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Commissioner : ________________
Admin. Law Judge : ________________
DRA Project Mgr. :
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DIVISION OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

REPORT ON RATE INCREASES OF VERIZON, AT&T, SUREWEST AND FRONTIER CALIFORNIA FOLLOWING ADOPTION OF THE UNIFORM REGULATORY FRAMEWORK IN DECISION 06-08-030

San Francisco, California
July 29, 2008

I. INTRODUCTION

This Report examines and summarizes the telephone rate increases allowed by the California Public Utilities Commission (Commission) following adoption of the Uniform Regulatory Framework (URF) for incumbent telephone companies or ILECs.[1] The Division of Ratepayer Advocates (DRA)[2] presents evidence here of significant rate increases for telecommunications services that the incumbent telephone companies (especially AT&T and Verizon) have implemented since they were granted pricing freedom in 2006. These increases appear to contradict the Commission's conclusion that ILECs like AT&T and Verizon lack significant market power in the voice telecommunications marketplace.[3] Accordingly, DRA recommends that the Commission maintain current rates for basic residential service until the Commission completes an affordability study for basic residential service. DRA also recommends that the Commission consider adoption of price controls for certain ancillary and vertical services on a stand-alone basis.

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1 On April 14, 2005, the Commission instituted its Uniform Regulatory Framework (URF) Rulemaking 05-04-005 to assess and revise the rate regulation of large ILECs in California. Decision 06-08-030, the Phase I URF decision, removed all remaining pricing regulation for business and residential telecommunications services with the exception of stand-alone basic residential service. It also established a framework for deregulating the price of basic residential service.

2 DRA is an independent consumer advocacy division of the Commission. DRA's statutory mission is to obtain the lowest rate for service consistent with safe and reliable service levels.

3 See D.06-08-030: "In addition to the comments and testimony directly discussed, we have reviewed the entire record on this matter and conclude that Verizon, SBC, SureWest, and Frontier lack market power in their service territories. We, therefore, conclude that price regulation is no longer needed to ensure that prices are just and reasonable." Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the Regulation of Telecommunications Utilities, R.05-04-005, p.132.

Many of these rate increases have been substantial. For example, AT&T has recently raised its rates for local calling and "Zone 3" calling[4], by more than **471%** for some minutes.[5] These nearly local calls have historically had very low rates because they are part of the caller's local community of interest. On average, AT&T raised a three minute local, day period call by 34%, evening period calls by 92% and night/weekend calls by 233%.[6] It raised a three minute "Zone 3" day period call by 24%, evening period calls by 78% and night/weekend calls by 212%. AT&T has also increased the local toll rate for residential customers between 68% and 163% for a three-minute call, depending on time and call mileage.

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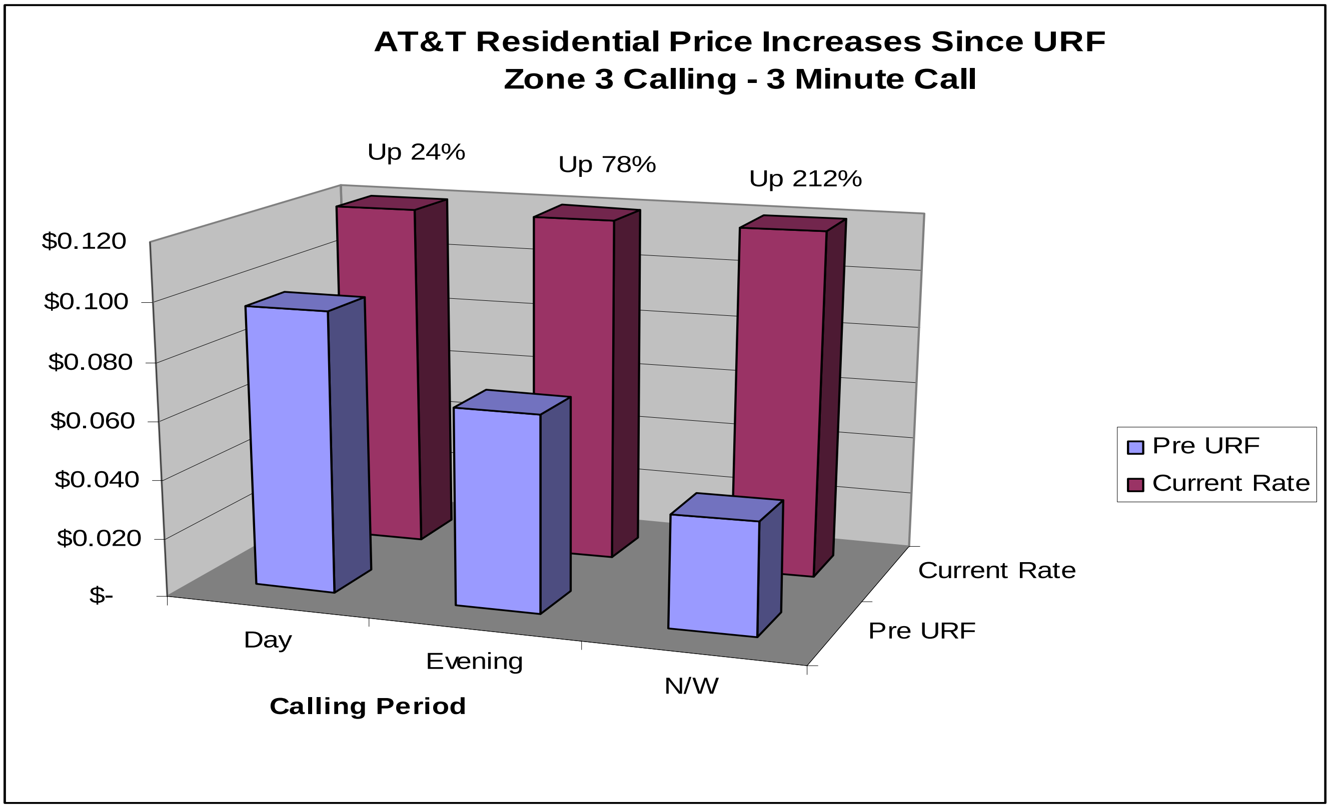
4 "Zone 1" and "Zone 2" calls are within 12 miles of the callers wire center and are considered "local." Customers with flat rate local calling pay no additional charge for calls in those zones. Customer who choose measured rate local service have a lower monthly rate but pay for Zone 1 and Zone 2 calls. That choice provides a significantly lower total bill for customers who are can minimize the amount of calling they do. A substantial increase in the cost per call will tend to drive customers from the affordable measured rate option to a higher-cost monthly service.

"Zone 3" describes calls that fall just outside of the "local" calling area (calls to a rate center between 13-16 miles away from the caller's rate center).

