

Introduction

The Commission prepared this status report on its current California High Cost Fund – B (CHCF-B or B-Fund) program review in response to a legislative mandate. On August 31, 2007, the Legislative Analyst’s Office issued the Supplemental Report of the 2007 Budget Act which requires the Commission to report quarterly on its efforts to produce a review of the California High Cost Fund – B program, an update on the proceeding and efforts to comply with the statutorily mandated sunset of the program. This is the report for the quarter ending September 30, 2007.

On April 18, 2007 the Communications Division provided the prior status report on the CHCF-B Program Review. That report explained the authority and history of the Universal Service program as it applies to rural, insular and high cost areas served by the larger (non-rural) carriers. In this report, we summarize a major September 2007 decision impacting the CHCF-B program.

Interim Decision Summary

On September 6, 2007, the Commission unanimously issued an interim decision in Order Instituting Rulemaking (R. 06-06-028) to adopt major reforms to the CHCF-B Program. (This decision is attached as Appendix A). This Decision (D.) 07-09-020 is responsive to the mandate of the legislature in Senate Bill (SB) 1276 (Chapter 847, Statutes of 2004) to update the B-Fund and evaluate reducing the size of the B-Fund. The Commission’s review, as explained in D.07-09-020, determined that the existing level of the B-Fund benchmark threshold is overly inclusive and

results in subsidies to basic lines beyond the level that is required to meet the universal service goal of a 95% penetration rate for basic telephone service.

In this decision, the Commission adopted the following changes:

- Increasing the subsidy threshold from the current \$20.30 to \$36.00 in a series of steps;
- Changing the method of calculation of the subsidy payment from the difference between cost and revenue to the difference between cost and the threshold level;
- Reducing the retail surcharge from the current 1.30% to 0.50% effective January 1, 2008 which will further reduce the balance in the fund;
- Permitting AT&T and Verizon to increase residence basic local exchange flat rates by the amount of inflation (2.36%) on January 1, 2008 as allowed by the Digital Infrastructure and Video Competition Act (DIVCA);
- Setting forth a schedule of Phase II issues to consider (1) including a reverse auction mechanism to determine future subsidy levels and (2) establishing a fund to subsidize advanced communications services such as broadband deployment to unserved and underserved areas of California.

The Commission estimates that the B-Fund program currently at \$434.6 million will decline by approximately \$315.4 million by July 1, 2009, representing a 74% reduction in subsidy expenditures. The Commission will separately determine suitable transitional increases in the residential basic local exchange service rate caps for each respective URF¹ incumbent local exchange carrier (ILEC) in the next phase of this proceeding to mitigate rate shock.

¹ Uniform Regulatory Framework implemented by D.06-08-030.

The changes implemented by this decision signal that the Commission will rely more upon competitive market forces, rather than regulatory subsidies that favor only one technology (landline), to keep basic residential phone rates affordable. However, the Commission has found that, at this time, the complete elimination of the B-Fund program is not feasible nor in the interests of consumers. The Commission is concerned that the cost for basic residence service, at least in certain high cost areas, still exceeds reasonably affordable levels, thus requiring some continued subsidy. These changes will permit the B-Fund program to continue on a more limited basis for only areas that are truly high cost.

Although Public Utilities Code Section 739.3 is scheduled to sunset on January 1, 2009, there will be a continuing need to address service in high cost areas after that date. The Commission anticipates that the universal service need will continue in high cost areas and will continue a program in a modified and more targeted form.

Next Steps

B-Fund Review

The next phase of R. 06-06-028 will address the remaining issues necessary to implement the reforms that were identified in D.07-09-020. Among other Phase II issues, the Commission will examine legal, policy, and technical implementation issues associated with the establishment of the California Advanced Services Fund (CASF). The CASF, if implemented, would provide funds to subsidize broadband development in unserved and underserved areas. On September 12, 2007, the Assigned Commissioner issued a ruling seeking comments from parties on issues

related to the establishment of the CASF. This ruling is discussed below. Also, in Phase II of the proceeding, the Commission will complete the long-overdue update of the relevant cost proxies for deriving subsidy draws. As another high priority, the Commission intends to institute a market-driven reverse auction process to determine high cost support levels. A market-driven reverse auction process may be preferable to updating the cost proxy model.

