Decision 08-09-042 September 18, 2008

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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

DECISION ADOPTING PHASED TRANSITION PLAN FOR PRICING BASIC TELEPHONE SERVICE

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DECISION ADOPTING PHASED TRANSITION PLAN FOR PRICING BASIC TELEPHONE SERVICE

1. Introduction

By this decision, we adopt a transitional plan for additional flexibility permitting adjustments in retail rates for "basic telephone service"[1] effective beginning January 1, 2009. Pursuant to the Uniform Regulatory Framework (URF) adopted in Decision (D.) 06-08-030, current restrictions on the rates for residential basic service of the four major incumbent local exchange carriers (ILECs) in California[2] are due to expire effective January 1, 2009.

ILEC basic rates have remained fixed since the mid-1990s (except for one minor inflation adjustment in 2008 allowed by the Commission and the state Legislature through the Digital Infrastructure and Video Competitive Act (DIVCA). Prior to 2008, Verizon last increased its rate in 1995 (from a monthly rate of $9.75 to $17.25), Frontier last increased its rate in 1996 (from $16.40 to $17.85), SureWest last increased its rate in 1997 (from $16.85 to $18.90), and

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[1] "Basic Telephone Service" consists of the service elements offered to residential customers as prescribed in the tariff of each respective ILEC, and represents the minimum level of telecommunication services that must remain available ubiquitously, consistent with the universal service principles in D.96-10-066. In response to a request by parties, the Commission is concurrently evaluating how the "basic service" definition should be updated to recognize the wide array of technological choices available today.

[2] The URF ILECs are: Pacific Bell Telephone Company dba AT&T California (AT&T), Verizon California Inc. (Verizon), SureWest Telephone (SureWest), and Citizens Telecommunications Company of California Inc, dba Frontier Communications Company of California (Frontier). Any subsequent reference to ILECs, as used in this decision is intended to apply exclusively to the URF ILECs. Unless expressly indicated otherwise, references to ILECs are not intended to refer to any small independent local exchange carriers. Any subsequent references herein to "high-cost" areas pertain exclusively to the B-Fund program.

AT&T last increased its rate in 1995 (from $8.35 to $11.25, subsequently lowered to $10.69 in 1999). Monthly rates for AT&T customers in California are the lowest in the nation and more than $8 per month lower than the nationwide average.[3]

Today we also adopt as an interim California LifeLine Telephone Program (LifeLine) rate increase a basic service rate cap for the period beginning January 1, 2009 through December 31, 2010 of 25% of the rate cap increment that we authorize today. In doing so, and as necessary to comply with today's decision, we temporarily suspend General Order 153, Sec. 8.1.4, which otherwise limits LifeLine rate discounts to 50%.[4] This authorization will expire upon issuance of a decision in our Universal Service proceeding (R.06-05-028), addressing how the LifeLine program will be changed to reflect the Basic Rate Decision adopted today.[5]

We direct parties in the Universal Service Docket (R.06-05-028) to file comments on October 1, 2008, to refresh the record, including considerations of affordability, avoiding rate shock, and the impact of the LifeLine subsidy on nonLifeLine customers; funding for needed increase in LifeLine subsidies; and

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[3] *See* FCC's 2007 Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service, Table 1.3 (rates from the Urban Rates Survey as of October 15, 2006).

[4] Under Pub. Util. Code § 874, we are directed to establish LifeLine rates at "no […]more than 50 percent of [the basic service rate]," and we rely upon that statutory authority in our action today.

[5] The LifeLine Program, formerly known as the Universal Service LifeLine Telephone Service (ULTS) Program, was established by the Commission in compliance with Pub. Util. Code § 871 and provides discounted basic residential (landline) telephone services to eligible low income households.

any reforms to the LifeLine program structure such as changes in eligibility and/or services that are recommended in light of today's decision. We commit to adopt our decision on LifeLine reform in R.06-05-028, including the final LifeLine basic rates, with an effective date of January 1, 2009.

D.06-08-030 determined that the voice market in California is competitive and D.07-09-020 reaffirmed that finding and determined that after a transition period, prices should be based on competitive market forces.[6] The plan adopted herein will allow for ILEC basic rates to transition to market-based pricing beginning January 1, 2009, through an orderly phased process that avoids rate shock while preserving affordability. The basic provisions are as follows:

1. AT&T, Verizon, SureWest, and Frontier (the ILECs) shall each be permitted, but not required, to increase their basic rates by prescribed amounts over a two-year phase-in period beginning January 1, 2009, as follows.
2. Each of the ILECs is permitted to increase its basic flat rate by up to $3.25 effective January 1, 2009 and by up to an additional $3.25 effective January 1, 2010. These increases capture the cumulative difference (between nominal and inflation-adjusted dollar value in the AT&T basic rate since AT&T's basic rate was frozen in 1995 through December 31, 2010), applied in equal installments over a two-year period.
3. In order to be consistent with the flat rate adjustments, each of the ILECs is also permitted, but not required, to increase basic rates for measured residential service by the same percentage as applies to the corresponding flat rate increase. The resulting percentage increases allowed for

[6] *See* D.06-08-030 at 132, FOFs 77, 86, COLs 20, 28, D.07-09-020 OPs 7-8, 13, as modified by D.07-11-039. As noted above, the Commission has a LifeLine program that will address issues relating to affordability of telephone service by low-income residents.

measured service rates are: (a) For AT&T – 30% for 2009 and 23% for 2010; (b) For Verizon- 18% for 2009 and 16% for 2010; for SureWest – 17% for 2009 and 15% for 2010; for Frontier – 18% for 2009 and 15% for 2010.

4. The authorization to increase the basic service rate cap means that the ILEC may elect to charge less than or equal to the capped amount, but may not charge more. The Commission is not requiring the ILEC to raise its basic rate but giving it permission to do so if it so desires to meet current market conditions. If an ILEC does increase basic rates pursuant to the additional flexibility granted in this decision, the ILEC must first file an advice letter and provide 30-day advance notice of the increase to affected customers pursuant to D.06-08-030 (Ordering Paragraph 9).

5. Effective beginning January 1, 2011, all four ILECs will acquire full pricing flexibility for stand-alone basic rates in regions where basic service is not subsidized by the California High-Cost Fund B (CHCF-B) (and excluding Lifeline).[7]

6. In areas where basic service continues to be supported by the B-Fund, any rate adjustments implemented by a Carrier of Last Resort (COLR) for stand-alone basic service after January 1, 2011, may not exceed (a) 150% of the highest rate for stand-alone basic service offered by that same COLR outside of the high-cost areas, or (b) the high-cost benchmark of $36 minus the EUCL, whichever is lower.[8] This restriction will only apply to those carriers

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[7] Possible reform to the Lifeline program, including preserving affordability resulting from any effects from changes authorized in this decision, is before us in Rulemaking (R.) 06-05-028. We make no prejudgment in this proceeding as to how Lifeline will be reformed.

[8] Rules for reverse auctions are currently being formulated as the means by which a COLR will be selected, regions where B-Fund support will be applied, and amount of B-Fund support will be determined. In the event that a carrier other than the ILEC should take over as COLR in a given high-cost area, then any rate restrictions on basic

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serving in high-cost regions where they are designated as a COLR. The restriction will not apply to any carriers in regions where they are not designated to receive B-Fund support as a COLR.

7. LifeLine rates for basic flat rate and measured service will be affected as previously explained above.

With the expiration of the remaining rate freeze on January 1, 2009, we are seeking to provide for an orderly transition of the basic rate to market-based pricing while preserving affordability in high-cost areas. Under the plan adopted herein, customers will experience more market-driven pricing of basic service. Given the level of competition in the marketplace, we believe the ILECs should be allowed to adjust the basic rate to meet their unregulated competition in a flexible manner. This transition plan is builds upon reforms initiated in Phase I of this proceeding, in which we reduced CHCF-B support by more than $300 million per year through the phase-in of a new $36 benchmark to calculate support amounts. At the same time, we retain appropriate safeguards to preserve the affordability of stand-alone basic service, particularly in "high-cost" areas. If basic service becomes unaffordable to customers, we will fall short of our long-standing goal of universal telephone service.[9]

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service rates prescribed by this Decision would apply thereafter to that new COLR. We institute this requirement as an interim measure for the period after January 1, 2011, to provide an additional level of protection, though we do not anticipate it will ever be invoked as additional changes to the CHCF-B methodology will supersede this requirement.

[9] Policies enacted by the Legislature and the Commission have enabled California to consistently have one of the highest telephone penetration rates in the nation for the past 20 years. (*See* CPUC Universal Service Telephone Report to the California Legislature at 4-5, 16, May 2008.) Thus, even though the real inflation-adjusted price of basic telephone service has fallen between 1995 and 2007, price has had little effect on

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The transition process that we authorize herein continues the reform measures begun in URF and continued in Phase I of this Universal Service B Fund proceeding, which resulted in a major retargeting of B-Fund subsidies to "carriers of last resort" (COLRs). As determined in D.07-09-020, beginning on July 1, 2009, high-cost support will be limited to regions with a proxy cost above $36 per line. We also intend to further update the level of high-cost support by implementing a reverse auction process to ensure that affordable basic service remains available while minimizing the required subsidy. Protections for customers within designated high-cost areas similar to those that we adopt in this decision will be incorporated into the design of the reverse auction.

2. Procedural and Historical Background

This decision implements provisions of Phase II of this proceeding concerning how basic rates may be adjusted subsequent to January 1, 2009. As a framework for implementation, it is useful to review how the Commission's pricing policies have evolved to ensure affordable basic service within the changing dynamics of technology and competition within the industry.

In the late 1980s, we replaced the long-standing practice of reliance on cost-of-service studies for ILEC rate setting, and instead implemented a more modern price cap index mechanism, in recognition of the increasingly important role of competition in the telecommunications industry. This "New Regulatory

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penetration rates for basic service. See also Study on Affordability of Basic Telephone Service, 2004, Field Research Corporation, Volume 1 at 2.3a and 5.2a and Volume 2 at 4.7 (both mean and median total cost per month of respondents were significantly higher than actual monthly cost, and higher than new high cost benchmark).

Framework" (NRF), was adopted for the two largest ILECs,[10] and was subsequently authorized for the two mid-sized ILECs.[11]

Under NRF, ILEC services were accorded differing categories of pricing flexibility based on the competitiveness of the underlying services. "Basic monopoly services," including basic exchange service, were the accorded the most restrictive pricing. "Partially competitive" services were less restrictive, with rates capped subject to downward flexibility. Pricing of "competitive" services was accorded the maximum flexibility allowed by law.

In 1995, we effectively froze ILEC basic service rates[12] at a level set to recover one-half of the ILEC's costs, and all other rate elements to recover the remaining costs of service. In this manner, we provided assurance that basic service remained affordable, at least for that year, 1995. Basic service rates remained frozen as we implemented the B-Fund program in 1996, pursuant to Pub. Util. Code § 739.3, as part of our framework to promote universal service as local exchange markets opened to competition.