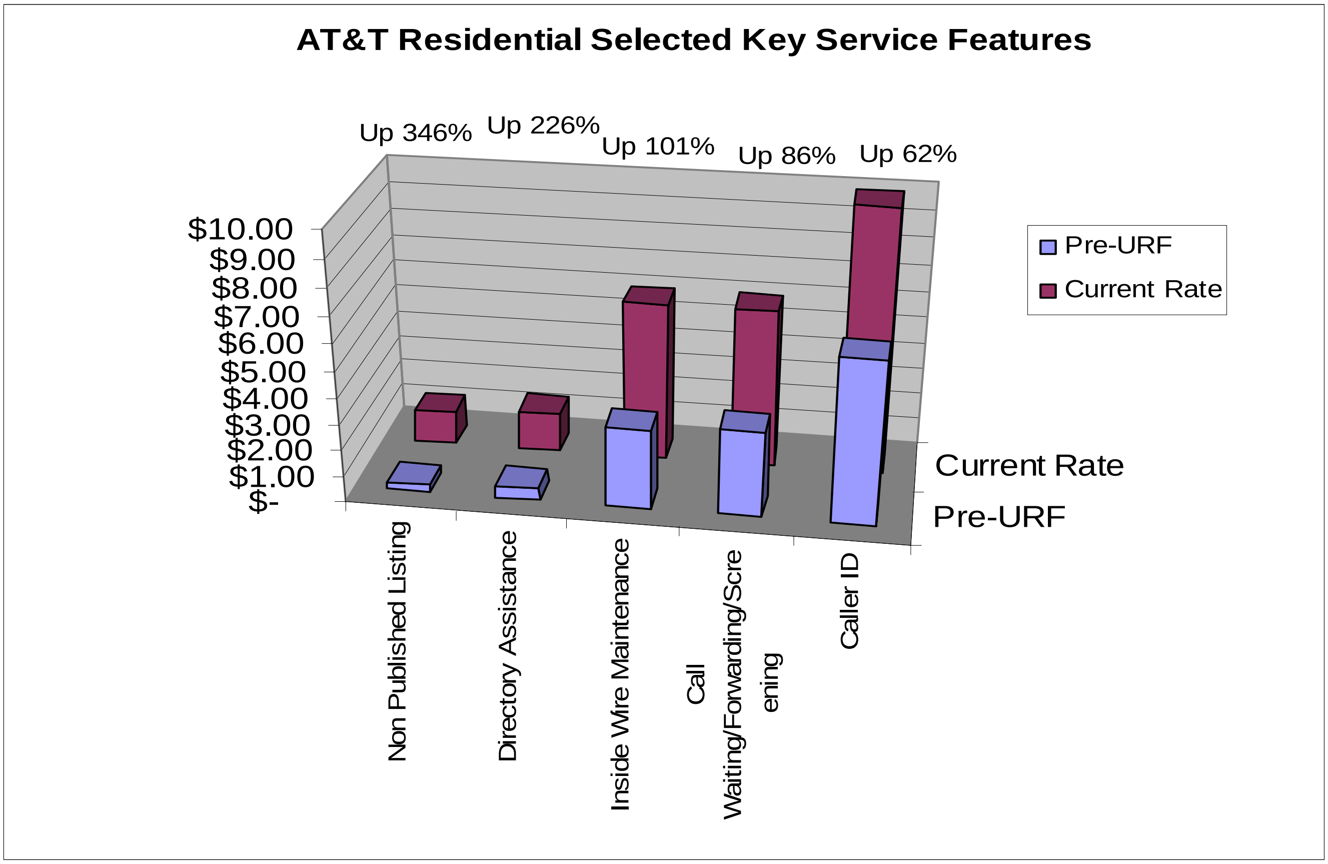
5 AT&T Advice Letter No. 32304, served March 28, 2008. AT&T's filing increased rates for most mileage zones, at most times of day and for all "additional minutes" of calling time. The increases are offset in some part by a small decrease to the initial minute rate for day and some evening calls.

6 AT&T's new rate structure for local calls will thus cause the most substantial rate shock to frugal customers who have been conditioned for decades to reduce costs by calling during late night and weekend hours.



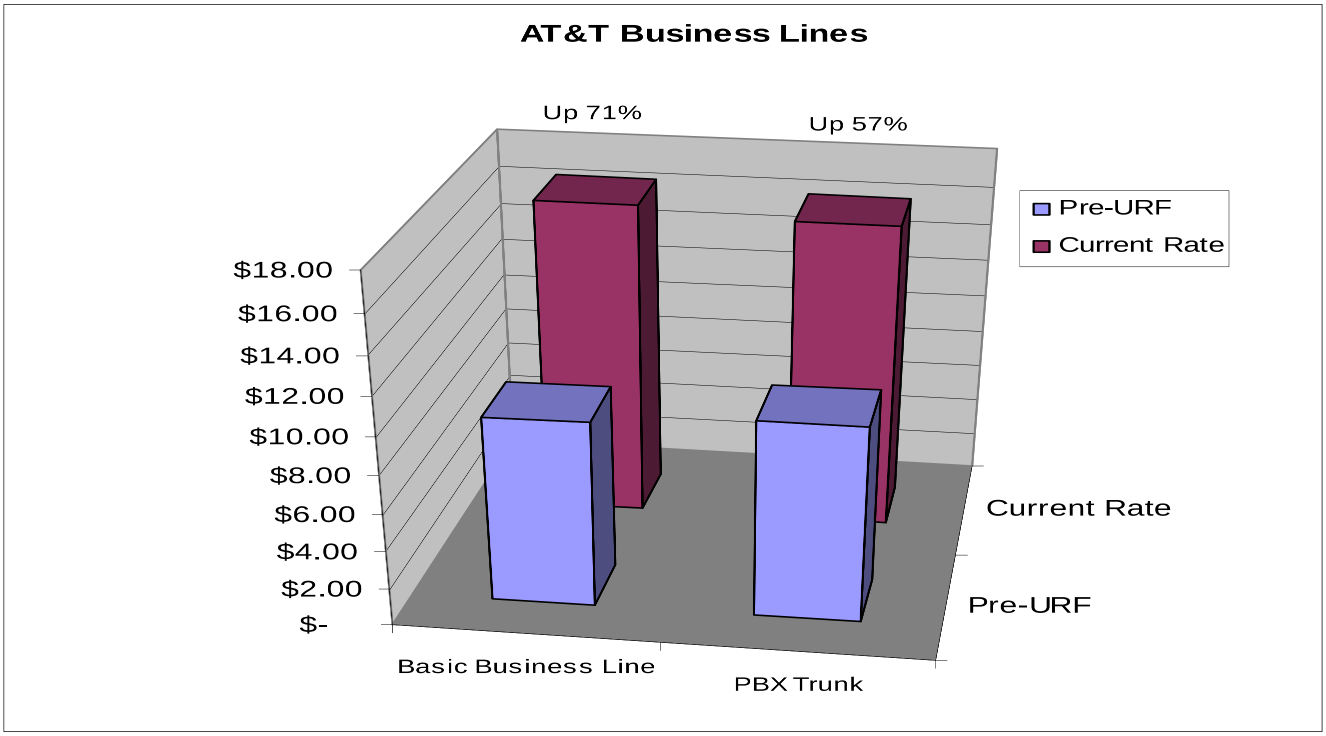
To provide just a few more examples, AT&T has also raised the price of inside wire maintenance 101%;[7] directory assistance 226%; call waiting and other vertical services 86%; non-published listing services 346%; and caller ID 62%.

[7] Prior to its URF decision the CPUC rightly stepped in to prevent further rate hikes for residential customers because of AT&T's rapid increases to the rate for this service. Overall, AT&T has increased the rate for this basic service option by 600% in recent years. DRA URF Reply Comments, 9/2/05, p. 68. See also, SBC Advice Letter (AL) 27179, effective 8/15/05.