While the Commission's ultimate goal remains to rely upon competitive market forces to determine the appropriate pricing of basic residence local exchange services, the Commission believes a transition process is necessary to mitigate potential "rate shock" of sudden, large URF ILEC retail basic rate increases in response to reforms in the decision. In Phase II of this proceeding the Commission, therefore, will also establish a process for a phase-in of any increases to basic residential rate levels as of January 1, 2009 to provide an orderly transition to full pricing flexibility over a limited time period. As a basis for calculating the applicable level of rate increases, the Commission will examine whether to establish a target cap for each Carrier of Last Resort² (COLR). Once the targeted cap is reached, the cap restrictions may be removed and the COLRs may be granted full pricing flexibility to make any subsequent adjustments in basic rates based on competitive market forces.

Assigned Commissioner Ruling

² A designated Carrier of Last Resort is obligated to serve customers within its service area - even those in very high cost areas.

As a basis for addressing the Phase II issues, the Assigned Commissioner will provide guidance to parties concerning the development of the record and will provide appropriate opportunity for comments on relevant issues. In this regard, an initial Assigned Commissioner Ruling (ACR) has already been issued.

The September 12, 2007 ACR seeks comments on the following CASF issues:

- What legal basis and policy merits exist for funding and administering the CASF under the provision of the CHCF-B program?
- What overall dollar amount, funding source(s) and time considerations are appropriate for the CASF to build advanced infrastructure in California?
- What process should be established for prospective applicants to apply for and receive grants of CASF money for the purpose of deploying broadband services which will include as one component basic residential service within underserved or unserved areas?
- What are the merits of the process to apply for funding from the CASF in Appendix 3 of D.07-09-020? Are there additional requirements that should be added to help avoid waste, fraud and abuse?
- Should an application for CASF funding trigger and open a 60-day window for other applications for substantially the same geographic area?

- What specific audit, verification, and other requirements would be warranted as a basis to administer the CASF funding consistent with universal service goals?
- If Pub. Util. Code § 739.3 is the basis for the CASF, should the term “telephone corporation” in that section limit recipients of CASF money to those entities qualifying under Pub. Util. Code § 234?

The comments solicited in the ACR were filed on September 26, 2007. Reply comments are due on October 3, 2007. When these comments are received, they will be evaluated by the Commission staff, and further comments may be solicited if necessary.

Reverse Auction Process

The Commission will solicit comments and may subsequently hold a workshop to provide the opportunity for parties’ input in establishing a reverse auction mechanism for determining the COLR eligible for subsidy payments. The Commission is exploring the use of a reverse auction, where the lowest bid is successful to establish the level of subsidy in targeted high cost areas. A reverse auction would allow the lowest bidder to set the level of support that they would need to serve a particular area. The specific mechanism and rules would have to be worked out in future workshops. It would be technology neutral program. A pilot program may be appropriate to explore rules and procedures that would ensure the proper and efficient use of market-driven mechanisms to further universal service goals.

Other Phase II Issues

The Rulemaking in Phase II will also examine the administrative procedures for processing B-Fund claims and will seek ways to improve the process through streamlining and administrative efficiencies while still permitting proper verification and audit of the claims. There are other Commission proceedings that are underway or expected to be opened that consider Public Purpose Programs, the URF proceeding and a review of the California High Cost Fund – A³.

Conclusion

In summary, the changes implemented by the decision will reduce the balance in the B-Fund dramatically and reduce the size of the program while meeting the universal service goal of 95% penetration. Consumers will immediately benefit by a reduction of the surcharge from 1.30% to 0.50% on January 1, 2008. The increase in the threshold and modification of the method to calculate the amount of the subsidy will reduce the magnitude of the claims and better target them to the highest cost areas. The B-Fund changes are being phased in over a period of time. Basic phone rates after January 1, 2009 may be subject to transitional caps in order to ease “rate shock” to consumers. The subsequent phase(s) of the OIR will address market mechanisms such as a reverse auction and possible updating of costs as a basis for determining support levels. Also the California Advanced Services Fund will be investigated as a method of furthering universal service and state broadband goals as to voice services

³ The California High Cost Fund – A provides universal service support to eligible smaller local exchange carriers in California.

on advanced systems in specifically targeted high cost areas of California.

Appendix A

Decision 07-09-020

INTERIM OPINION ADOPTING REFORMS TO THE HIGH COST FUND-B MECHANISM