Prior to the B-Fund, basic telephone service costs had been cross-subsidized implicitly through higher rates for other services.[13] In

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[10] Re Alternative Regulatory Frameworks for Local Exchange Carriers, D.89-10-031, 33 CPUC2d 43, 61 (1989).

[11] *See* Re Citizens Utilities Company of California, D.95-11-024, 62 CPUC2d 244 (1995), and Re Roseville Telephone Company, D.96-12-074, 70 CPUC2d 88 (1996), respectively.

[12] Re Incentive-Based Regulatory Framework for Local Exchange Carriers, D.95-12-052, 63 CPUC2d 377, 381 (1995).

[13] Because the ILEC basic rates were based upon an average between high and low cost areas, basic residential rates in high cost areas were internally subsidized by revenues in more profitable exchanges, subsidies between product lines, and from other sources of revenues. (*See* D.95-07-050; 60 CPUC2d, 536, 546.)

D.96-10-066, the B-Fund created an *explicit* subsidy, and eliminated the *implicit* cross subsidies by reducing rates for many non-basic services that had been priced above cost.[14] By replacing implicit pricing cross-subsidies with an explicit subsidy, the CHCF-B facilitated competitive market-based pricing for other services, while supporting the affordability of basic service. Over the following decade, we continued to impose price caps under the provisions of the NRF program.

Basic rates have remained frozen since then with the limited exception of inflation-adjusted increases of 2.36% authorized in D.07-09-020 for AT&T and Verizon rate caps, effective January 1, 2008. These increases were permitted under Pub. Util. Code § 5040 which codifies provisions of the 2006 Digital Infrastructure and Video Competition Act (DIVCA).[15] AT&T and Verizon may charge less than the capped rate, but not more.

The table below summarizes the tariff flat rate for basic residential service that was in effect for each ILEC as of December 31, 2007, as well as the adjustments for 2008 that were authorized for AT&T and Verizon:

Basic Flat Rate Cap	
Effective 12/31/07	Effective 1/1/08

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[14] 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 from the B-Fund. Companies that did not reduce non-basic rates applied a surcredit on customer bills to offset B-Fund receipts.

[15] DIVCA permits inflation-related adjustments to basic rates prior to January 1, 2009, limited to carriers that obtain a statewide video franchise. AT&T, Verizon, and Cox have all received such franchises. Current rates for SureWest and Frontier remain in effect until January 1, 2009.

AT&T	$10.69	$10.94[16]
Verizon	$17.25	$17.66
Frontier	$17.85	$17.85
SureWest	$18.90	$18.90

Transitioning to market-based pricing for basic service is the next step in implementing the major pricing reforms that were extended in D.06-08-030 (the URF proceeding). In that decision, we removed rate cap and geographic averaging requirements for all services (except stand-alone basic and LifeLine service) in recognition of the growing influence of competition as a constraint on ILEC market power. As stated in D.06-08-030:

> "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."[17]

In view of our findings that the ILECs no longer possess market power, we eliminated remaining price constraints on all retail services, but temporarily extended the cap for stand-alone basic and LifeLine service provided by the COLR until January 1, 2009, pending review in this proceeding or in R.06-05-028.[18] The rate caps were temporarily continued "in order to address the

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[16] Although the revised rate cap was effective January 1, 2008, AT&T did not actually increase its basic rate to $10.94 until April 18, 2008.

[17] D.06-08-030, at 132.

[18] In D.06-08-030 as modified by D.06-12-044, we extended the basic service rate cap to any of the services "associated" with basic residential service which are included in the subsidized basic residential service package. However, we did not continue price

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statutorily-mandated link between the LifeLine rate and basic residential service rates."[19] We further concluded that: "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."[20]

In D.07-09-020, we determined that while our ultimate goal remains to rely upon competitive market forces to determine the appropriate pricing of basic services, a transition process is necessary to avoid the potential "rate shock" of sudden, large retail basic rate increases in response to reforms that we adopt

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regulation for "associated" services if they are not included in a subsidized basic residential service package. (*See* D.06-12-044, OP 1.h., modifying D.06-08-030.). As explained in D.07-09-020, *mimeo.,* pp. 5-6, 78-79, and as used in this decision, "Basic Service" was not subsidized when the CHCF-B support levels were first established. Accordingly, pursuant to D.06-12-044, OP 1.h., the rate cap could not include any of the services "associated" with the subsidized basic residential service package as identified in D.06-12-044, OP 1.h. The rate cap thus did not apply to: local usage; ZUM; EAS; recurring and non-recurring charges; Caller ID; call trace; 976 service; 900/976 call blocking; non-published and unlisted telephone numbers; white pages listings; busy line verification and interrupt services; and inside wire maintenance plans. However, we note that changes to some of these rates may not be permissible where they would diminish the value of basic service. For example, it would be improper to increase ZUM rates that would diminish the 1 MR call allowance value without providing a corresponding increase for that call allowance.

[19] D.06-08-030, at 2 and Conclusion of Law 30. The relationship between basic residential rates and funding needed to support the LifeLine program is being addressed in the Universal Service, Public Policy Programs Rulemaking (R.06-05-028). A discount program for low income individuals, LifeLine is a critical element in our universal service program to bring local telephone service at affordable rates to low income Californians. Any changes to basic residential rates have a potential bearing on LifeLine programs. Any effects from this decision that may have a bearing on the LifeLine program are within the scope of R.06-05-028.

[20] D.06-08-030 at 152.

herein.[21] We have previously noted how a small minority of customers purchase only basic service, and have noted the significant loss of access lines experienced by the ILECs as reported by the FCC.[22] We further directed that in Phase II of this proceeding, we would adopt an interim process for a gradual phase-in of any increases to basic rate levels to provide an orderly transition to full pricing flexibility once the current caps expire on January 1, 2009, consistent with URF and B-Fund program reforms.[23] Once the transition period is completed, the cap will sunset automatically with no further Commission actions required. Each COLR would be allowed to make any subsequent adjustments in basic rates based on competitive market forces, not based on Commission directive. We do not intend to apply rate caps any longer than is reasonably necessary to promote an orderly transition to full pricing flexibility. Of course, COLRs may refrain from implementing any basic rate increases, depending on competitive market forces in their service areas.

3. Parties' Position

By ruling dated February 23, 2007, we provided notice and opportunity for comment as to whether, or in what manner, basic residential rates should be modified as a function of revisions to the B-Fund mechanism adopted in D.07-09-020. By ACR dated October 5, 2007, parties' comments were solicited

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[21] D.07-09-020 at 49-50, 93-95, OP 8.

[22] D.06-08-030 at 119. In addition to the 19% reduction in residential access lines and the 23% reduction in business access lines experienced by AT&T from 2000-2004, we can see that his trend has continued as the most recent *FCC Report on the Status of Local Competition*, March 2008, indicates that the ILECs in California are serving one million fewer access lines since 2004 despite continued population increases across the state.

[23] D.07-09-020 at OP 13.

concerning a process for basic rate levels to transition from existing levels to a point at which further price restrictions can be eliminated, thereby allowing for full pricing flexibility. The record of written comments provides a sufficient basis for the reforms that we adopt.

Comments on basic rate transition issues were filed by each of the URF incumbent LECs, and also by Sprint Nextel (Sprint), the Division of Ratepayer Advocates (DRA), and The Utility Reform Network (TURN).

Parties' proposals differ as to: (1) the maximum cumulative increase in basic rates that would be "affordable," and whether a empirical study is necessary to determine a maximum affordable rate; (2) the maximum per-year increase in basic rates sufficient to avoid rate shock; (3) the length of the transition period before full pricing flexibility for basic service should be authorized; (4) whether or subject to what conditions, full pricing flexibility would be justified at all; and (5) what restrictions should apply to a COLR in the pricing of basic rates in high cost areas subsidized by the B-Fund.

3.1. AT&T

AT&T argues that pricing regulation of basic service distorts competitive choices and causes harm to consumers, and thus recommends a phase-in period for transitioning to market-based rates for local exchange service limited to no more than two years. AT&T recommends that the cumulative increase in basic rates over this two-year period be sufficient to allow the AT&T rate to be equal to the current SureWest rate, which is set at the highest level among the four ILECs. In calculating the resulting rate increase, AT&T incorporates its tariffed intrastate basic rate plus its federal End User Common

Line or EUCL charge.[24] Because the AT&T rate is lower than the SureWest rate, AT&T residential customers' maximum basic rate would consequently increase by $10.32, calculated as follows:

SureWest		
Basic Rate	$18.90	
EUCL	6.50	
Total	$25.40	$25.40
AT&T		
Basic Rate	$ $10.69	
EUCL	4.39	
Total	$15.08	
Increase in the AT&T rate		$10.32

AT&T proposed to phase in the $10.32 increase in equal installments over a two-year period, with a $5.16 per-month increase beginning January 1, 2009, and an additional $5.16 per-month increase beginning January 1, 2010.[25]

AT&T Proposed Rate Cap:

January 1, 2009:

Basic Rate	$15.85
EUCL	4.39
Total	$20.24

January 1, 2010:

Basic Rate	$21.01

[24] The EUCL charge is a federally mandated charge reflects the FCC determination of the interstate portion of non-traffic-sensitive costs that should be collected from the basic exchange subscriber.

[25] AT&T's calculations used a starting rate of $10.69, which was the rate in effect at the time its comments were filed. Subsequent to filing comments, AT&T's rates have changed due to the 2.36% increase allowed for 2008 and a small change to their EUCL. The difference between their rate plus the EUCL and the SureWest rate and EUCL is now $10.06, which would result in $5.03 per-month increases in 2009 and again in 2010.

EUCL	4.39
Total	$25.40

On a percentage basis, the $5.16 increase would represent an increase of 34.2% and 25.5% respectively over the two years. Assuming the first step of the basic rate cap increase were implemented beginning January 1, 2009, and the second step on January 1, 2010, AT&T proposes that it be granted full pricing flexibility for basic rates beginning on January 1, 2011. AT&T argues that this approach is reasonable because the resulting increase would bring AT&T rates for basic rate plus EUCL into line with what is already being charged to customers of SureWest.

Since AT&T California has not increased basic service rates since 1995, however (except for the single 2.36% cost of living increase allowed for 2008), the resulting increase would equate to less than a 5% annualized increase if it had been evenly distributed over the entire period since 1995. AT&T argues that the transitional pricing approach that it advocates is reasonable, taking into account the Commission's concerns over avoiding consumer rate shock while realizing the benefits of a competitive market.

3.2. Verizon

Verizon likewise argues that in order to minimize market distortions that result from price caps, the Commission should keep any transition period as short as possible. Verizon proposes a three-year phase-in period for transitioning to market-based rates for local exchange service.

Verizon believes that while the rate cap for basic service at the end of the transition period need not be increased up to the full $36 high-cost benchmark adopted in D.07-09-020, it should not be set so low as to risk rate shock once full pricing flexibility takes effect. Verizon thus proposes to increase the cap up to 50% of the difference between the $36 benchmark and the amounts each ILEC currently charges for basic service (including the EUCL).

