STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service
Commission held in the City of
New York on June 18, 2003

COMMISSIONERS PRESENT:

William M. Flynn, Chairman
Thomas J. Dunleavy
James D. Bennett
Leonard A. Weiss
Neal N. Galvin

CASE 03-C-0971 - Proceeding on Motion of the Commission to Consider the Adequacy of Verizon New York Inc.'s Retail Service Quality Processes and Programs.

CASE 00-C-1945 - Proceeding on Motion of the Commission to Consider Cost Recovery by Verizon New York Inc. (fka New York Telephone Company) and Modification of Performance Regulatory Plan under Merger Standards and to Investigate the Future Regulatory Framework.

ORDER INITIATING VERIZON NEW YORK SERVICE QUALITY PROCEEDING

(Issued and Effective July 11, 2003)

BY THE COMMISSION:

INTRODUCTION

The terms of the Verizon Incentive Plan were adopted in large measure based on Verizon New York Inc.'s (Verizon or the company) commitment to maintain retail service quality at specified levels.[1] Unfortunately, service quality has been below such levels. Although we continue to believe that the Verizon Incentive Plan will keep the company focused on maintaining quality service, its service improvement plans raise concerns regarding, among other things, the adequacy of the company's long term-service improvement plans and pockets of chronic, poor performance. Accordingly, we conclude that additional Commission action is necessary. We therefore initiate a Service Quality Proceeding, including an independent audit, to evaluate the adequacy of the company's long-term, state-wide service quality efforts. In addition, we will require that the Verizon Service Inquiry Reports be filed with the Commission Secretary rather than submitted solely to Department of Public Service staff (staff), and that copies be provided to all parties requesting them. Finally, we will direct the company to file, within 20 days of this order, a corrective action plan designed to achieve all five incentive plan objectives for Plan Year 2.

BACKGROUND

The Commission sets standards for the quality of telephone services for all carriers. These service standards were last revised in 2000 to increase the focus on the quality

[1] Cases 00-C-1945 and 98-C-1357, Order Instituting Verizon Incentive Plan (issued February 27, 2002), p. 1.

of basic telephone services.[2] Verizon was also directed to improve its performance for Special Services – services used predominantly by businesses which must be separately designed and engineered – relative to Commission guidelines in 2001.[3] Telephone companies, including Verizon, are enjoined to provide services which meet or exceed those standards and guidelines.

Verizon is also operating under an incentive regulatory plan agreed to and accepted by the company – known as the Verizon Incentive Plan (VIP, or the Plan) – that began March 1, 2002 and expires in part on February 29, 2004.[4] It contains a three-year Retail Service Quality Plan that expires on February 28, 2005.

The VIP establishes a specific penalty structure of customer credits that is tied to five objectives as well as to pricing flexibility. Missing objectives, regardless of the degree of miss, requires the following credits be given to customers or that other action be taken:

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[2] The primary criteria for measuring telephone service quality are the Telephone Service Standards, which were adopted by the Commission in 1973 (Opinion No. 73-40, Case 26158) and revised in 1989, 1991, and 2000. The Service Standards appear as Part 603 of 16 NYCRR and require measurement of service quality in four separate categories: 1) Maintenance Service, 2) Installation Service, 3) Network Performance, and 4) Answer Time Performance. Staff receives monthly reports of service measurements in these categories that are analyzed to evaluate the level of service quality delivered to consumers.

[3] Opinion No. 01-1 (issued June 15, 2001).

[4] Cases 00-C-1945 and 98-C-1357, Order Instituting Verizon Incentive Plan (issued February 27, 2002).