In contrast to customers who subscribe to high-end bundles that include features like unlimited usage, broadband and/or wireless services, customers of basic phone service, who have relatively limited requirements or budgets, are more likely to purchase these separate features. AT&T's price increases for a range of these types of stand-alone services since the Commission's adoption of URF granted upward pricing flexibility are depicted in the graphs below. Overall, AT&T appears to have targeted large rate increases at the handful of basic services and features that its must vulnerable low usage and low income customers would depend on the most. Verizon, Frontier and SureWest have also implemented rate increases since the adoption of D. 06-08-030. Examples of these rate increases are depicted in the graphs above and at the end of this report.

After the Commission deregulated basic business rates, AT&T launched a program of massive rate increases for those services that smaller business customers are likely to depend on, including basic service itself. AT&T has increased its basic business line monthly rate by 71% and its rate for business PBX trunks by 57%.



Given that residential customers have even fewer competitive options for stand-alone basic service than small business customers, AT&T's increases for residential users may be even more extreme once the Commission removes the price caps for basic residential service.[8]

DRA believes that the recent rate increases have significantly affected affordability in California. Permitting any increase to the underlying basic service rates, without firm

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[8] DRA recognizes that in a separate docket the Commission may consider a adopting a proposed decision that would apply certain price controls for the URF ILECs' basic residential service in 2009 and 2010. On July 21, 2008, DRA filed comments on that proposed decision and opposes its adoption for the reasons set forth therein.

information regarding how rate increases will affect the affordability for those services, is not responsible regulation.

As also shown below, the other ILECs have shown a similar pattern of rate increases for services that are likely to be in demand by low usage and vulnerable customers. DRA believes these prices increases are intended to force residential customers into "sticky" and more expensive service bundles.

II. THE ILECS CONTINUED MARKET POWER IS ALREADY CAUSING ADVERSE CONSEQUENCES FOR CALIFORNIA CONSUMERS

In this Report, DRA documents price increases imposed over the last year and a half – especially by AT&T and Verizon – which indicate that the large ILECs still retain significant market power.[9] AT&T (and other ILECs) have dramatically increased rates for precisely those services that low usage and fixed and low income customers require, a pricing stratagem that indicates that the ILECs are not concerned about losing these customers to a competitor. Other data also indicates that the ILECs still retain significant market power in their service territories. For example, the large ILECs still provide service to the majority of California households. As of June, 2007, the most recent data available from the FCC, AT&T and Verizon continue to serve the vast majority of switched access lines in California – 8.2 million and 2.4 million residential lines, respectively, or about 85% of all residential lines.[10] The potential financial

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[9] Another indication is that, with the notable exception of SureWest and the SureWest service area, the ILECs are not making any significant effort to compete for basic residential wireline service customers outside of their traditional service areas. If basic residential service was viably competitive, the large incumbents would have entered each others service territories in order to compete amongst themselves.

[10] See Selected RBOC Local Telephone Data as of 6/30/07, Posted 04/08, and Local Telephone Competition (Report), 3/08 Release, as of 6/30/07, Tables 7 and 12. Table 12 shows that 58% of all ILECs and CLEC switched access lines are residential in California. Of a total of 21,383,910 ILEC and CLEC lines in California, 12,342,387 are attributable to residential lines. The RBOC Local Telephone

damages from abusive pricing of basic residential services or key ancillary custom calling features on the part of the ILECs would therefore be widespread and significantly damaging to the California economy.

Competition is not protecting low income and basic service customers, *i.e.*, those customers who either need or can afford only basic residential service. For decades, the Commission worked diligently to ensure that these particularly vulnerable customers had access to the telecommunications network. The results have been impressive. According to FCC analysis, the telephone penetration rates for low-income households in California increased from 82.9% in March 1984 to 87.7% in March 1997 and reached 93.2% in March 2007 (the latest available data).[11] Heretofore, California has been one of the most successful states in this key public policy objective.

Today that progress is very much at risk. California will almost certainly see a decline in our high level of network access if the Commission lifts the price controls on basic service rates before there is real and significant competition *for fixed and low income and/or low usage basic service customers*. The ILECs own behavior since URF was implemented provides strong evidence that such competition does not exist today, at least not in those specific markets. DRA believes the ILECs should have the ability to market and compete for customers seeking broadband and bundled services, but that customers should also have the ability to select an

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Data as of 6/30/07 shows that AT&T serves 8,175,246, or approximately 66%, and Verizon serves 2,375,527, or about 19% of total residential switched access lines.

[11] Telephone Penetration by Income by State (Data Through March 2007), Alexander Belinfante, Industry Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission, Released: March 2008, at Table 3, page 9.

affordable wireline service option, including affordable custom calling features on a stand-alone basis.

In URF the Commission removed pricing restraints for nearly every service rate (except measured and flat rate residential service) based on the finding that there is market-wide competition. Since URF, the ILECs and their competitors have introduced many promotion and deals for customers of broadband service and for customers interested in substantial bundles of service. That behavior suggests that at least some level of competition exists for broadband and bundled services.

Fixed income, low income and low usage wireline customers have not experienced the benefits of competition. In addition to incurring charges for local and "Zone 3" calling, some customers needing a limited number of additional stand-alone customer calling features have experienced rate increases. For example, parents with children may need the Call Waiting feature to ensure that their children can call home in case of an emergency. Someone who has received harassing calls may need Caller ID and/or a non-published listing. Customers may also need to use the phone occasionally for toll calls, but not enough to justify a plan with a monthly fixed rate. As shown below, the cost of all of these stand-alone, simple features that a customer might need have gone "through the roof". The magnitude of the increases demonstrates that the ILECs are not concerned about losing these customers to competition. Thus, fixed income and low income customers are already facing the choice of doing without their stand-alone features and making fewer calls or even doing without telephone service altogether.

That is just the opposite of what the Commission was promised when it was considering whether to uncap service rates. For example, Dr. Harris, AT&T's (then SBC) economic expert in the URF hearings stated:

> I'm firmly convinced that the stupidest thing SBC or Verizon could do was think, oh, we got some pricing flexibility now. Let's start jacking up local service rates.[12]

Accepting that testimony, the Commission must now conclude either that AT&T and Verizon are stupid, or that the ILEC economist's assessment of the competitive market for basic services was flawed. In either case, vulnerable basic local service customers are already suffering.

In the absence of competitive service alternatives, California's ILECs have been boosting stand-alone rates for many services rapidly and substantially. They are likely doing so because they want to lock those customers into more "sticky" service bundles as opposed to subscribing to stand-alone services[13] before competition actually arrives. The ILECs are also seeking to boost average revenue per customer, which is attractive to investors. For example, in its first quarter 2008 Investor*Briefing*, AT&T boasts that its average monthly revenues per consumer primary line have "ramped steadily over the past several quarters," from $57.08 in the first quarter of 2007 to $60.16 in the first quarter of 2008.[14] Basic residential service customers (and Lifeline customers) are a drag on that "progress." AT&T's stand-alone service rate increases are surely helping its goal of increasing subscribership of expensive (unregulated) bundles. They will encourage low profit-margin customers to either drop their service or to move into a service bundle to avoid the barrage of price increases to their stand-alone service options. Whatever the

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12 CPUC01-#220620-v1-R0504005_013006_Vol__2, at 364.

