and magnitude of the phase-in should be addressed in the next phase of this proceeding.

12. Upon completion of the phase in of rate caps, up to the level of the revised benchmark, the COLR should thereafter be granted full pricing flexibility for basic rates.

13. Once full pricing flexibility is granted, the COLR should be subject to an annual certification process to qualify for B-Fund support, as prescribed in the order below.

14. Any applicable implications for the CHCF-A as a result of the lifting of the rate freeze, along with more general review of the CHCF-A program, should be addressed in a separate proceeding.

15. The Commission should complete and implement a cost study utilizing the HM 5.3 model to update the applicable high cost proxies for lines served by designated COLRs which exceed $36 per line in basic service costs.

16. For purposes of updating the cost proxy utilizing the HM 5.3 model, the previously adopted cost methodology or sources used to calculate input prices, such as depreciation rates or costs of capital should not be relitigated. Rather, the updating process should focus merely to reflect the cost inputs to that were used in the most recent UNE cost proceedings for AT&T and Verizon.

17. The Commission should undertake a process in the next phase of this proceeding to develop rules for a reverse auction which would be applied to determine the applicable COLR and subsidy level required to support high cost lines in designated areas.

18. Consistent with the universal service goals articulated in Pub. Util. Code § 709 (a) "assuring the continued affordability and widespread availability of high-quality telecommunications services to all Californians," it is appropriate to promote deployment of broadband services by establishment of a California Advanced Services Fund.

19. The next phase of this proceeding should pursue investigation of appropriate funding levels and sources, as well as appropriate rules whereby applicants may seek to qualify for funding from the California Advanced Services Fund for purposes of deploying broadband services in regions of California that are not currently being served, or that are underserved. Funding sources should include consideration of whether, or to what degree, existing B-Fund surcharge contributions should be redirected to the CASF.

20. The Commission should also develop a record on the additional issues in Phase II of this proceeding as set forth in the Order below.

## INTERIM ORDER

**IT IS ORDERED** that:

1. The formula for computing the applicable level of B-Fund subsidy support is hereby modified to revise the adopted threshold benchmark to $36 per line, consistent with the transition schedule set forth in Appendix Table 1. The first stage of the transition to the $36 benchmark shall become effective October 1, 2007, with successive adjustments on January 1, April 1, July 1, and October 1, 2008, as shown in Appendix Table 1 of this order. The final adjustment to $36 shall take effect on January 1, 2009. Carriers of Last Resort (COLR) shall apply the revised benchmark threshold values in accordance with

the schedule set forth in Appendix Table 1 in calculating B-Fund draws to which they are entitled beginning on October 1, 2007.

2. To facilitate Commission staff review and monitoring of the amount of B-Fund subsidy draws submitted by COLRs for payment under this order, the COLR submitting any subsequent claims for B-Fund support shall clearly identify, for each of the revisions to the threshold amount, as shown in Appendix Table 1, the specific Census Block Groups, and associated proxy costs, that have been eliminated and are no longer eligible for B-Fund support due to revisions in the threshold benchmark.

3. Pursuant to this order, the Commission hereby authorizes the establishment of the California Advance Services Fund to be implemented for the purpose of promoting the deployment of broadband services in areas that are not served or that are underserved within the service territories of the Incumbent LECs that are currently subject to the B-Fund. The specific measures to fund and implement the California Advanced Services Fund, and to develop rules for eligibility to draw from the CASF shall be addressed in the next phase of this proceeding.

4. Effective January 1, 2009, the B-Fund retail surcharge shall be reduced to 0.5% to reflect the anticipated reduced level of B-Fund support claims resulting from the revised threshold benchmark adopted in this order. Communications Division Staff is directed to prepare a resolution for the Commission's consideration to implement the revised 0.5% surcharge, to become effective by January 1, 2009. Since the resolution shall be implemented in compliance with this order, no public comment period is required.