- Miss 1 annual objective - $15 million
- Miss 2 annual objectives - $40 million
- Miss 3 or more annual objectives - $100 million, plus $35 million for each objective missed above 3
- Miss 2 objectives based on a quarterly review of the previous 12 months - Prospective Pricing Flexibility is suspended (and was suspended as of May 31, 2003)

For the twelve months ended May 31, 2003, Verizon failed to meet the Out-of-Service and Outlier targets of the VIP. Thus, under the express terms of the VIP, Verizon's pricing flexibility is suspended.[5]

On April 22, 2003, Chairman Flynn wrote to the Chief Executive Officer of Verizon Communications, expressing concern over the company's service performance, noting workforce reductions and construction budget expenditure reductions, and requesting action by the company. On May 7, 2003, the company presented its expectations for improving Plan Year 2 performance under the VIP.

The company expects to meet the four VIP objectives for Troubles, Installation, Complaints, and Outliers. It expects that meeting the Out-of-Service objective of 20% or less will remain a challenge, and projects performance in the "low 20%" range. In other words, its expectations are to perform in a range similar to Plan Year 1 wherein it missed one of the five

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[5] Cases 00-C-1945 and 98-C-1357, Order Instituting Verizon Incentive Plan (issued February 27, 2002); Appendix A, Joint Proposal Concerning Verizon Incentive Plan, "If Verizon fails two Performance Objectives at the end of any Review Period, the following applies: Prospective pricing flexibility as provided in the Plan is suspended," (p. 8).

objectives, Out-of-Service, and paid a rebate of $15 million to affected customers.

Verizon's current plans include expenditures on jobs specifically identified to improve service, expenditures to reduce workload through proactive cable maintenance and rehabilitation, additional training, increased management focus on productivity and the use of global positioning equipment to better utilize its outside plant workforce. Verizon also assigned additional people to deal with complaints to the Public Service Commission (PSC) and expects to reduce the number of consumers contacting the PSC by timely resolving customer problems.

Staff's 2003 first calendar quarter service quality report to the Commission for Verizon expressed serious concern that the company's efforts may be insufficient to achieve all five of the VIP service quality objectives. Those concerns have been confirmed by the company's stated expectation that it will not achieve all five VIP objectives in Plan Year 2 and are exacerbated by the significant planned reduction in construction expenditures and a further reduction in workforce planned for this year. It appears that productivity improvements are to be the primary focus of the company's overall efforts because other typical means of achieving improvements are being reduced (e.g., construction expenditures). Increased productivity is a necessary and laudable goal that management and the workforce should continually strive for, especially in view of increasing market pressures. However, it is questionable whether productivity improvements alone will be sufficient to bring the company's service quality performance to the level expected generally, and that required by the VIP specifically.

Recently, other parties have expressed concern about the company's performance, including the Communications Workers of America and the Assembly Standing Committee on Corporations, Authorities and Commissions (the Standing Committee).[6] When the Commission approved the VIP in February 2002, we stated:

> With respect to retail service quality, the significant improvement since 1995 (when the current PRP went into effect), together with the positive impact of competitive pressures on service quality, warrant a new approach, directed less to bringing service up to predetermined targets and more to maintaining quality at the new, higher levels. The Service Quality Plan permits Verizon to freely compete and invest while protecting consumers from serious erosion in telephone service quality. With rebates that may be paid to customers if service quality falls, and performance objectives crafted to discourage pockets of poor performance, backed by Verizon's risk that pricing flexibility will be suspended if service

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[6] The Standing Committee recently issued a report on Verizon performance entitled Interim Report - Verizon Service Quality in New York State (May 7, 2003). In its interim report, the standing committee raises a number of issues, but the primary ones in our view call into question: (1) the use of annual statewide average performance objectives that allow for monthly variations throughout the year, (2) whether or not there are adequate protections against pockets of poor performance, and (3) whether or not the penalty structure should be modified to increase penalties overall and apply them on a graduated basis (i.e., the greater the extent an objective is missed, the greater the penalty).

> quality declines significantly and a process for monitoring performance, service quality protections afforded by the Plan are effective.[7]

We believe our overall findings on service quality as stated above are still valid today. Of the five service objectives in the VIP, four – Troubles, Out-of-Service, Installation, and Complaints -- are statewide averages, while the fifth – Outliers -- is not. Outliers is a count of the number of poor performing areas within specific geographic areas of the state in a given plan year.