13 Customers with a bundle of services are far less likely to change service to a competitor hence a bundle is "stickier." Changing from a bundle is cumbersome for customers as it can involve significant research, time and effort by the customer.

14 AT&T InvestorBriefing 1Q 2008 (Briefing No. 260, April 22, 209), at 11.

motivation, it is plain that there are no regulatory or market obstacles for the ILECs to substantially increase the rates for vital basic services.

Based on the recent price increases by AT&T and Verizon, DRA predicts that they will increase basic residential service rates when the existing price controls expire. That will pose a serious threat to the Commission's successful public policy programs and to California's most vulnerable customers. And removal of the basic residential service price controls will provide the tool the ILECs needs to drive these customers into expensive bundles or potentially off of their networks.

III. TELEPHONE SERVICE PRICE INCREASES SINCE THE ADOPTION OF URF

Since the adoption of URF, ratepayers have faced sharp price increases for many services. Rate increases are most notable for AT&T. Since the new URF framework went into effect in August 2006, AT&T has dramatically raised rates for virtually all services that are likely to be of interest to low volume and income limited customer, as the following figures show:

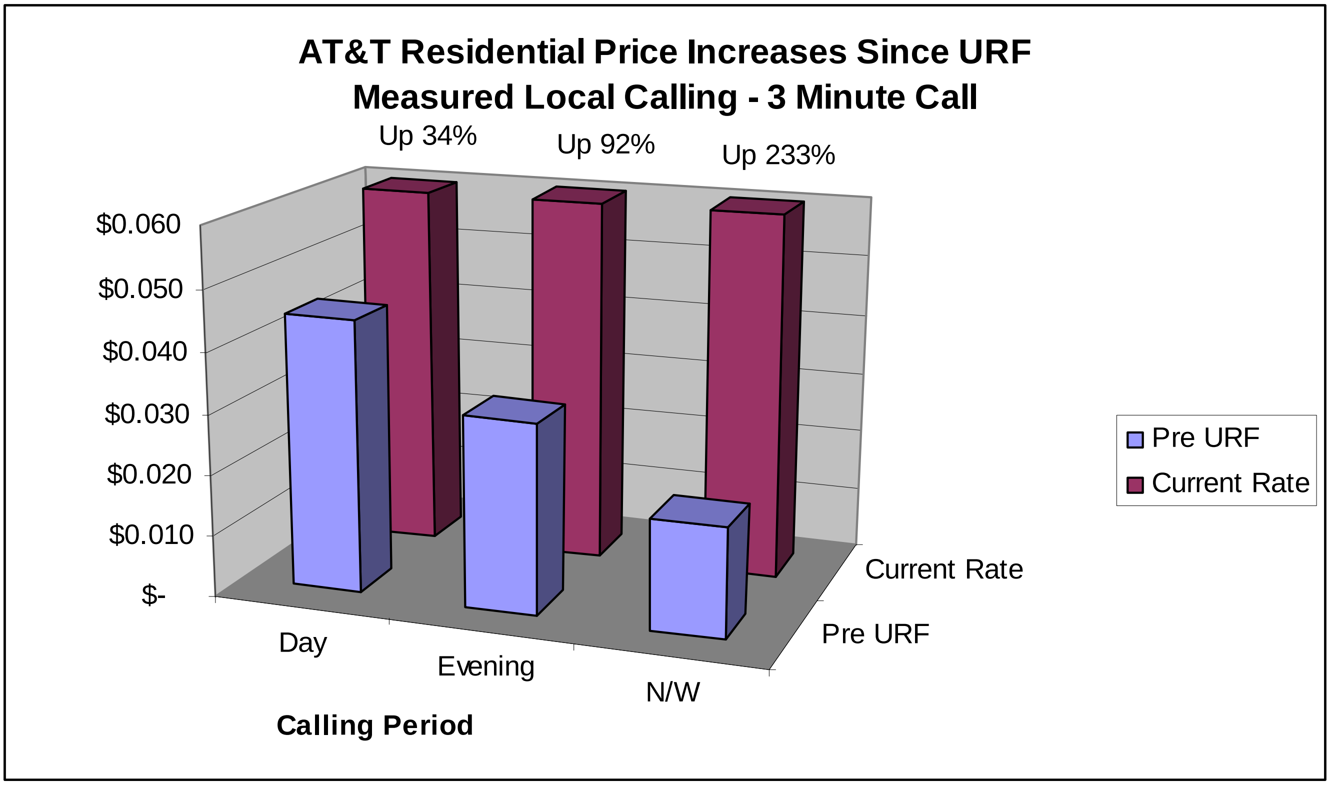
- Directory Assistance: 226%
- Returned Check Charge: 276%
- Residential Inside Wire (WirePro) Protection Plan: 101%
- Non-Published Listing Service: 346%
- Caller ID: 62%
- Call Waiting, Call Forwarding, Call Screening, 3-Way Calling: 86%
- Anonymous Call Rejection: 163%
- Local Calling: from 34% to 233% for a 3 minute call
- Zone 3 Calling: from 24% to 212% for a 3 minute call
- Local Toll: from 69% to 163% for a 3 minute call

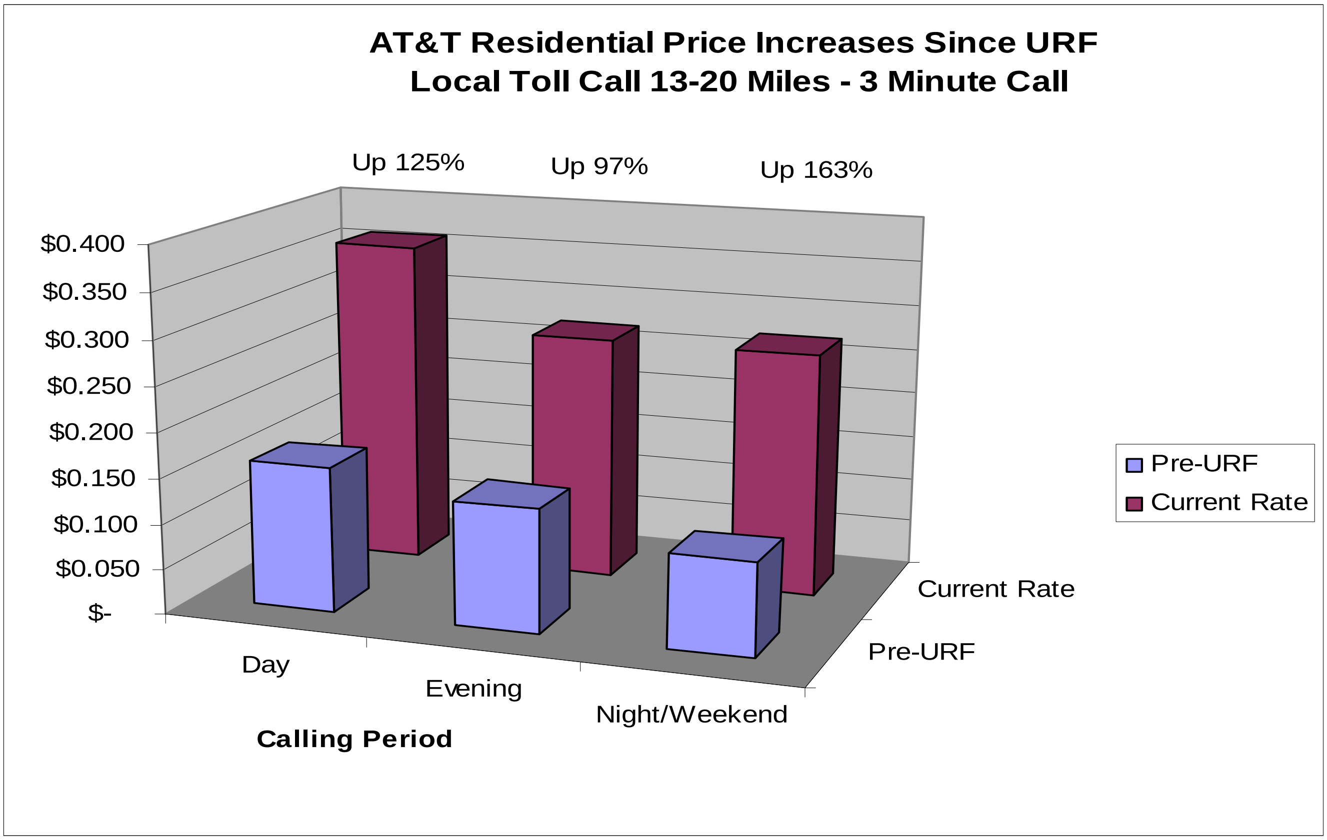
AT&T has also increased prices for vulnerable customers by adding a new $5.00 "Convenience Fee" for customers who utilize an AT&T employee to assist in making a payment.