The effects of Verizon's proposal on the basic rates for each of the ILECs is summarized below:

Verizon Proposal for Price Cap Increases

	AT&T	Verizon	SureWest	Frontier
Basic Flat Rate Cap as of 1/1/08	10.94	17.66	18.90	17.85
Subscriber Line Charge	4.38	6.5	6.5	6.5
Total	15.32	24.16	25.4	24.35
Benchmark	36	36	36	36
Difference	20.68	11.84	10.6	11.65
50% of the difference	10.34	5.92	5.3	5.825
Revised Cap at 1/1/11	25.66	30.08	30.7	30.175

The resulting annual increase in Verizon's basic rate cap would be $5.92 (or 50% of $11.84, equal to the $36 benchmark- $17.66 rate + $6.50 EUCL). At the end of the three-year phase-in period, Verizon's cap would increase to $30.08. Verizon proposes to implement the increase by applying $1.97 annual increases for each of the three years to the basic service rate.

Applying Verizon's proposal would yield an annual increase of $3.45 in the AT&T basic rate in each of the three-year transition period. AT&T's annual increase would be relatively higher than Verizon's due to a lower starting point for applying the increases. After three years, the AT&T basic rate would increase to $25.66 (including the EUCL). At the end of the third year, under Verizon's proposal, remaining price caps would expire, and full pricing flexibility would take effect. Verizon argues that rate increases under its proposal are consistent with the magnitude of increases of $2.90 and $6.05 for AT&T and Verizon, respectively, that the Commission adopted in the Implementation Rate Design Proceeding in 1995, and should therefore raise no concerns over rate shock.

3.3. SureWest

SureWest supports annual step increases of between $1 and $2 in the monthly rate for basic service, representing an increase in the range of 10% to 20% for the URF ILECs. SureWest claims that such yearly increases would not result in rate shock to basic service subscribers. SureWest suggests that after a period of three-to-five years, the Commission could evaluate whether subsequent ongoing step increases were necessary or whether to permit full pricing flexibility on basic service.

3.4. Frontier

Frontier recommends that basic rates be allowed to increase up to $4 per year over a four-year period before full pricing flexibility takes effect. Frontier argues that a four year period is a reasonable interval during which to allow customers to adjust to higher basic rates. Frontier argues that the Commission should thereafter rely upon the competitive marketplace to dictate whether an URF company would elect any further increase in its basic rates.

3.5. TURN

TURN argues that before an informed judgment can be made concerning the maximum feasible adjustments in basic rates, the Commission must first conduct an investigation as to what constitutes affordable rates in California. TURN argues that the Commission needs to examine California-specific data as a basis to determine a maximum affordable rate cap. TURN proposes that Field Research be enlisted to undertake a modified version of the affordability study, which was one of the NRF monitoring reports eliminated in D.06-08-030.

TURN believes that a specific time period for a transition process is difficult to assess without knowing the maximum rate that would be affordable.

Given that caveat, TURN proposes that any ILEC increases be limited to no more than the general rate of price inflation, measured by the Gross Domestic Product Price Index (GDP-PI). Alternatively, if the Commission chooses to increase rates by a greater amount, TURN proposes no more than a 10% per year increase over a five-year period. TURN further proposes that no carrier be permitted to charge rates that exceed 150% of the lowest rate that the service provider charges in other regions of its service territory. TURN notes that the overwhelming majority of states place some type of cap on basic rates, referencing a 2007 NRRI report regarding phone regulation in other states.

3.6. DRA

DRA agrees with TURN that in order to identify a transition period to prevent rate shock, the Commission must first determine the maximum retail rate that would be affordable. In determining affordability, DRA proposes that the Commission distinguish between the basic residential rate, which is currently capped, and the total bill for residential telephone services, which is flexibly priced. DRA further argues that because affordability of basic service may vary substantially by local region, the interim rate cap not be permanently reset until the Commission obtains geographically and demographically disaggregated baseline information about penetration rates and customer perceptions of affordable rates. DRA joins TURN in recommending a modified version of the Field Research Affordability study to assist in such a determination.[26]

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[26] TURN and DRA propose that the earlier Field Research Studies be modified (1) to include more geographically granular data than were collected in prior surveys (to detect the effects of any geographically deaveraged prices and to investigate what is happening specifically in designated high-cost areas), and (2) to cover all four URF

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On an interim basis pending the affordability study, DRA recommends that any increase in ILEC basic rates be allowed to rise no higher than the highest rate charged by a California ILEC, equal to SureWest's rate of $18.90. DRA calculates that increasing the AT&T rate up to the SureWest rate level would result in a 64% price rise. DRA argues that without an affordability study, however, the Commission cannot presume that SureWest's current rates are affordable. DRA also proposes that the basic rate in any pricing zone of an ILEC's service territory not exceed 150% of the lowest rate for basic service that the ILEC charges for the same service in any other pricing zone. DRA proposes this relative limitation to avoid unacceptable rate disparities between urban and rural customers due to geographic de-averaging.

DRA argues that basic rates should not be allowed to rise to the point where the Commission's goal of at least a 95% penetration rate is jeopardized. DRA argues that the 95% penetration goal should be met not just on an aggregate basis, but within separate geographic and demographic sectors. If rate increases result in a drop in penetration rates below 95%, DRA suggests that the Commission could reduce the rate or mandate other programs to boost connectivity.

DRA further proposes a maximum basic rate increase within a 12-month period of no more than $2 per month. A $2 per-month increase would represent a nearly 19% increase in AT&T's current rate. DRA argues that limiting any annual increases to this extent is an essential minimum curb on potential rate shock. DRA further argues that increases of no more than $2 per

ILEC territories and customers of all service providers. (*See* DRA Opening Comments on the PD at 6.)

month are more than sufficient to offset the reduced subsidy draws that the Commission authorized in D.07-09-020.[27] Moreover, DRA points to AT&T's recent increases in other popular residential service options which may be offered on a bundled basis with basic service and which could easily more than offset the reduction in B-Fund subsidy on a weighted-average basis, even without an increase in the basic rate.

DRA contends that a $2 level is an essential minimum curb on potential rate shock. Setting an interim cap at $18.90 for all the URF ILECs would allow rate increases up to the highest rate for local phone service among those companies that the Commission has thus far identified as reasonable. Phasing in increases in annual increments of $2, a four-year period would be required to reach an $8 increase. DRA's proposal for a maximum increase of $2 per year would effectively result in a phase-in period of one year in order for Verizon and Frontier to reach the $18.90 cap.

DRA's proposes that the cumulative increase for AT&T be limited to $8.21, the difference between the AT&T and SureWest basic intrastate rates ($18.90 - $10.69). While AT&T proposes a somewhat similar approach, AT&T also incorporates the EUCL in its calculation, yielding a higher cumulative increase of $10.32, as discussed previously. (The EUCL for AT&T is only $4.40, but is $6.50 for SureWest.) DRA argues that there is no basis to include the EUCL in calculating the increase required to bring the AT&T rate up to the SureWest level, since the EUCL only reflects federal jurisdictional costs. The

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[27] DRA calculates that the authorized reduction in AT&T's draw from the B-Fund as of January 1, 2008 could be offset by an increase of $2.08 per line, and the further reduction

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EUCL does not increase the intrastate revenues of the other URF ILECs. Thus, DRA argues there is no basis to increase AT&T intrastate revenues by raising the rate cap for AT&T to reflect any differences attributable to EUCL charges.

3.7. Sprint

Sprint argues that efforts to continue price controls are unnecessary, would be misleading, and have no practical value. Sprint argues that even if a price increase were to occur as a result of lifting the price caps, any price fluctuation would likely be small, with little effect on penetration rates for basic service. Sprint notes that although the price of basic telephone service fell between 1994 and 2007 in real inflation-adjusted terms, penetration rates for basic service changed little during the same period. Based on this past relationship between price and demand for basic service, Sprint argues that any foreseeable change in the price of basic service as a result of lifting price caps will have minimal effect of penetration rates for non-ULTS-subsidized customers, and that 95% of all households will continue to purchase local phone service.

Sprint supports the continued provision of assistance on a means-tested basis for low-income customers eligible for discounted rates through the ULTS program.

Sprint also proposes that AT&T be authorized (but not required) to gradually increase its existing price cap up to the level of SureWest's basic service rate (including the EUCL), with elimination of all price caps as of January 1, 2010. Sprint similarly proposes that Verizon, SureWest and Frontier be authorized (but not required) to effect similar price cap increases (*e.g.*, by the

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as of January 1, 2009 could be offset by an increase of $0.76 per line. (*See* DRA Comments at 29-30.)

same percentage as authorized for AT&T) and to consider price caps eliminated on the same dates.

4. Discussion

4.1. General Framework for Transition Plan

As a general framework for the transition process for basic rates beginning on January 1, 2009, we are guided by the dual goals of promoting a competitive market-based environment while preserving universal service goals. In particular, we seek to maintain affordable basic service at levels sufficient for at least a 95% penetration rate.

As a basis for determining affordable basic service, our preference is to rely upon market forces rather than cost-of-service studies wherever feasible. In D.07-09-020, we adopted a $36 benchmark for limiting regions eligible for B-Fund support without relying upon cost-of-service studies. We have likewise expressed our preference for using a reverse auction as a means of allocating high-cost support rather than litigating new cost proxy studies of high-cost areas in a lengthy and costly proceeding. Consistent with these preferences for market-based solutions, we likewise decline to conduct cost study updates as a basis to determine the magnitude, timing, and transition period for rate changes in the basic exchange service scheduled to take effect beginning January 1, 2009. There simply is no basis in the record to consider that price regulation based on cost studies is necessary to ensure that the prices are just and reasonable.

Nonetheless, even though we will not rely upon cost studies to determine changes in rate levels for basic service, we recognize that, with the passage of time since the basic rate freeze took effect in 1995, existing rate levels are significantly outdated. Since 1995, consumers have been paying for the basics of life (*e.g.*, a loaf of bread, a gallon of gas, sewer service), and have no reasonable expectation that prices for such basics will remain frozen, given rising costs and inflation during this time period. Further, although we agree with Sprint that in general changes in the price of basic service will have minimal effect of penetration rates for non-ULTS-subsidized customers, we are cognizant that basic economic theory shows that dramatic price changes have different results than normal market-based price changes. Therefore, we have determined that we should navigate a path from the outdated rate caps currently in effect to a more reasonable program that phases in necessary rate increases while allowing the ILECs to more flexibly price their services consistent with today's intermodal market realities.

As part of the framework for a transition plan to implement pricing flexibility for basic rates, it is also necessary to recognize that different considerations apply to: (1) areas subject to B-Fund subsidy support and (2) areas that are not subsidized by the B-Fund. As noted in D.06-08-030, even in a competitive market, CHCF-B subsidies can distort the market for the provision of basic stand-alone service. Accordingly, we adopt a transition plan leading to full basic service pricing flexibility in regions not subsidized by the B-Fund while retaining restrictions on the maximum rates that a COLR may charge in high-cost areas in order to qualify for B-Fund support. By tying the rates in areas subsidized by the B-Fund to the rates in areas not subsidized by the B-Fund we provide a "backstop" mechanism in areas subsidized by the B-Fund so that those rates will be determined through market forces prevalent throughout California.