Annual averages are used instead of monthly or quarterly averages because there are normal variations by season in service quality results. Monthly targets would not necessarily allow for unusual weather events such as ice storms, peak demand periods, and the like. Monthly or quarterly objectives would also produce requests for allowances or waivers for unusual events; or in the alternative, the objectives would have to be set in such a way as to recognize such potential events. The annual objectives of the VIP do not envision waivers for most such events. Thus, Verizon must meet the VIP objective or pay rebates to its affected customers. Statewide service quality targets also dovetail with the VIP's statewide pricing flexibility provisions. By linking service quality to pricing flexibility the VIP provides added assurance that the dominant carrier, Verizon, would maintain its service quality statewide.

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[7] Cases 00-C-1945 and 98-C-1357, Order Instituting Verizon Incentive Plan (issued February 27, 2002), p. 34.

Moreover, the VIP recognizes that statewide averages might obscure poor performance on a more localized basis. Hence, it contains the Outlier objective. This objective is designed to identify all such poor performance, and establishes a statewide limit on their number. Outliers are directly tied to the number of Service Inquiry Reports (SIRs)[8] that must be filed with staff pursuant to the Commission's Service Standards, Part 603 of NYCRR Title 16. All 10 metrics of the Service Standards are embodied in the Outlier objective, and these metrics are measured at a very localized level. For example, Customer Trouble Report Rate (CTRR) is measured in 543 individual central offices across the state, and Percent Out-of-Service Troubles Lasting Over 24 Hours is measured in 35 repair service bureaus. Thus, the Outlier measure protects against pockets of inadequate service performance.

The service performance objectives of the VIP have significant overlap or interrelationships. The Complaint objective is broad-based and subsumes all other objectives. The Outlier objective is also broad-based, but focuses on very localized service entities. Thus, if Verizon felt it was unable to achieve the Out-of-Service objective, the Complaint and Outlier objectives continue to provide incentives for the company to focus on its out-of-service performance.

[8] In general, an SIR identifies the reasons for poor performance, the steps necessary to improve performance, and when service will return to the expected level of performance for that metric (e.g., CTRR) and measurement entity (e.g., central office) as defined in the Service Standards. It must be filed whenever performance is outside of the acceptable range for three out of five months (including the current month) for most metrics.

Considering the interrelationship among the service objectives and the penalty structure of up to $170 million in customer rebates, we believe the VIP provides powerful incentives for the company to provide good service quality. The company's service performance early in the Performance Regulatory Plan (PRP) deteriorated, but after paying penalties of approximately $70 million it began a long improvement trend. Thus, experience indicates that penalty avoidance can produce good service results, and potential rebates under the VIP are larger than under the PRP. Moreover, competitive pressures from wireless, cable and the Internet are greater today than during the PRP.

DISCUSSION

For the reasons discussed above, we are convinced that the VIP remains effective and provides appropriate incentives. The specific thresholds it established, based on our Service Standards using both annual and monthly measures, subject to verification by independent auditors, and comprising both statewide average performance, local community performance and customer complaints, are well conceived.

Verizon’s current plans include service improvement projects, proactive cable maintenance and rehabilitation, improved productivity through more training, increased management focus on productivity, and use of global positioning equipment to better utilize its outside plant workforce. It has also assigned additional people to resolve PSC complaints. Nevertheless, we remain concerned about the effectiveness of the company’s service quality programs, processes, and resource allocations based on our review of the company’s performance with respect to the service standards generally, the company’s performance to date in Plan Year 2 of the VIP specifically, workforce reductions in 2002 and further reductions planned for 2003, and a significant reduction in planned investments in the network, particularly with regard to service improvement investments.

Verizon expects that meeting the Out-of-Service objective of 20% or less will remain a challenge, and projects performance in the "low 20%" range for VIP Plan Year 2. Stated another way, Verizon plans to meet only four of the five service objectives, and to pay an additional $15 million in consumer credits in 2004. The company's goal is inconsistent with our expectation for performance under the VIP, which was that the company was starting from a point of improved service and would maintain those levels. Accordingly, the company will be directed to file within 20 days of the date of this order, a corrective action plan which envisions achievement of all five VIP service goals in Plan Year 2 of the VIP Retail Service Quality Plan.