5. The basic rate freeze shall remain in effect until January 1, 2009.

6. Effective after January 1, 2009, the basic rate freeze shall be lifted on all remaining basic residential lines, but subsequent increases in ILEC basic rates shall be phased in under a process to be determined in Phase II of this proceeding in order to bring basic rate caps up to the level of the revised benchmark threshold of $36 per line.

7. Upon the conclusion of the phase-in period, COLRs shall be granted full flexibility to adjust basic rates.

8. As a basis to receive B-Fund support after full pricing flexibility takes effect, however, a COLR must certify annually that it is not charging rates for basic service in excess of the benchmark levels that we establish herein. A COLR that does not make the required annual certification must provide detailed a detailed showing as to why they are unable to comply with the Commission's Orders. The Commission will evaluate the evidence and determine what, if any, action is required.

9. The Commission shall undertake a second phase of this proceeding to resolve the remaining issues in this proceeding. Specifically, the second phase of the proceeding shall address the following issues:

(a) Implement updated cost proxies utilizing the HM 5.3 Model for qualifying High Cost Census Block Groups for each of the COLRs,

(b) Implement a process for the phase-in of increases in the caps on COLR basic rates to transition from the current levels up to the level of the adopted $36 benchmark.

(c) Implement a process whereby the COLR shall certify that its basic rates do not exceed the designated benchmark as a basis to qualify for B-Fund support once full pricing flexibility takes effect;

(d) Consider the possible modification of rules to accommodate a broader base of eligibility for B-Fund support to include wireless and other intermodal carriers. Comments shall be taken as to the merits of such a modification to promote competitive neutrality in the allocation of B-Fund support, consistent with public policy goals.

(e) Consider the need for, or extent of, additional reporting requirements or other safeguards to guard against the potential for cross subsidization of video services, as prohibited under Pub. Util. Code § 5940.

(f) Develop and implement a reverse auction mechanism to determine B-Fund subsidy support levels and COLR status as a means of funding high cost support in the future;

(g) Solicit comments regarding (1) the appropriate rules and procedures for applicants to apply for funding from the California Advance Services Fund to qualify for deployment of broadband services in areas that are not served (or underserved), consistent with the statutory principles of Pub. Util. Code § 709 and (2) the appropriate funding level, sources, and size of the California Advanced Services Fund.

(h) Develop standards and procedures for future periodic review of the B-Fund program;

(i) Seek consensus on more streamlined administration of the B-Fund program, as discussed in this order.

10. The assigned Commissioner and Administrative Law Judge shall promptly issue a ruling setting forth a schedule for further proceedings to resolve the issues identified for Phase II of this proceeding, as set forth above.

Dated _____, at San Francisco, California.