During an initial transition period, we shall continue to restrict the maximum rate for basic service that each ILEC may charge for stand-alone basic service throughout its service territory. Given the length of the rate freeze (13 years since 1995) and the fact that AT&T basic rates remain more than

$8 below the national average for monthly household expenditures for telephone service, the potential exists that the AT&T basic rate is abnormally low. By limiting rate increases during this transition period, the risk of consumer rate shock is avoided. Once the transition period expires, the ILECs will acquire full pricing flexibility in regions not subsidized by the B-Fund. In regions that continue to be subsidized by the B-Fund, the COLR (the ILEC and/or any successor carrier(s) assuming the role of COLR) must certify that its basic rates do not exceed 150% of the highest basic rate that it charges in non-high-cost areas in California.

We therefore must resolve the following issues associated with transitioning basic rates to reflect competitive market forces:

- Length of the transition period;
- Maximum year-to-year increase allowed in basic rates during the transition period; and
- Maximum cumulative increase allowed in basic rates during the transition period.

We find that implementing a transition to flexible pricing for basic service is consistent with URF policies, because it moves basic service rates toward a level that reflects competitive market forces. Particularly in view of the extended period that basic rates remained frozen despite changing market dynamics, allowing for increases in basic rates is appropriate and fair.

While our ultimate goal is to rely upon competitive market forces to determine the pricing of basic services, we stated in D.07-09-020 that a transition process was necessary to avoid potential consumer "rate shock" once the cap expires on January 1, 2009. In this decision, therefore, we adopt a phase-in process to provide an orderly transition, and to ensure reasonable and affordable rates as required by Pub. Util. Code § 451.

In D.07-09-020, we took an important step in better targeting B-Fund support by raising the threshold to $36 for qualifying as a high-cost area. Accordingly, for residential lines in regions no longer subsidized by the B-Fund, it is reasonable to allow basic rates to adjust to levels dictated by competitive market forces, thereby promoting economic efficiency. We determine it is not necessary or desirable to conduct lengthy and expensive cost-of-service studies as a basis for determining rate changes. We believe that the telephone marketplace is very vibrant in California, with head-to-head competition throughout the state, involving incumbent phone companies, wireless carriers, and VoIP providers, particularly cable and over-the-top VoIP carriers, as well as traditional competitive local exchange carriers. We note that the rate freeze set in the mid 1990s was predicated upon certain cost-of-service assumptions. In particular, rates were set at a level to recover only 50% of the fully allocated cost of providing basic service. The remaining 50% of the fully allocated costs was to be recovered through non-basic rate elements. By maintaining the rate freeze for an extended period, the disparity between market forces and regulated prices for basic service became more pronounced as time passed. Consistent with our goals to achieve toward more market-based pricing, we adopt measures herein for step increases in the basic rates.

For purposes of developing a transition plan for basic rates to increase after the freeze is lifted on January 1, 2009, it is useful to consider how the ILEC currently recovers the costs associated with basic service. For those lines for which basic service is provided on a stand-alone basis, customers pay no more than the authorized rate cap. By contrast, where a bundle of services are provided together with basic service, the customer pays a market rate for the entire bundle. Another distinction in cost recovery may apply between basic service provided in high-cost regions where the ILEC receives B-Fund subsidies versus those lines served outside of high-cost regions with no subsidy.

With high levels of competition in California, our goal is to phase out all rate caps. The Commission will continue to monitor the market to guard against abuses, however. In order to ensure that the full benefits of competition are maintained in affordable rates throughout the state, we will create a new backstop rate cap in those regions where high-cost support payments apply. In those regions where high-cost support payments will continue to apply, basic service rates will continue to be restricted to a level no higher than (a) 150% of the highest rate charged by the ILEC (and/or a successor COLR(s)) in its California service area outside of any subsidized high-cost areas, as explained further below, or (b) the $36 high-cost benchmark minus the EUCL, whichever is lower.[28] The 150% threshold continues the Commission's longstanding policy of providing high cost universal service support only after local exchange rates go up to, but not to exceed, 150% of comparable California urban rates.[29] To the

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[28] As an illustration of how the 150% limitation applies, if the highest stand-alone rate charged by a COLR in California outside of high-cost areas was $18 (excluding EUCL, taxes, and surcharges), after December 31, 2010, this same COLR could increase basic stand-alone rates within a high-cost area by no more than 50% above the $18 rate, an increase equal to $9. Thus, the COLR's stand-alone basic rate in the high-cost area could not exceed $27 (=$18+$9).

[29] *See*, Alternative Regulatory Frameworks for Local Exchange Carriers, D.91-05-016, 40 CPUC2d 40 as modified by Alternative Regulatory Frameworks for Local Exchange Carriers, D.91-09-042, 41 CPUC2d 326 at Appendix B. CHCF-A guidelines require a small LEC's CHCF-A requirement to first be met by increases in its local exchange rates up to, but not to exceed, 150% of comparable California urban rates. After this rate limit has been met, the small LECs can then apply for CHCF-A funding if they make regular GRC filings. TURN proposes we constrain the basic rate in all areas through a similar

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extent any differential in rates exists, we believe that the highest rate in an area that is not receiving high cost support is the most comparable to those areas that are receiving CHCF-B support, and thus use that rate as the benchmark for this "backstop" mechanism.

Moreover, in the event that applying the 150% limitation was to result in a stand-alone basic rate plus the EUCL exceeding $36 (the currently effective high-cost benchmark), the stand-alone rate must be reduced to $36 minus the EUCL. Otherwise, the COLR would no longer be entitled to continue to receive B-Fund subsidy. It would be an abuse of the B-Fund program for a COLR to receive both B-Fund subsidy for costs above the $36 benchmark and revenues for the same purpose through basic rates.

Another transitional matter is the phase-out of surcredits relating to B-Fund subsidies. D.07-09-020 noted that in order to offset B-Fund subsidies, Frontier and Verizon each apply a <u>surcredit</u> to their customers' bills for all intrastate services except basic residential service. In D.07-09-020, we stated that these surcredits should be phased out in a series of steps in tandem with the schedule for revisions to the benchmark and corresponding reductions in B-Fund draws, to be completed by July 1, 2009. We thus expressly authorize Frontier and Verizon to complete the phase-out of their surcredits to conclude as of July 1, 2009. The phase-out of the surcredits is conducive to the goal of moving more toward reliance on competitive forces rather than subsidies to meet universal service goals.

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means by not permitting rates in excess of 150% of the lowest rate that the service provider charges in the state. TURN Comments on Phase II ACR at 48-49.

4.2. Authorized Duration of the Phase-In Period for Rate Increases

We shall adopt a two-year phase-in period for transitioning to full pricing flexibility for basic service. During the phase-in period, we shall continue to constrain the maximum rate that the ILEC may charge for basic service. In reaching this result, we balance countervailing goals. We seek to avoid consumer "rate shock" by not immediately allowing full pricing flexibility after the current rate freeze expires on January 1, 2009. We disagree with Sprint's claim that competition in the marketplace would fully prevent any "rate shock" as a result of immediately eliminating all controls on basic residential rates. Although the voice market is competitive, basic residential rates have not been priced at competitive market levels, but were frozen at 50% of the fully allocated cost of providing basic service for well over a decade. As observed in D.06-08-030, subsidized pricing of basic service distorts market processes. Therefore, in view of these market distortions, a transition period will allow for an orderly movement to a competitive environment.

In comments on the PD, certain parties object to any continuation of basic rate limitations beyond January 1, 2009, but instead advocate immediate removal of any and all constraints. AT&T, for example, argues that extending any limits on basic rates for an additional two years beyond January 1, 2009, would constitute a "step backwards" from the direction laid out in the URF proceeding. Cox, Sprint, and T-Mobile express similar arguments arguing that no transition period is needed.

The transition plan we adopt herein is entirely consistent with URF. In D.06-08-030, we expressly 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.) In D.07-09-020 (in Phase I of the instant proceeding), we expressly affirmed that, upon expiration of the basic rate freeze for each ILEC, 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.

In this regard, D.07-09-020 stated:

> Although the basic rate freeze will end on January 1, 2008,[30] we conclude that it would be premature to grant full pricing flexibility for all basic rates immediately. . . . Therefore, we shall adopt a phased-in schedule to take effect beginning January 1, 2008, 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 to be determined in Phase II. In this manner, any potential "rate shock" will be avoided.

Therefore, our transition plan implements the principles previously adopted in D.07-09-020. By objecting to *any* transition period beyond January 1, 2009, parties are attempting to reargue principles that have already been adopted in D.07-09-020. Accordingly, such objections are procedurally improper and without merit.

On the other hand, an excessively prolonged period of artificially low prices would unduly impede progress toward unimpeded competitive market pricing as envisioned in the URF proceeding. Moreover, while we will maintain

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[30] The rate freeze was lifted on a limited basis on January 1, 2008 for AT&T and Verizon pursuant to DIVCA, which allows inflation-related rate adjustments for eligible carriers prior to January 1, 2009. Subject to this limited exception, the currently effective URF ILEC rate freeze is scheduled to expire effective January 1, 2009.

appropriate measures to ensure that stand-alone basic service remains available and affordable throughout the state, there is no valid basis to perpetuate anachronistic rate levels that distort price signals.

While certain parties propose a transition period longer than two years, we find that prolonging rate caps beyond two years would unduly delay progress toward market-based pricing. URF was decided in August 2006, and the basic rates for the URF carriers have been frozen by this Commission until January 1, 2009 in this proceeding (and others related to it) were completed. This time period should also be factored into our considerations. Since D.06-08-030 was issued in URF, we have noted vigorous levels of competition for telephone service in California, with aggressive head-to-head competition between ILECs and competitors including cable systems using either VoIP or CLEC authority. Further, we have seen wireless phones become entrenched with our residents, with more wireless phones than wireline phones in our state.[31] Recent statistics show that 15.8% of California households are wireless only, a trend we expect to see continue.[32] Thus, a two-year phase-in period, beginning January 1, 2009, strikes the appropriate balance in protecting customers from rate shock while progressing forward to achieve the benefits of competition. We conclude that the

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[31] FCC Local Telephone Competition: Status as of June 30, 2007 (Mar. 2008) at Tables 7 and 14 (as of June 2007, there were 30,203,842 wireless subscribers in California compared to 18,485,441 ILEC and 2,898,469 CLEC switched access lines in California).

[32] Centers for Disease Control and Prevention National Center for Health Statistics, *Wireless Substitution: Early Release of Estimates from the National Health Interview Survey, July-December 2007* (nearly one out of every six American homes (15.8%) had only wireless telephones during the second half of 2007, and more than one out of every eight American homes (13.1%) received all or almost all calls on wireless telephones despite having a landline telephone in the home).

maximum rate changes allowed over the two-year transition period, as well as any potential rate changes after the transition period expires is sensible in light of market conditions. We believe this phased transition period will preserve the affordability of basic service, as well as the market based rates that will result after the two year period ends.