We are also troubled that Verizon is not doing enough to correct problems in areas that are experiencing chronically poor service. Our Service Standards require Verizon to file an SIR each time it fails a service standard on a local or regional basis for three of the last five months. A number of entities have experienced multiple or repeated SIRs. These reports, normally filed with staff, will now be filed by Verizon directly with the Commission in the new service quality proceeding that we are initiating, and sent to any party who requests them. This heightened scrutiny will help us to determine whether Verizon's corrective action plans will prevent chronic, poor service performance on a localized level.

Given the overall decline in service performance, the existence of pockets of persistent poor service, the company's significant reductions in budgeted expenditures related to service improvement and its reliance on productivity reflected in its improvement plans, we will initiate a comprehensive service quality proceeding to review Verizon's retail service quality, including Special Services. That investigation will aid us in evaluating Verizon's long-term approach to service quality, and in our continuous efforts to assure that Verizon meets its long-term service quality obligations. The new service quality proceeding will include an independent audit conducted pursuant to Section 96 of the Public Service Law, paid for by Verizon and performed by an acceptable outside auditor under the direction of and managed by the staff of the Department. The audit should include, but not be limited to, areas of the company's management and operations such as the amount of network investment and resources dedicated to improving service quality and the mix of these resources, the adequacy of company records to locate and correct deficient equipment in a quick and efficient manner, available workforce, expected workload, and worker productivity.

It is critical for the long term, that we be satisfied that Verizon is doing all that is necessary in terms of investment, management practices and workforce to ensure acceptable service quality is maintained. That includes understanding how Verizon New York's productivity compares to other telephone companies across the nation and identifying management practices that could improve the environment for labor productivity. Our analysis of service results shows that Verizon's performance failures under the VIP involve productivity-related measurements associated with the timeliness of responding to consumer concerns about repairs and installations. Company data indicates that productivity in some areas of New York is below the productivity of other states in the Verizon footprint as measured by the number of trouble reports or service installations completed per employee per day. We also note that productivity improvements appear to be the primary focus of the company's overall efforts as other means of achieving improvements, such as increasing expenditures and staffing, are being reduced. The audit will examine the adequacy and effectiveness of the workforce and the management of it.

The service quality proceeding we are initiating, including the related service quality audit, will help ensure that Verizon's long-term performance better meets the needs of New Yorkers throughout the State.

The Commission orders:

1. Verizon New York Inc. is directed to file revised tariff leaves by July 25, 2003, effective on 30 days notice, reflecting the suspension of upward pricing flexibility for all products and services as of May 31, 2003, until restored pursuant to the terms of the February 27, 2002 Order Instituting Verizon Incentive Plan.

2. Publication requirements of Section 92(2) of the Public Service Law are waived.

3. Within 20 days from the date of this Order, the company is directed to file with the Secretary to the Commission, five copies of a corrective action plan designed to achieve all five service goals in Plan Year 2 of the Verizon Incentive Plan Retail Service Quality Plan. The Plan shall also be served on all parties to these proceedings.

4. The company is directed to file three copies of all Service Inquiry Reports directly with the Secretary to the Commission and to serve them on all parties to these proceedings who request them. Parties wishing copies should notify the Secretary to the Commission, by July 21, 2003. Thereafter a

list will be compiled and posted on the Commission's website for the company's use.

5. A Service Quality proceeding as described in this Order is instituted to evaluate the company's programs, processes and resource allocations associated with its retail service quality performance.

6. Pursuant to Section 96(6) of the Public Service Law, an independent audit of Verizon New York Inc. shall be conducted in accordance with the discussion in this Order.

7. These proceedings are continued.

By the Commission,

(SIGNED)

JANET HAND DEIXLER
Secretary