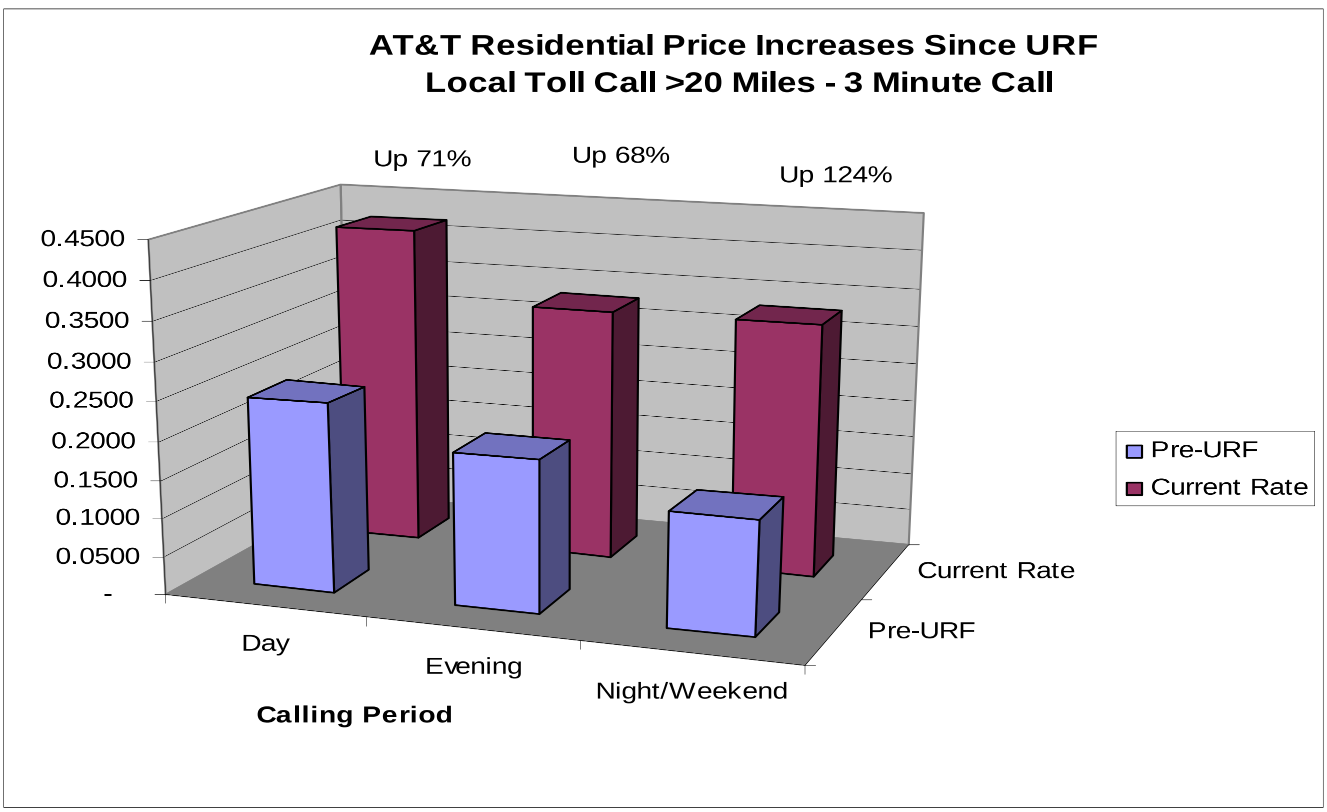
AT&T has also raised basic business service rates:

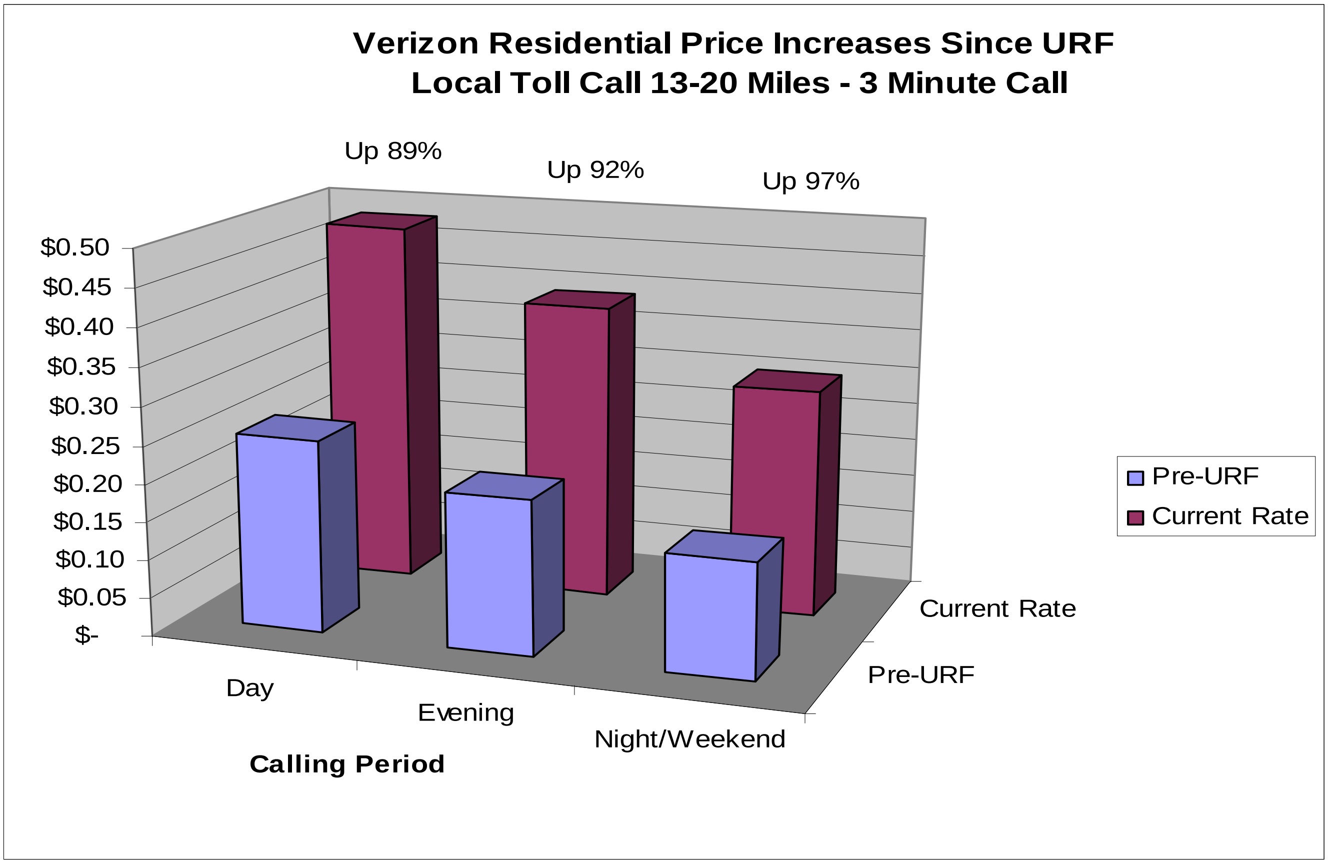
- Business Basic Exchange Service: 71%
- PBX Trunk: 57%
- Business Measured Rate Service local Usage 50%-139% for 3 minutes
- Business ZUM: 25% -77% for 3 minutes