We expect competitive market forces to constrain basic service price increases above affordable levels in areas that are no longer eligible for B-Fund subsidies. Given these considerations, we find no necessity to conduct an "affordability study" as a basis to determine the nature and extent of any future rate controls subsequent January 1, 2011. Conducting an affordability study, as proposed by DRA and TURN, is not warranted, particularly in view of the resources that such a study would require. An affordability study would require first an estimation of the demand function for local telephone service, that is, measuring the correlation of price changes with the quantity of local service demanded.[33] The resource-intensive work required to litigate such a study is not necessary since market forces can be relied upon to balance supply and demand for basic service. In addition, we did consider the most recent Study on Affordability of Basic Telephone Service conduced by Field Research Corporation in 2004 ("Affordability Study") when we established the new high cost benchmark. We rejected using those results as the both mean and median total cost per month of respondents were significantly higher than their actual monthly cost, and almost the same or in most cases higher than new high cost benchmark. As more than 82% of respondents did not find phone service

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[33] *See* Sprint Reply Comments at 10, dated November 28, 2007.

difficult to afford and the median monthly bill, excluding wireless, was reported by those respondents to be $35 (in 2004 dollars). The proponents of a new Affordability Study have failed to explain how such a study would be used to establish rates for any communication service. The proponents offer no precedent and the Commission has not found any state or nation where such an approach was used to establish rates. Finally, the proponents are effectively arguing that we should repeat a study to establish new rates at levels significantly higher than we approve herein. We do not find anything in their comments to contradict the findings of D.06-08-030 or D.07-09-020, or that an Affordability Study will produce results in any way contrary to those findings. We reject the use of the Affordability Study as a basis for establishing basic rates.[34] However, we do find merit in conducting another Affordability Study as it has proven useful in the context of evaluating the California Lifeline program. We believe that the Commission should undertake such an Affordability Study in the 2009-2010 fiscal period and will request an appropriation from the Legislature to conduct such a study as part of its ongoing evaluation of the California Lifeline program in R.06-05-028.

[34] The Affordability Study has been useful in the past to show how and why the California Lifeline Program is an important component of our overall strategy to maintain a high subscribership rate. We note that approximately 25% of households in California are subscribers to California Lifeline, and that as part of the overall reforms to the California Lifeline programs being considered in R06-05-028 we expect that an update to the Affordability Study will be useful in ensuring that our policies continue to meet the goal of 95% subscribership. As the number of California Lifeline households exceeds those that found telephone service difficult to afford or had concerns about paying their phone bill, we believe that the results of the 2004 Affordability Study are entirely consistent with our reliance on California Lifeline to address affordability issues. The use of an Affordability Study will not produce helpful or usable information related to matters in this docket.

Further, in the designated high-cost areas where B-Fund support will continue to be provided after the transition period concludes, we will take an additional step to ensure that basic rates remains affordable. Thus, while we expect the same market forces to constrain prices in high-cost areas, in those areas where a COLR is receiving high cost support we will add an additional backstop (to limit basic rates based on the 150% limitation as described above) that will ensure prices are affordable and reasonably comparable to areas that have lower costs of service.

In comments to the PD, various parties object to our basic rate transition plan, but for different reasons. Although TURN and DRA claim there is no record to show that basic rates will remain affordable under the transition program as set forth in this decision, they disregard the record in the URF proceeding. As found in D.06-08-030, the URF ILECs "lack the market power needed to sustain prices above the levels that a competitive market produce" and "market conditions support pricing freedoms for basic residential rates that are not subsidized by the CHCF-B or LifeLine." These Commission findings provide a proper record to support the transition to full pricing flexibility for basic service adopted herein. Moreover, the protections precluding the COLR from raising basic rates above 150% of its highest rate outside of high-cost areas provide an additional backstop to ensure affordability.

We likewise are not persuaded by parties' opposition to the PD that argue that since competition exists even in high-cost areas, there is no need for any further regulatory constraints at all on basic service prices. To the contrary, although we recognize that the marketplace is competitive, we have also determined that B-Fund protections continues to be appropriate to help preserve affordable service in high-cost regions after January 1, 2009, as D.07-09-020 states:

> 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. (D.07-09-020 at 33.)

Thus, even with a competitive market, we expressed concern in D.07-09-020 that competing carriers could incur costs to serve certain customers in remote or hard-to-reach areas that are higher than in more populated regions. As a result, without B-Fund protections, competitors might decline to serve, or raise basic service rates to unaffordable levels for such customers. Thus, as noted in D.07-09-020, even within a competitive market, B-Fund pricing protections remain appropriate as a backstop to ensure affordability in high-cost regions. The price protections adopted herein are thus fully consistent with our findings that markets are competitive.

4.3. Authorized Increases in the Basic Rate During Transition Period

We shall authorize increases in the stand-alone basic rate cap over a two-year period for service offered by each respective ILEC, limited to the amounts set forth in Appendix 2. These rate cap increases shall apply to basic service offered to residential customers throughout the ILEC service territory). The rate cap increases that we authorize, both on an annual and cumulative basis, appropriately balance the objectives of avoiding rate shock while allowing for timely transition to market-based pricing.

In assessing the appropriate magnitude of rate cap increases during the transition period, we turn our attention first to AT&T. Many parties argue that because the current rate cap of AT&T remains significantly lower than that of the other three ILECs, a relatively larger increase is warranted for AT&T. We expect that absent the rate freeze, the rate disparity between AT&T and the other ILECs will narrow given normal competitive forces. We are not persuaded that policies simply designed to narrow the rate disparity will promote a more competitively level playing field. Competitive forces, income levels and costs vary by specific region, and thus, some disparities will be expected and normal.

We do not agree the proposal both of DRA and AT&T to reduce the disparity in basic rates between AT&T and the other ILECs rises to the level of a goal of the Commission. We also decline to adopt a one-year increase as large as that proposed by AT&T and Verizon. In the interests of minimizing the risk of rate shock, we conclude that a more modest increase is warranted.

We do not necessarily agree with the arguments of AT&T and Verizon that based on rate increases previously authorized in D.94-09-065 (the IRD proceeding), an annual increase as high as $6.05 would be defensible here, as conditions were different in 1994 at the time we approved basic service rate increases of $6.05 in D.94-09-065. For example, as a consideration in approving the $6.05 increase in basic rates in D.94-09-065, we concurrently adopted lower toll calling plans. Consequently, we observed that customers who made toll calls would not experience a full $6.05 increase in their overall monthly bills as a result of offsetting bill decreases from lower toll calling charges. By contrast, however, while the reduction in the CHCF-B surcharge is significant, it alone does not offset an increase as large as $6.05. Further, because non-basic rates were deregulated after the URF decision in August 2006, AT&T has increased rates for many unregulated features for California subscribers. Therefore, a relatively more modest monthly rate increase is warranted here.

We find merit in TURN's proposal to limit rate increases based upon the rate of inflation. But rather than simply considering inflation on a prospective basis, it is reasonable to recognize the effects of price inflation that have accumulated since basic rates were frozen in the mid-1990s. As a benchmark for purposes of measuring the cumulative increase in the AT&T rate before the transition to full pricing flexibility, therefore, we find it reasonable to apply the cumulative effects of consumer price inflation over the period since the basic rate was frozen in 1995.

In D.94-09-065, the Commission set basic service rates for AT&T at $11.25 for the residential flat rate and $6.00 for the residential measured rate. These rates remained in effect from January 1995 until November 1999 when the basic rate was further reduced to $10.69 in compliance with D.94-09-065, which directed actual price changes when permanent surcharges or surcredits total 5% or more on a cumulative basis. In 1999, AT&T California's surcredit reached that level for a variety of reasons, including annual price cap filings. The rate of $10.69 remained in effect until April 2008 when AT&T was authorized to increase its basic rate to $10.94 to account for one year of inflation pursuant to D.07-09-020.

During the intervening period that basic service rates remained frozen, the cumulative effects of price inflation resulted in the true economic retail charge for basic service actually declining when measured in terms of real inflation-adjusted purchasing power. Therefore, by allowing for basic rates to increase by the cumulative effects of inflation-adjusted price level changes, we are merely restoring the price of basic service to its real inflation-adjusted value in relation to 1995 price levels. Such an approach is clearly consistent with the goal of affordability. Thus, while the resulting rate increases represent a higher cost in nominal dollars, the increase does not constitute a significantly higher share of consumers' overall purchasing power, in terms of real inflation-adjusted dollars. By limiting the increase in the basic rate equal to the cumulative rate of inflation over this period since rates were frozen, we thereby preserve affordability of basic service.

Based upon our calculation as summarized in Appendix 1, assuming that the effects of inflation had been incorporated each year into basic service rates from 1995 through 2008, the inflation adjusted amount for the basic flat rate would be $16.14, representing a cumulative increase of $5.20 through 2008. Taking into account an estimated CPI inflation rate for 2009 and 2010 of 3.94%, the cumulative increase carried through 2010 would be $17.44 (*i.e.,* $16.14 x 1.0394 x 1.0394). The cumulative increase over two years would be $6.50 (*i.e.,* $17.44 - $10.94). Since the rate increase is phased in over a two-year period, one half of this amount, or $3.25 would be applicable each year.

Accordingly, we authorize AT&T to phase in this increase in its monthly basic rates by $3.25 per line effective January 1, 2009, and by an additional $3.25 per line effective January 1, 2010, equivalent to the cumulative increase in nominal dollars required to adjust for inflation as measured by the consumer price index from 1996 through 2010.

The annualized rate increase that we adopt for AT&T strikes an appropriate balance, higher than the amount proposed by DRA but lower than the amount proposed by AT&T and Verizon. At the same time, the total cumulative increase that we authorize for AT&T during the transition period is less than the cumulative increases proposed by the parties. While we are lifting restrictions on the ability of AT&T to impose further increases after January 1, 2011, we conclude that the forces of competition, together with the

150% basic rate limitation in high-cost areas, will constrain AT&T from increasing the rate above affordable levels going forward.

While the basic rates for Verizon, SureWest and Frontier have also been frozen since the mid-1990s, those rates remain significantly higher than the rate charged by AT&T. If we were to allow the other ILECs rates to increase on an equivalent percentage basis for the cumulative effects of past inflation, the dollar-amount of increase would be higher as compared with AT&T, and consequently, we would simply maintain the rate disparity between AT&T and the others. We conclude instead that an identical dollar-amount increase in the basic rate as we authorize for AT&T is appropriate for them during the two-year transition period, resulting in a lower percentage increase compared to AT&T. By adopting the same dollar-amount increase in the basic rate for the other three ILECs, we will be able to meet our goal of avoiding rate shock for customers as the carriers move toward market-based pricing.[35] As a result of applying the same rate cap dollar increase for all four ILECs, we will facilitate a smoother transition to market-based pricing once the two-year transition expires.