# Appendix Table 1

**Adopted Revision to the High Cost Threshold and Associated Reduction in Monthly Subsidy**

| Effective Date of Revision | (Current) | 10/1/2007 | 1/1/2008 | 4/1/2008 | 7/1/2008 | 10/1/2008 | 1/1/2009 |
|---|---|---|---|---|---|---|---|
| **Revisions to Thresholds** | **$20.30** | **$22.96** | **$25.62** | **$28.28** | **$30.96** | **$33.60** | **$36.00** |
| **Carriers:** | | | | | | | |
| **Pacific** | $29,008,709 | $22,119,132 | $14,077,086 | $11,610,434 | $9,312,155 | 7,728,103 | 6,439,067 |
| **AT&T - Pac** | 289,861 | 289,861 | 262,273 | 137,915 | 74,777 | 56,722 | 42,842 |
| **AT&T - Ver** | 197,427 | 197,427 | 197,427 | 181,236 | 136,311 | 68,239 | 47,313 |
| **Subtotal AT&T** | $29,495,996 | $22,606,420 | $14,536,786 | $11,929,585 | $9,523,243 | $7,853,064 | $6,529,222 |
| **Verizon GTE** | 2,018,286 | 2,018,286 | 1,862,676 | 1,449,913 | 1,171,626 | 1,030,141 | 894,993 |
| **Verizon Contel** | 1,669,707 | 1,669,707 | 1,634,600 | 1,528,180 | 1,395,752 | 1,320,754 | 1,236,759 |
| **MCI** | 397,140 | 306,672 | 216,834 | 188,623 | 161,746 | 137,776 | 115,669 |
| **Subtotal Verizon** | $4,085,133 | $3,994,665 | $3,714,110 | $3,166,716 | $2,729,125 | $2,488,671 | $2,247,421 |
| **Cox -Pacific** | 1,383,074 | 936,360 | 305,516 | 210,381 | 168,558 | 140,342 | 108,288 |
| **Cox -Verizon** | 1,769 | 1,769 | 1,147 | 0 | 0 | 0 | 0 |
| **Subtotal Cox** | $1,384,843 | $938,129 | $306,663 | $210,381 | $168,558 | $140,342 | $108,288 |
| **SureWest** | 37,729 | 37,729 | 37,729 | 23,206 | 10,912 | 856 | 0 |
| **Frontier** | 162,172 | 162,172 | 162,071 | 158,529 | 140,071 | 128,973 | 109,388 |
| **Grand Total** | $35,165,873 | $27,739,115 | $18,757,359 | $15,488,417 | $12,571,910 | $10,611,907 | $8,994,319 |

**Percentage Reduction of Claims**

| **Thresholds** | **$20.30** | **$22.96** | **$25.62** | **$28.28** | **$30.96** | **$33.60** | **$36.00** |
|---|---|---|---|---|---|---|---|
| **Carriers:** | | | | | | | |
| **Subtotal AT&T** | 0% | 23% | 51% | 60% | 68% | 73% | 78% |
| **Subtotal Verizon** | 0% | 2% | 9% | 22% | 33% | 39% | 45% |
| **Subtotal Cox** | 0% | 32% | 78% | 85% | 88% | 90% | 92% |
| **SureWest** | 0% | 0% | 0% | 38% | 71% | 98% | 100% |
| **Frontier** | 0% | 0% | 0% | 2% | 14% | 20% | 33% |
| **Grand Total** | 0% | 21% | 47% | 56% | 64% | 70% | 74% |

This table is based on the claims filed by carriers for December 2006 and does not include EAS payments to SureWest.

**(END OF APPENDIX TABLE 1)**

# APPENDIX TABLE 2

## AT&T Local Phone Service Rate Changes
## (For Major Components of Residential Services)
### (Between September 2006 through July 2007)

| Services | 9/1/2006 – Base line[1] | By July 2007 | % Change |
|---|---|---|---|
| **Local Toll Service** | | | |
| Initial min/additional min[2] | $0.092/$0.028 | $0.12/$0.07 | 31% / 147% |
| **Directory Assistance Services** | | | |
| Per call charge | $0.46 | $1.00[3] | 117% |
| **Non-published listing[4]** | | | |
| Exclude from white page directories/ month | $0.14 | $1.00 | 614% |
| Exclude from white page directories & calls to DA/month | $0.28 | $1.25 | 346% |
| **Returned Check Charge** | | | |
| Per incident | $6.65 | $25.00 | 276% |
| **Late Payment[5]** | | | |
| Fixed Charge/incident (unpaid balance equal or > $20 | $0.00 | $5.50 | |
| Variable Charge/unpaid balance equal or > $20 | 1.5% | 1.0% | - 33% |
| **WirePro** | | | |
| Monthly Rate | $2.99 | $5.00 | 67% |
| **Custom Calling Service[6]** | | | |
| Service Charges (One time) | $4.75 | $7.50 | 58% |
| Anonymous Call Rejection/Month | $1.90 | $4.00 | 111% |
| Call Forwarding, waiting, 3-way, etc. (each feature/Month) | $3.23 | $5.00 | 55% |
| Caller ID/Month | $6.17 | $9.00 | 46% |

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[1] URF decision became effective at the end of August 2006.