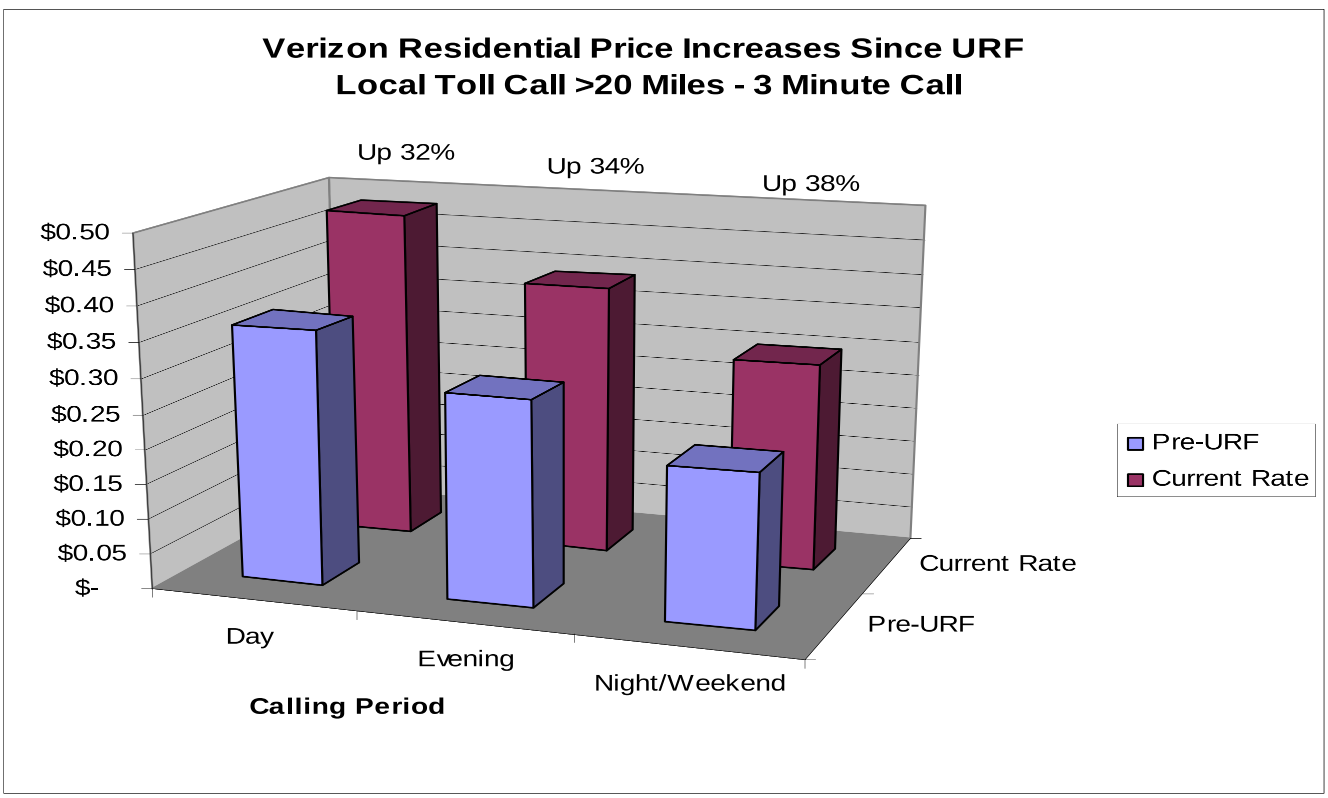
The magnitude of some of AT&T's and other ILEC's stand-alone service rate increases are depicted graphically below:

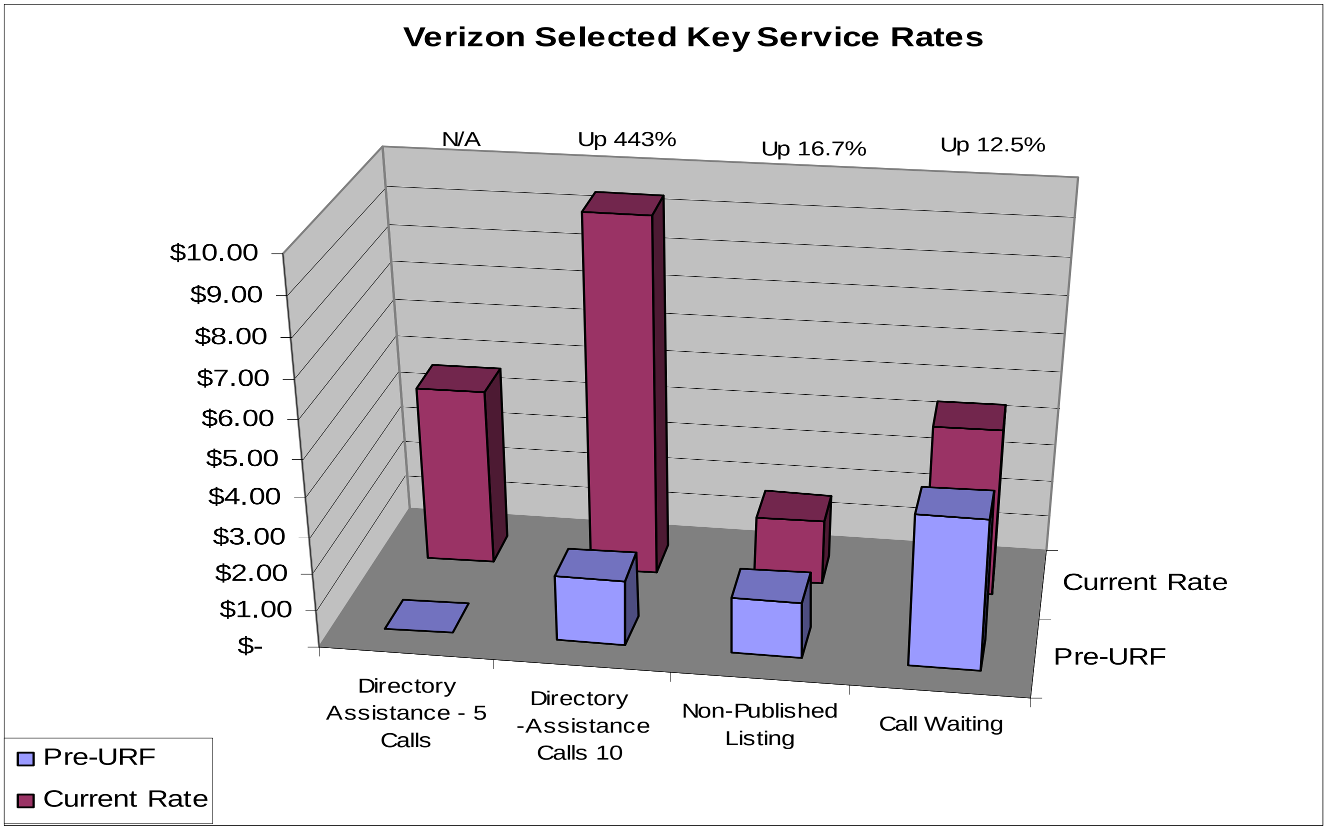


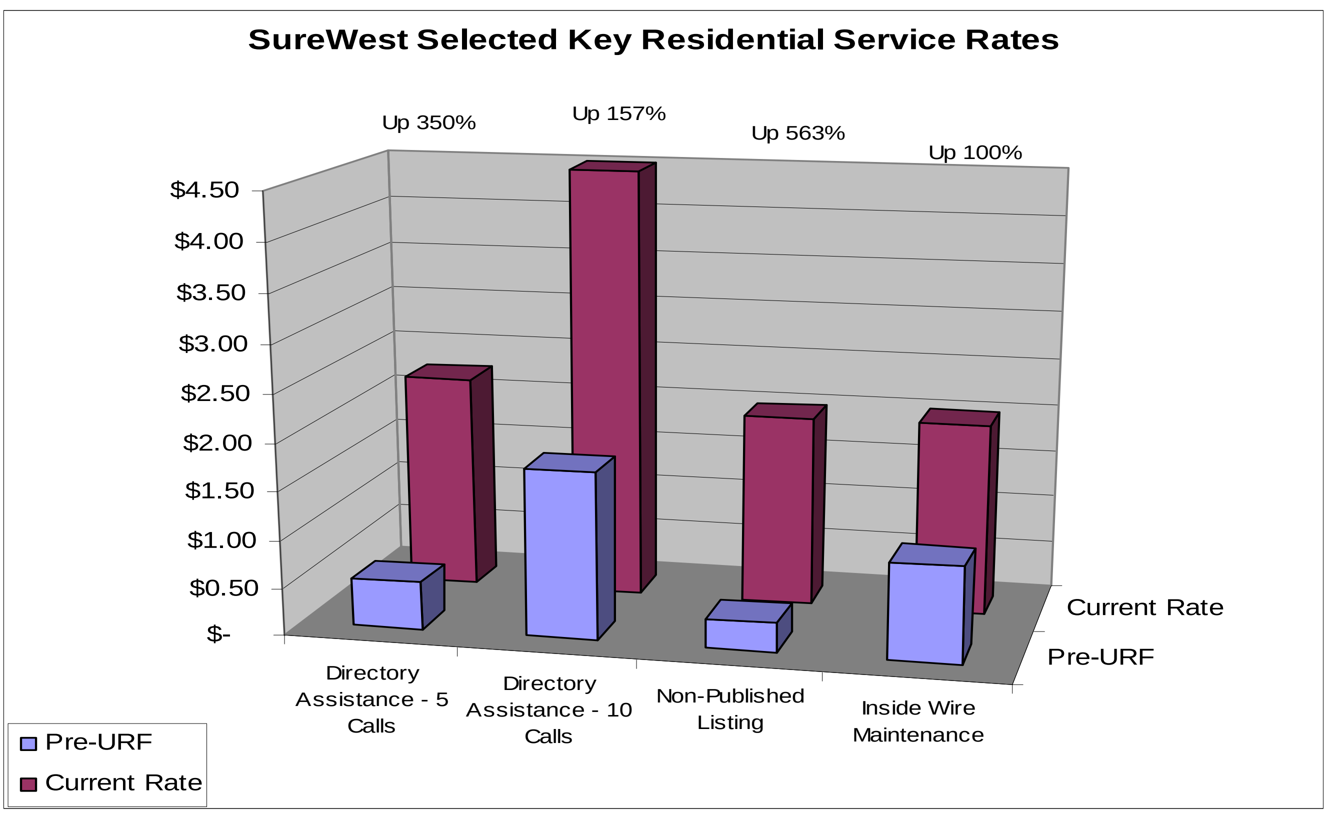

AT&T Residential Price Increases Since URF
Local Toll Call 13-20 Miles - 3 Minute Call
Up 125%
Up 97%
Up 163%
$0.400
$0.350
$0.300
$0.250
$0.200
$0.150
$0.100
$0.050
$-
Day
Evening
Night/Weekend
Calling Period
Current Rate
Pre-URF
Pre-URF
Current Rate