For the three ILECs other than AT&T, therefore we shall allow annual increases in their monthly rate caps equivalent to the AT&T amount of $3.25 effective January 1, 2009 and 2010, respectively. As noted previously, we concurrently adopt as an interim California LifeLine Telephone Program

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[35] We note that the Commission has previously determined that the basic rate offered by SureWest is just, reasonable, and affordable for California consumers. If we were to apply the full CPI adjustment to this SureWest rate, we could extrapolate a significantly higher basic rate percentage increase that would be just, reasonable, and affordable. However, since the marketplace will ensure that prospective rates remain just, reasonable, and affordable we do not engage in this analysis.

(LifeLine) rate increase a basic service rate cap for the period beginning January 1, 2009 through December 31, 2010 of 25% of the rate cap increment that we authorize today. In doing so, and as necessary to comply with today's decision, we temporarily suspend General Order 153, Sec. 8.1.4, which otherwise limits LifeLine rate discounts to 50%.[36] This authorization will expire upon issuance of a decision in our Universal Service proceeding (R.06-05-028), addressing how the LifeLine program will be changed to reflect the Basic Rate Decision adopted today.[37]

We direct parties in the Universal Service Docket (R.06-05-028) to file comments on September 30, 2008, to refresh the record, including considerations of affordability, avoiding rate shock, and the impact of the LifeLine subsidy on nonLifeLine customers; funding for needed increase in LifeLine subsidies; and any reforms to the LifeLine program structure such as changes in eligibility and/or services that are recommended in light of today's decision. We commit to adopt our decision on LifeLine reform in R.06-06-028, including the final LifeLine basic rates, with an effective date of January 1, 2009.

The effects of the authorized increases in the caps for basic flat rate service for each of the ILECs is summarized below:

Revised Dollar Amount of the Basic Flat Rate Caps (by carrier)

Currently Effective	AT&T	Verizon	SureWest	Frontier

[36] Under Pub. Util. Code § 874, we are directed to establish LifeLine rates at "no […]more than 50% of [the basic service rate]," and we rely upon that statutory authority in our action today.

[37] The LifeLine Program, formerly known as the Universal Service LifeLine Telephone Service (ULTS) Program, was established by the Commission in compliance with Pub. Util. Code § 871 and provides discounted basic residential (landline) telephone services to eligible low income households.

Basic Rate	$10.94	$17.66	$18.90	$17.85
EUCL	4.40	6.50	6.50	6.50
Total	$15.34	$24.16	$25.40	$24.35

Rate Change Date Rate Increase ($)	AT&T	Verizon	SureWest	Frontier
1/1/2009	3.25	3.25	3.25	3.25
1/1/2010	3.25	3.25	3.25	3.25

Total Revised basic rate (by carrier)

	AT&T	Verizon	SureWest	Frontier
1/1/2009				
Basic Rate	14.19	20.91	22.15	21.10
EUCL	4.40	6.50	6.50	6.50
Total	18.59	27.41	28.65	$ 27.60

1/1/2010	AT&T	Verizon	SureWest	Frontier
Basic Rate	17.44	24.16	25.40	24.35
EUCL	4.40	6.50	6.50	6.50
Total	$21.84	30.66	$31.90	$30.85

The applicable percentage increases in the flat rate for each ILEC as a result of applying the uniform $3.25 increase effective beginning January 1, 2009 and January 1, 2010, respectively, are summarized below:

Percentage Increase in Authorized Basic Rate Cap

Effective Date	**AT&T**	**Verizon**	**SureWest**	**Frontier**
1/1/2009	$10.94	$17.66	$18.90	$7.85
	$3.25	$3.25	$3.25	$3.25
% Increase	30%	18%	17%	18%
1/1/2010	$14.19	$20.91	$22.15	$21.10
	$3.25	$3.25	$3.25	$3.25
% Increase	23%	16%	15%	15%

Consistent with these authorized increases in the rate cap for basic service under the flat rate option, we correspondingly authorize increases of the same magnitude for basic service offered under the measured rate option. Since the measured rate is billed as a function of a customer's usage, rather than as a flat amount, we shall derive the applicable increase in the measured rate cap by applying the same percentage increases as derived above for the flat rate.

The increases calculated on an annualized basis for the ILECs represent a much smaller average relative increase when taking into account the extended period during which there were no basic rate increases (and when the inflation-adjusted value of the basic service rate actually declined).

The rate increase caps for basic flat and measured rate service that we adopt herein shall continue to apply to the provision of service by the COLR in each of the respective ILEC service territories for the two-year transition period beginning January 1, 2009. We note, however, that concurrent proceedings are underway to implement a reverse auction process whereby different carriers may be selected as COLRs in one or more service regions during the transition period.[38] If different carriers were to assume COLR responsibilities before the end of the phase-in period, at a minimum, customers of the original COLR would be able to transfer to the new COLR in order to continue to receive basic stand-alone service while preserving affordability, dependant on the transition rules adopted in a subsequent phase of this proceeding. In our subsequent decision adopting the reverse auction protocols, we shall address the process whereby the customers of the original COLR will be apprised to any change in COLR(s) and provisions for switching service in order to maintain stand alone basic service at an affordable COLR rate.

[38] Issues such as to whether one or multiple carriers may serve as COLRs within the same high-cost region and possible revisions in the basic service definition to promote more technology-neutral standards will be addressed in a subsequent decision adopting reverse auction protocols. We make no prejudgment of those issues here.

4.4. Maintaining Basic Rate Affordability After January 1, 2011

At the end of the two-year transition period, we reaffirm that full pricing flexibility is allowed for stand-alone basic service within those regions that are not subsidized by the B-Fund. The ILECs will be free thereafter to adjust residential basic rates in areas not subject to Lifeline subsidy or B-fund, based on competitive market forces. As of January 1, 2011, the URF ILECs may change their basic rates by filing a Tier 1 advice letter. The ILECs will be able to price residential service by geographic area rather than being required to apply uniform prices in all areas. A requirement of geographically averaged prices could encourage the provision of services by high-cost but subsidized technologies, while discouraging service by competitors offering lower-cost but unsubsidized services.[39]

As a result of the transitional rate increases that will be allowed over the two-year period, we will avoid the risk that any subsequent increases will result in consumer rate shock. We believe that competitive market forces will provide an effective check to keep any subsequent basic rate adjustments after January 1, 2011 at affordable levels. We have already determined in D.06-08-030 that the market for telecommunications services is competitive and that the ILECs no longer possess market power. Thus, the ILECs would not be able to sustain rate increases for basic service above affordable levels, particularly in areas that are not subsidized by the B-Fund. As we stated in D.06-08-030, cross-platform competition, particularly from wireless and VoIP technologies,

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[39] For example, in many rural areas, it may prove less expensive to provide basic service via wireless technologies than by subsidizing the construction of long copper wire traditional telephone service connections.

constrains the ability of an ILEC to raise basic rates.[40] Even where competitors do not offer an exact equivalent to the stand-alone basic service that is available from the ILEC, the competitive pricing of service packages offered by competitors will still serve as a check against increasing the basic service rate beyond an affordable level.

Therefore, it is not necessary to make findings concerning the precise magnitude of rate changes in basic service that may be deemed affordable subsequent to January 1, 2011. Although we set a threshold of $36 per line in D.07-09-020 as a generalized measure of affordability for purposes limiting eligibility for B-Fund subsidy support, we expressly affirmed that the $36 threshold was *not* intended for use as a stand-alone rate for basic service. We expressly made this clarification in D.07-11-039, and affirm it again today.

While we set the high-cost benchmark at $36 per line in D.07-09-020, the level of the high-cost benchmark does not necessarily constitute an affordable stand-alone basic rate. As we stated in D.07-09-020:

> The $36 benchmark, however, is in no way intended to serve as a cap on basic rate levels, or as a determination that retail rates for basic service alone as high as $36 would be affordable. Likewise, this benchmark level does not indicate that we believe it is appropriate for basic service to rise to a level of $36 per line. (D.07-09-020 at 46.)

Therefore, even though we set the benchmark at $36 per line for eligibility to claim B-Fund support, we do not create any correlation between the benchmark for determining where high cost support is appropriate and rates.

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[40] D.06-08-032, at 132.

Even if there was a correlation, the $36 threshold was based upon national aggregate data that incorporates revenues for bundles of telecommunications services. So while TURN tried to calculate how much of the $36 benchmark for high cost support contemplates a basic rate level lower than $36,[41] it errs in this approach because the Commission has not set the $36 figure as any kind of benchmark for determining that price regulation is no longer needed to ensure that prices are just, reasonable and affordable. Actual adjustments in the basic rate will be a function of competitive influences, marketing strategies of the ILEC, as well as actual changes in costs and technologies over time. Even if the ILEC relied exclusively on the revenues from the stand-alone basic rate to recover its costs, the currently assumed cost proxies that are set below the $36 level do not accurately measure the actual costs that would be incurred to provide basic service based on today's most efficient technology. The pricing of basic service will be set in the context of the overall market environment, taking into account revenue-generating opportunities from

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[41] By extrapolating a figure is 69.9% higher than the nationwide median basic service rate of $14.25, by excluding the subscriber line change (SLC) and other taxes and fees TURN believes that $21.19 represents the portion of the $36 that is attributable to basic service. Applying this 69.9% ratio to the service offerings of the ILECs, TURN computes the basic service rate element would represent $21.19 (*i.e.*, $21.19 * 1.699 = $36). *See* TURN Comments of 11/29/07 at footnote 14, citing Table 1.1 in the *2007 FCC Reference Book of Rates, Price Indices and Household Expenditures for Telephone Service,* http://fjallfoss.fcc.gov/edocs_public/attacmatch/DOC-276876A1.pdf. However, TURN does not account for the impact of the frozen basic rates in California on the originating data set. In addition, other assumptions could increase or decrease the figure calculated by TURN. In any case, since the $36 figure is used in calculating where California will provide high cost support and that calculation does not consider whether the actual rate is higher or lower than the benchmark, their extrapolation is not probative in our analysis.

bundles of product offerings marketed to customers. As we stated in D.07-09-020, the ILECs have considerable flexibility under our URF regulatory regime to bundle a variety of features (*e.g.*, voicemail, call forwarding, Caller ID, etc.) together with the primary basic residential line offered to its retail customers. Even though the primary line remains subject to regulatory price controls, the ILECs have flexibility under URF to adjust its prices for additional services bundled with the basic line, constrained only by competitive forces. In applying the $36 benchmark to determine high cost areas, we appropriately took into account this broader context in which residential lines are marketed with the flexibility to bundle the basic line with additional features and to flexibility price those additional features.

While we make no findings as to the precise magnitude of basic rate changes deemed affordable subsequent to January 1, 2011, we conclude that it is appropriate to continue to restrict the maximum stand-alone rate, as noted previously, by an amount not to exceed 150% of the highest stand-alone rate charged by the COLR in its California service area outside of high-cost regions or $36 minus the EUCL, whichever is lower. As discussed below, we shall adopt appropriate measures to ensure that as a condition of receiving B-Fund support, COLR stand-alone basic rates meet this requirement.