[2] Rates vary by distance and by initial or additional minute of calls. (The rates presented herein show the range of the prices.)

[3] AT&T will provide express call completion without additional charges.

[4] These non-published listing rates will become effective on June 1, 2007.

[5] These late payment charges become effective June 18, 2007.

[6] New custom calling feature rats become effective July 15, 2007.

## Verizon Local Phone Service Rate Changes
## (For Major Components of Residential Services)
**(Between September 2006 through Aug 2007)**

| Services | 9/1/2006 – Base line | By Aug 2007 | % Change |
|---|---|---|---|
| **Local Toll Service** | | | |
| Initial min/additional min[7] | $0.114/$0.042 | $0.144/$0.086 | 26% / 106% |
| **Directory Assistance Services** | | | |
| Free Allowance | 5 | 3 | |
| Per call charge | $0.35 | $0.75 | 114% |
| **Inside Wire Maintenance Plan (IWMP)** | | | |
| Monthly Rate | $2.99 | $3.99/$4.95[8] | 33%/66% |
| **Call Waiting (monthly)** | $3.50 | $4.00 | 15% |
| **Call Waiting & Cancel Call (monthly)** | $4.00 | $4.50 | 14% |
| **Bundles/Packages** | | | |
| Verizon Local Packages | $ 30.95 - 39.95 | $ 32.99 - 41.95 | 5-7% |
| Verizon Regional (Freedom) Essential/Value | $ 27.00 - 44.95 | $ 32.04 – 49.99 | 11 -19% |
| Service Charges (one time) | $4.75 | $7.50 | 58% |
| Anonymous Call Rejection/Month | $1.90 | $4.00 | 111% |
| Call Forwarding, waiting, 3-way, etc. (each feature/month) | $3.23 | $5.00 | 55% |
| Caller ID/Month | $6.17 | $9/00 | 46% |
| **New Calling Plans (bundled/packages)** | | | |
| Unlimited local calls + 13 calling features | N/A | $24 | |
| Unlimited local calls + 13 calling features + Inside wire maintenance plan | N/A | $26 | |

## SureWest Local Phone Service Rate Changes

[7] Rates vary by distance and by initial or additional minute of calls. (The rates presented herein show the range of the prices.)

[8] Customers subscribe to both IWMP and bundled services will be charged $3.99 while customers who subscribe to IWMP but not bundled service will be charged $4.95/month.

## (For Major Components of Residential Services)
**(Between September 2006 through July 2007)**

| Services | 9/1/2006 – Base line | By July 2007 | % Change |
|---|---|---|---|
| **Return Check Charge** | | | |
| Per occurrence | $10 | $20 | 100% |
| **Directory Assistance (DA) Services** | | | |
| Free Allowance | 5 | 0 | |
| DA Per call charge | $0.25 | $0.45 | 80% |
| Call completion | $0.35 | $0.80 | 129% |
| **Inside Wire Maintenance Plan (IWMP)** | | | |
| Monthly Rate | $1.00 | $2.00 | 100% |

## Frontier (Citizen) Local Phone Service Rate Changes
## (For Major Components of Residential Services)
**(Between September 2006 through July 2007)**

| Services | 9/1/2006 – Base line | By July 2007 | % Change |
|---|---|---|---|
| **Inside Wire Maintenance Plan (IWMP)** | | | |
| Monthly Rate | $0.99 | $1.99 | 100% |

**(END OF APPENDIX TABLE 2)**

## INFORMATION REGARDING SERVICE

I have provided notification of filing to the electronic mail addresses on the attached service list.

Upon confirmation of this document's acceptance for filing, I will cause a Notice of Availability of the filed document to be served upon the service list to this proceeding by U.S. mail. The service list I will use to serve the Notice of Availability of the filed document is current as of today's date.

Dated August 3, 2007, at San Francisco, California.

/s/ ELIZABETH LEWIS
Elizabeth Lewis