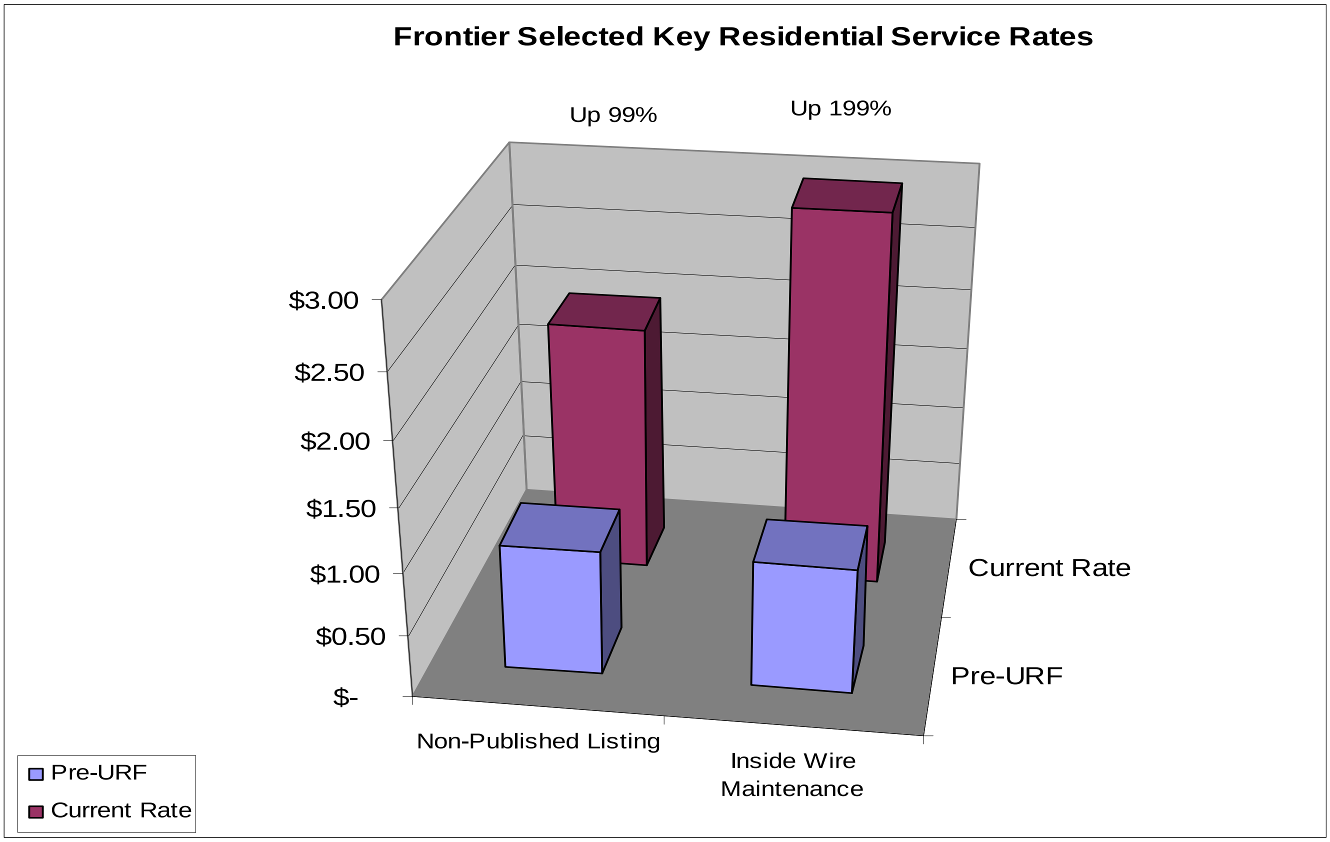

AT&T Residential Price Increases Since URF
Local Toll Call >20 Miles - 3 Minute Call
Up 71%
Up 68%
Up 124%
0.4500
0.4000
0.3500
0.3000
0.2500
0.2000
0.1500
0.1000
0.0500
-
Day
Evening
Night/Weekend
Calling Period
Current Rate
Pre-URF
Pre-URF
Current Rate


Verizon Residential Price Increases Since URF
Local Toll Call 13-20 Miles - 3 Minute Call
Up 89%
Up 92%
Up 97%
$0.50
$0.45
$0.40
$0.35
$0.30
$0.25
$0.20
$0.15
$0.10
$0.05
$-
Day
Evening
Night/Weekend
Calling Period
Current Rate
Pre-URF
Pre-URF
Current Rate


Verizon Residential Price Increases Since URF
Local Toll Call >20 Miles - 3 Minute Call
Up 32%
Up 34%
Up 38%
$0.50
$0.45
$0.40
$0.35
$0.30
$0.25
$0.20
$0.15
$0.10
$0.05
$-
Day
Evening
Night/Weekend
Calling Period
Current Rate
Pre-URF
Pre-URF
Current Rate


Verizon Selected Key Service Rates
N/A
Up 443%
Up 16.7%
Up 12.5%
$10.00
$9.00
$8.00
$7.00
$6.00
$5.00
$4.00
$3.00
$2.00
$1.00
$-
Current Rate
Pre-URF
Directory Assistance - 5 Calls
Directory -Assistance Calls 10
Non-Published Listing
Call Waiting
Pre-URF
Current Rate


SureWest Selected Key Residential Service Rates
Up 350%
Up 157%
Up 563%
Up 100%
$4.50
$4.00
$3.50
$3.00
$2.50
$2.00
$1.50
$1.00
$0.50
$-
Current Rate
Pre-URF
Directory Assistance - 5 Calls
Directory Assistance - 10 Calls
Non-Published Listing
Inside Wire Maintenance
Pre-URF
Current Rate



As discussed above, these price increases indicate that the ILECs still possess significant market power in the voice services markets in which they operate. Basic residential service has historically been the least elastic of the ILECs' services; i.e., customers are least likely to change their basic wireline service in response to a price increase. DRA maintains that this is because basic service is still a public convenience and necessity like electricity or water. Vertical services (or custom calling features), such as call waiting and call forwarding, are somewhat more discretionary services, and are a little more elastic; meaning the demand for them is more responsive to price changes, since customers can drop them if they become too expensive without losing basic services.[15]

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15 Also, as explained above, any given feature can be essential to a particular customer depending on that customer's individual situation.

In contrast, basic residential service is considered to be essential to most customers and its demand is less responsive to price increases when the ILECs raise basic residential service rates. Therefore, the ILECs' grip on local basic residential service is likely to be even stronger than on the ancillary services for which the ILECs have already raised their prices.[16] For this reason, the ILECs would be expected to be even less concerned about raising rates on basic residential service than on non-basic services. In the absence of price controls that maintain affordability, the increases the ILECs are likely to implement for basic residential service may well be as significant as those that they have already made on ancillary and vertical services.

The rate increases that AT&T has already implemented for its business single line service may provide some indication of the initial increases in store for basic residential service. Indeed, before the Commission issued its Phase I URF decision, AT&T had started a series of increases to stand-alone business services that parallels the changes to residential service rates DRA has documented above.[17] At the time, DRA predicted that those increases to rates for less elastic business services, the services that low usage businesses would most likely rely on, were an indication that AT&T would also increase basic exchange business service if allowed to do so.[18] DRA's parallel prediction relative to business services was correct. As shown above, AT&T raised business line access rates by approximately 71% and raised its local measured usage rates by a range of 50% (daytime rates) to 139% (night/weekend rates) based upon a three-minute call. Verizon has raised its business local usage rates by a corresponding range of 17% to 67%.

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16 AT&T and Verizon have both recently raised their residential basic service rates to account for inflation, as allowed by DIVCA (The Digital Infrastructure and Video Competition Act of 2006, Public Utilities Code Section 5800 et seq.). The increase was approximately 2.4%.

17 DRA URF Reply Comments, 9/2/05, at 70-72.

18 *Ibid.*

This is strong evidence of the ILECs continuing market power in the wireline market, and a clear indication that inter-modal competition is not present.

IV. CONCLUSION – MARKET FORCES HAVE BEEN INSUFFICIENT TO CONTROL PRICE INCREASES

The large magnitude of the rate increases reported above raises concerns that the ILECs continue to possess significant market power, and that their pricing power is not sufficiently constrained by competition to prevent them from significantly raising prices. The price increases that have occurred since the adoption of URF may reflect unintended consequences; and the most financially damaging of these consequences is yet to come. When the price controls on basic residential services are lifted on January 1, 2009, market forces alone will be ineffective in preventing the ILECs from significantly raising their rates for basic residential services potentially well above affordability levels.

Given the established trends demonstrated above, DRA is especially concerned that basic residential rates will increase significantly after January 1, 2009. There is no indication of any change in the near future regarding the current state of competition. Market forces have not yet met the challenge of controlling price increases. For these reasons, it is necessary to maintain current rates until the Commission completes an affordability study for basic residential service. It is also prudent to consider adoption of price controls for certain vertical services on a stand-alone basis.