We also will continue to monitor the residential telephone subscribership in California to ensure that the metric we use as a determination that services are affordable remains above 95%. At this point there is no need to maintain broad all-encompassing policies for wireline telephone service. The Commission can best assure the continued affordability of telecommunications services through targeted programs and policies such as California Lifeline and the CHCF-B. Further, the Current Population Survey (CPS) that the Commission uses to measure telephone subscribership may "be on the low side" and any action based on its results should use it in a conservative manner.[42] Accordingly the Commission may choose to evaluate its existing programs and consider new targeted programs should the CPS penetration rate for telephones available to households fall below 95% for an entire year.[43]

4.5. Annual Certification Process for High-Cost Areas

In areas where costs of service exceed the high-cost threshold, (*i.e.,* currently defined as regions in CBGs with an assumed cost in excess of $36 per line), as previously decided in D.07-09-020, B-Fund support will continue to be available to supplement revenues collected through the end-user's basic rate. Therefore, after the two-year transition period expires, the basic rate charged in high cost areas shall continue to be subject to the 150% limitation, as explained above, as a backstop to ensure affordability. As a basis to receive B-Fund support after full pricing flexibility takes effect, we stated in D.07-09-020, that further guidance would be provided regarding measures to ensure that the COLR will not increase charges for basic service above an affordable level. The B-Fund subsidy support is provided to a COLR on the condition that the basic rate that is charged to the end user will not exceed a prescribed maximum.

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[42] CPUC Universal Service Telephone Report to the California Legislature at 3-4, May 2008.

[43] The CPS survey is conducted every month, but not all questions are asked every month. The telephone questions are asked once every four months. As the sample is staggered, reported information for any given month actually reflects responses over the preceding four months. The FCC aggregates summaries of the responses based on the surveys conducted through March, July, and November of each year.

As stated in D.07-09-020 (ordering paragraph (OP) 9), as modified by D.08-04-061, a COLR will be required to certify annually that rates for basic service within its designated high-cost area:

> "do not exceed a level consistent with the authorized amount of B-Fund support pursuant to further disposition in Phase II of this proceeding."

The intent of OP 9 of D.07-09-020, as modified by D.08-04-061, is to ensure that the COLR does not charge more than what would otherwise be affordable in areas that are not subsidized by the B-Fund. In order to implement this goal, we shall require that the COLR certify that it does not charge stand-alone basic rates in high-cost areas (a) that are more than 150% of the highest rate for stand-alone basic service that it charges within its aggregate California service territory not subsidized by the B-Fund, or (b) that are more than the $36 high-cost benchmark minus the EUCL, whichever is lower.[44] Since this rate will be subject to pricing flexibility after January 1, 2011, some additional reporting requirements will be necessary to provide the requisite data to ascertain the highest stand-alone basic rate in the COLR's California service area outside of high-cost areas. We shall address the details of how this process of verifying the highest rate in our subsequent decision adopting protocols for the reverse auction.

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

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[44] If the COLR does not offer stand-alone basic residential service outside of high-cost areas, the highest stand-alone basic rate offered by an adjacent ILEC may serve as a suitable proxy.

determine what, if any, action is required. As part of the bidding process, we expect that as a condition of winning the bid for a given level of support in high cost areas, the winning bidder must agree to limit the maximum that it will charge customers for basic service in the high-cost areas. Therefore, the COLR must certify that the charge for stand-alone basic service does not exceed the maximum amounts deemed affordable, as described above.

A reverse auction mechanism is now being considered which will develop parameters to determine the level of support that will apply in remaining high-cost areas. The maximum rate levels that may be charged within a given high-cost area will serve as one of the factors to be taken into account in bidding on B-Fund support levels in the reverse auction. The winning bidder will be expected to bid on the minimum level of subsidy that it will require as condition of serving as COLR for the period designated, subject to a limitation on maximum charges for residential basic service in designated high-cost areas, as prescribed above.

5. Comments on Proposed Decision

The proposed decision of Commissioner Rachelle B. Chong in this matter 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 July 21, 2008, and reply comments were filed on August 4, 2008. We have taken the comments into account in finalizing this decision.

6. Assignment of Proceeding

Rachelle B. Chong is the assigned Commissioner and Thomas R. Pulsifer is the assigned Administrative Law Judge 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 environments.

2. The level of basic residential rates remained fixed when the B-Fund was adopted in 1996, and have not increased above those levels since then, except for limited inflation-related adjustments for 2008 as authorized for AT&T and Verizon in D.07-09-020.

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

4. After January 1, 2009, as directed in D.06-08-030, the currently effective caps on basic residential service rates not subsidized by CHCF-B will sunset automatically.

5. D.06-08-030 also 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. As noted in D.06-08-030, even in a competitive market, CHCF-B subsidies can distort the market for the provision of basic stand-alone service.

7. In D.07-09-020, the Commission adopted a framework for a period of transition to market-based pricing of basic service once the current rate caps expire on January 1, 2009, so as to avoid consumer rate shock.

8. The plan adopted in this decision provides for a transition to market-based pricing of basic service that is consistent with the framework adopted in D.07-09-020.

9. After the current rate caps expire on January 1, 2009, a period of two years will provide for a reasonable transition to phase-in rate changes prior to allowing full pricing flexibility for basic service, while retaining restrictions on the maximum rates that a COLR may charge in high-cost areas subsidized by the B-Fund.

10. A two-year phase-in period to transition to full pricing flexibility will avoid the effects of consumer rate shock that would result from immediately removing all pricing restrictions, yet will be short enough to provide a timely transition to market-based pricing.

11. During the period that basic service rates remained frozen, the cumulative effects of price inflation resulted in the true economic retail charge for basic service actually declining in terms of real purchasing power.

12. By allowing for a basic rate increase equal to the cumulative effects of inflation-adjusted price level changes since 1995, the price of basic service is merely adjusted to its real inflation-adjusted value in relation to 1995 price levels.

13. The goals of maintaining basic service affordability while transitioning to market-based pricing can be reasonably balanced by allowing AT&T to increase its basic rate over a two-year period by an amount equal to the cumulative inflation-adjusted price changes since the rate freeze was implemented in 1995.

14. The resulting cumulative increase in the basic rate for AT&T as a result of applying inflation-adjusted price changes since 1995, as derived in Appendix 1, would result in an increase of $3.25 on January 1, 2009, and $3.25 on January 1, 2010.

15. The basic rates for Verizon, SureWest and Frontier have also been frozen since the mid-1990s. If their rates were allowed to increase by the cumulative

effects of past inflation since 1995, the result would be significantly higher than merely limiting them to the same dollar increase as authorized for AT&T.

16. By allowing the same increase in the basic rate for Verizon, SureWest, and Frontier as calculated for AT&T, the dollar differences among the basic rates of all four ILECs will remain the same, and facilitate a smoother transition to market-based pricing.

17. The resulting basic rate increases of $3.25 per month for Verizon, SureWest, and Frontier, as set forth in Appendix 2 represent the amounts attributable to limiting the rate increases to the amount approved for AT&T for the period beginning January 1, 2009 and 2010, respectively.

18. Since the Commission found in D.06-08-030 that the market for telecommunications services is competitive, the ILECs would not be able to sustain rate increases for basic service above affordable levels after the end of the two-year transition period, under the provisions as adopted in this decision.

19. Once the two-year transition period expires, the forces of competition, together with additional backstop of the 150% basic rate limitation for basic service charges in high-cost areas adopted in this decision, should serve to constrain the COLRs from raising basic service rates above affordable levels in regions not subject to B-Fund subsidy support.

20. The authorization to increase the basic service rate cap means that the ILEC may elect to charge less than or equal to the capped amount, but may not charge more. The Commission is not ordering the ILEC to raise its basic rate but giving it permission to do so if it so desires to meet current market conditions.

21. Although a threshold of $36 per line was adopted in D.07-09-020 as a generalized measure for purposes limiting eligibility for B-Fund subsidy

support, the $36 threshold was *not* intended for use as a stand-alone rate cap for basic service.

22. The $36 threshold adopted in D.07-09-020 was based upon national aggregate data, reflecting revenues from sources other than just basic service.

23. In order to ensure basic service affordability once the two-year transition period expires, it is not necessary to determine a specific maximum affordable rate. Adjustments in basic rates after full pricing flexibility takes effect will be constrained by competitive influences, marketing strategies, as well as changes in costs and technologies over time.

24. The continued affordability of telecommunications services can best be assured through targeted programs and policies such as California Lifeline and the CHCF-B.

25. The Commission may choose to evaluate its existing programs and consider new targeted programs should the CPS penetration rate for telephones available to households fall below 95% for an entire year.

26. The Commission considered the most recent Study on Affordability of Basic Telephone Service conduced by Field Research Corporation in 2004 as part of this proceeding and did not find it useful for establishing new high cost rules or as a basis for establishing basic rates.

27. The Commission has found the Affordability Study useful in the context of evaluating the California Lifeline program.

28. The Commission should undertake such an Affordability Study in the 2009-2010 fiscal period and will request an appropriation from the Legislature to conduct such a study.

29. The Commission shall complete by June 30, 2010 a statewide Affordability Study in order to analyze the impacts of the transition plan and any reforms in

the California LifeLine Telephone Program. California Lifeline rates should not increase on the same percentage basis as the basic rate for non-Lifeline customers.

30. A reasonable way to implement this protection is to require that the COLR certify that it does not charge more than 150% of the highest rate for stand-alone basic service within its aggregate California service territory that is not subsidized by the B-Fund or $36 (equal to the high-cost benchmark) minus the EUCL, whichever is lower.

31. Since the basic rate will be subject to pricing flexibility after January 1, 2011, additional reporting requirements will be necessary to provide the requisite data to ascertain the highest basic rate.

32. California Lifeline rates should not increase on the same percentage basis as the basic rate for non-Lifeline customers.

33. Additional comment should be provided in the Universal Service, Public Purpose Programs (PPP) R.06-05-028 by October 1, 2008 to refresh the record in that proceeding.

Conclusions of Law

1. Pursuant to the directives in D.06-08-030 and D.07-09-020, a transition process is required to move to market-based pricing of basic service once the current rate caps expire effective January 1, 2009.

2. The transition process adopted in the ordering paragraphs below is compliant with the goals and framework of D.06-08-030 and D.07-09-020 for the treatment of basic service rates on and after January 1, 2009.

3. The provisions for basic rate adjustments for each of the ILECs, as set forth in Appendix 2 below, effective beginning January 1, 2009, should be adopted.

4. Granting full pricing flexibility after a two-year transition period for basic service in regions not subsidized by the B-Fund would be consistent with the goals of preserving universal service as well as promoting timely implementation of market-based pricing.

5. The Commission can best assure the continued affordability of telecommunications services through targeted programs and policies such as California Lifeline and the CHCF-B.

6. The provisions allowing for adjustments to basic rates applicable to the ILECs, as adopted in this decision, should be incorporated into the design of the reverse auction that is also being considered for implementation in this proceeding. Nothing in the basic rate transition plan adopted in this decision is intended to prejudge the protocols for the reverse auction, including revisions in the basic service definition to make it technology neutral and whether to permit one or multiple COLRs to draw B-Fund support within the same high-cost region.

7. Pub. Util. Code § 874 requires that "the lifeline telephone service rates shall not be more than 50% of the rates for basic flat rate service," and allows for discounts that make the California LifeLine rate less than 50% of the basic flat rate.

O R D E R

IT IS ORDERED that:

1. Upon the expiration of currently effective rate caps on January 1, 2009, the following incumbent local exchange carriers (ILECs): Pacific Bell Telephone Company dba AT&T California (AT&T), Verizon California Inc. (Verizon),

SureWest Telephone (SureWest), and Citizens Telecommunications Company of California Inc, dba Frontier Communications Company of California (Frontier) shall be permitted to increase their stand-alone residential basic flat rates by up to the amounts set forth in Appendix 2.

2. Each of the ILECs is also concurrently permitted to increase residential basic rates for measured service on the same percentage basis as is permitted for flat rates. The resulting percentage increases for measured service rates are: (a) For AT&T – 30% for 2009 and 23% for 2010; (b) For Verizon- 18% for 2009 and 16% for 2010; for SureWest – 17% for 2009 and 15% for 2010; for Frontier – 18% for 2009 and 15% for 2010.

3. The authorized increases in the basic rate caps for residential flat rate and measured rate service each of the Uniform Regulatory Framework (URF) ILECs shall take effect January 1, 2009 and January 1, 2010, respectively. If an ILEC does increase any basic rates pursuant to the additional rate cap flexibility granted in this decision, the ILEC must first file an advice letter and provide 30-day advance notice of the increase to affected customers pursuant to Decision (D.) 06-08-030 (Ordering Paragraph 9).

4. Effective on and after January 1, 2011, each the named ILECs shall be permitted to adjust stand-alone prices for residential basic service in regions not subsidized by the B-Fund, without regulatory restrictions, subject only to competitive market forces.

5. Each of the ILECs is permitted to increase California LifeLine basic rates for 2009 and 2010 by no more than 25% of the incremental rate cap change ($0.81).

6. Each of the ILECs is also concurrently permitted to increase California LifeLine basic rates for measured service on the same percentage basis as is permitted for California LifeLine basic rates.

7. The Commission will request an appropriation from the Legislature to conduct such an Affordability Study during the 2009-2010 fiscal period as part of its ongoing evaluation of the California Lifeline program in Rulemaking (R.) 06-05-028.

8. The Commission shall complete by June 30, 2010 a statewide Affordability Study in order to analyze the impacts of the transition plan and any reforms in the California LifeLine Telephone Program.

9. Pursuant to D.07-09-020, Verizon and Frontier shall file advice letters implementing the surcredit reduction to match any respective reduction in their CHCF-B support payments in tandem with the schedule for implementing revisions in the high-cost benchmark to be completed as of July 1, 2009.

10. Consistent with General Order 153, LifeLine rates for basic flat rate and measured service may be affected to the extent the ILECs implement increases pursuant to the rate flexibility permitted herein. This decision does not prejudge the merits of any subsequent reforms to LifeLine rates or program features as currently being considered in R.06-05-028.

11. To the extent necessary to effectuate the rates specified in this decision for California LifeLine, we suspend General Order 153, to the extent it limits California LifeLine rate discounts to 50%.

12. On or after January 1, 2011, the URF ILECs may change their rates for basic service by filing a Tier 1 advice letter.

13. We direct parties to file comments in the Universal Service, Public Purpose Programs R.06-05-028 by October 1, 2008 to refresh the record in that proceeding.

This order is effective today.

Dated September 18, 2008, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
TIMOTHY ALAN SIMON
Commissioners

We reserve the right
to file a concurrence.

/s/ JOHN S. BOHN
Commissioner

/s/ TIMOTHY A. SIMON
Commissioner

/s/ DIAN M. GRUENEICH
Commissioner

APPENDIX 1

Derivation of Adjustments to AT&T's Basic Rate for Cumulative Consumer Price Index (CPI) Changes (1995 to 2008)

Year	AT & T Basic Exchange Rates	Historic CPI Inflation Rate	CPI Adj Rate - base 1995
1994	$ 8.35	2.56	$ 8.35
1995	$11.25	2.83	$11.54
1996	$11.25	2.95	$11.86
1997	$11.25	2.29	$12.21
1998	$11.25	1.56	$12.49
1999	$10.69	2.21	$12.69
2000	$10.69	3.36	$12.97
2001	$10.69	2.85	$13.41
2002	$10.69	1.58	$13.79
2003	$10.69	2.28	$14.01
2004	$10.69	2.66	$14.32
2005	$10.69	3.39	$14.71
2006	$10.69	3.23	$15.20
2007	$10.69	2.85	$15.70
2008	$10.69/10.94[1]	3.94 (est.)	$16.18
2009			
2010			

(END OF APPENDIX 1)

1 The $10.94 rate took effect April 8, 2008.

APPENDIX 2

Adopted Increases in Basic Rates Effective January 1, 2009

Rate Change Date	Revised Basic Rate Caps (by carrier)			
1/1/2008	AT&T	Verizon	SureWest	Frontier
Basic Rate	$10.94	$17.66	$18.90	$17.85
EUCL	4.40	6.50	6.50	6.50
Total	$15.34	$24.16	$25.40	$24.35

Rate Increase ($)	AT&T	Verizon	SureWest	Frontier
1/1/2009	3.25	3.25	3.25	3.25
1/1/2010	3.25	3.25	3.25	3.25

Total Revised basic rate (by carrier)

	AT&T	Verizon	SureWest	Frontier
1/1/2009				
Basic Rate	14.19	20.91	22.15	21.10
EUCL	4.40	6.50	6.50	6.50
Total	$18.59	27.41	28.65	$27.60

1/1/2010	AT&T	Verizon	SureWest	Frontier
Basic Rate	17.44	24.16	25.40	24.35
EUCL	4.40	6.50	6.50	6.50
Total	$21.84	30.66	$31.90	$30.85

(END OF APPENDIX 2)

R.06-06-028
D.08-09-042

Concurrence of Commissioner John A. Bohn to Decision 08-09-042

I offer my support and my vote in favor of this decision to adopt a phased transition plan for pricing basic telephone service.

We are in the process of moving from an administratively-determined price system for telephone service to a market-based price system. We must continually re-evaluate the market to be sure that competition is providing adequate price discipline. In this process, things are changing and the key to a successful change is a transition plan that includes a study of affordability, which we have adopted in this decision. It is important that we refresh our thinking on what affordability means. Does the affordability issue relate to people who fall below the poverty line? Below double the poverty line? Is there a line we can reasonably draw?

There are a number of ways to handle the affordability issue as it relates to telephone service. One way is to set up a discount rates program for certain customers. Another way to deal with this issue is to keep rates artificially low, but if we keep rates too low, we starve our utilities for investment. Yet, looking at the trajectory of our current economic situation, more and more people may find themselves in a position to say that they have affordability issues. Clearly we are seeing a world-wide price increase for services, and it is unlikely to suddenly reverse itself.

Affordability is not only related to telephone service. We see it in the energy area and in water service as well. I intend to invest my time on this issue, not just with respect to basic telephone service, but also with respect to energy and water services as well. I think it is important for us to try to get this right as we move forward.

/s/ JOHN A. BOHN
John A. Bohn

San Francisco, California
September 23, 2008

R.06-06-028
D.08-09-042

Concurrence of Commissioner Dian M. Grueneich

Today's decision contains four major elements:

1. We allow major rate increases in basic services, up to 30% effective January 1, 2009 and up to 23% effective January 1, 2010;

2. We state an intent that, as of January 1, 2011, all caps will be removed on basic service rates in California;

3. We place a limit on LifeLine price increases for basic service of no greater than 81 cents per year, subject to a further review later this year which may demonstrate that expanded LifeLine services are needed in light of today's decision; and

4. We commit to complete a statewide affordability study by June 30, 2010, in order to inform our decision regarding post-2010 regulatory and rate structure.

I have concluded that the balancing of these four elements warrants my vote in favor of this decision. However, as I explain below, I remain troubled about whether we have sufficient safeguards in place to monitor the level of competition in California and protect our most vulnerable telephone customers.

This decision and others we have issued are premised on an assumption of existing and continuing robust competition in all segments of the communications market. We are at risk that a lack of knowledge – and fall back provisions if competition does not exist as assumed – will result in a failure of the goals we seek – low-cost, universal telephone and other communication services for all residents and businesses in the State.

Currently, most California telephone customers are dealing with a fluctuating economy and its uncertainty. However, those most vulnerable – low income families, seniors living on fixed incomes, and the disabled – are feeling an even greater impact from this worsening economy. As a regulator of California's utilities, I am witnessing California's low and moderate income households spending one-fifth of their annual income on home energy bills and an estimated 1.7 million families in arrears on their energy bills. The record in this proceeding shows that nearly two-thirds of LifeLine customers receive only basic service and will be directly impacted by our actions today.

In making the decision to approve lifting the decade's long freeze on basic telephone rates, we must balance the Commission's policy goal of cost-based rates, as disciplined by competitive market forces,[1] with its policy of Universal Telephone Service, whereby all California consumers have access to affordable and reliable telephone service.

Today's decision seeks to reach this balance. While taking a step closer to regulation by market competition, we have simultaneously put in place safeguards to prevent rate shock for the average consumer by setting rate caps on allowable increases. For the more vulnerable consumer, we have ensured them that price increases will be limited to no more than $0.81 a year and we have committed to reviewing the impact of these actions in a separate proceeding, the Universal Service, Public Purpose Programs Rulemaking 06-05-028. The commitment also includes a review of the LifeLine eligibility requirements. Because the cost of living is comparatively higher in certain California communities, the Commission should be certain that the LifeLine program has appropriate eligibility requirements to balance that higher cost of living. The LifeLine review should consider, if necessary, expanding program coverage. (By comparison, in our energy assistance programs, the eligibility criteria are 200% of federal income poverty levels whereas for LifeLine it is only 150%.)

I remain concerned whether we have adequate safeguards to monitor the level of voice competition and ensure appropriate prices <u>can</u> be determined by competitive market forces. This decision requires a statewide affordability study be completed by June 30, 2010, so it can inform our decision on post-2010 regulatory and rate structure. However, to properly ensure that competition is as vibrant as the Commission declares, we have a duty and responsibility to the consumers of California to monitor the level of competition to assure that prices remain affordable and telephone service remains reliable and accessible to all Californians. The Commission should schedule regular competition surveys to adequately meet this responsibility. This is an issue that I will be pursuing.

<u>/s/ DIAN M. GRUENEICH</u>
Dian M. Grueneich

San Francisco, California

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[1] *See* D.06-08-030 at 132, FOF 77, 86, COL 20, 28, D.07-09-020 OPs 7-8, 13, as modified by D.07-11-039.

September 23, 2008