the concept of keeping directory services deregulated while maintaining the contribution to keep basic rates affordable. In the business environment, although the number of competitors and directories have both increased, Pacific Bell Directory still maintains a dominant position in the state. (An example of this dominance is the fact that in 1993, Pacific Bell Directory distributed more than twice as many books than all other competitors in California combined.)[2] While constant, the environment is not necessarily static for any publisher because there exists in the California market several major publishers not associated with local exchange companies as well as many other publishers that have niche markets. All publishers are trying to expand their market share although attempts so far have not dislodged Pacific Bell Directory from its dominant position.

Possible future directory services.

The near future for directory services is expected to be dramatically impacted by technology and market changes. Instead of the familiar printed directories, there is activity in providing listings through CD-ROM disks and on-line access through modems. As electronic provision of service increases, the traditional form of printed directories may become less and less important. One main concern to ratepayers is whether the contribution that has been used to keep basic rates affordable will be continued in the future.

RELATED ISSUES

Rates for advertising - 10 largest markets

Rates for directory advertising for a Double Half Column (DHC) size ad in the 10 largest markets in California are shown in Appendix D for the years 1980 through 1993.

Pacific Bell's rates for advertising since 1980 were analyzed. The most popular ad size was studied in the ten largest markets. This ad size is called a DHC which is an ad two columns wide by half a column high. (Since each page in the directory has five columns, a DHC ad is just a little smaller than a quarter of the page.) As can be seen by the table in Appendix D, rates for directory advertising have increased at a faster pace than inflation.

---

[2] Data response of Pacific Bell dated February 25, 1994, in response to data request YP-002.LW.

The rates for a DHC ad have increased over 250% on average between 1981 and 1993 for the largest 10 market areas. (Among the separate market areas, the range of increases is from 210% to 308%.) The Consumer Price Index (Urban) estimates the inflation rate between 1982 and 1993 at 160%.[3] Therefore, while the growth rate for inflation is 4.04% and the growth rate for a DHC is 8.04%, over the course of 12 years the difference is greater than 90 basis points.

Since directory advertising revenue more than covers its cost, this increase in the advertising rates is not cost driven. The increase in rates suggests the market strength of Pacific Bell Directory.

Legislative hearings

On October 17, 1988, the California Legislature assembly held an informational hearing on competition in the yellow pages business. The main concern with regard to this issue for the California Public Utilities Commission (CPUC) was the amount from the directory activities that are imputed to help keep basic monthly rates affordable. Staff of the CPUC explained that this subsidy is substantial--about three dollars per access line per month. Staff also stated that the method of pricing is at the market rate and the margin, roughly 50%, is used to keep monthly rates low.[3] Much concern was expressed that the CPUC was not actively reviewing the accuracy of directory revenues. The chairperson was skeptical of the monitoring process which is used to review the amount imputed from directory activities. Staff provided a letter to reassure the chairperson about the monitoring process.

During the hearings, the Assembly heard from other directory providers and businesses that advertise. The chairperson expressed concern over the confusion that existed due to the proliferation of directories.

One speaker presented a small business viewpoint on the issue of numerous directories in an area. He stated that prior to deregulation "[t]he telephone directory was a reference book... [t]o find the goods and services needed in that community -- kin of like a dictionary. If you wanted to spell a word and the dictionary were published by 880 different publishers, some of them not complete, it wouldn't be a very good situation."[4]

---

[3]DRI/McGraw-Hill U.S. Review, April 1991, Page 89.

[4]Report on the Informational Hearing of the Assembly Committee Utilities and Commerce -- Competition in the Yellow Pages Business: Consequences for Advertisers and Readers, Page 11.

Revenue amount imputed over the years

As mentioned above, the revenues and expenses of directory advertising are included above-the-line. Above-the-line treatment means that the revenues and expenses are considered part of the regulated company. Conversely, below-the-line treatment means that the revenues and expenses are considered unregulated.

An Opinion issued on August 11, 1982 by Judge Greene states that directory services earn "supra-competitive profits". That same Opinion cites a filing from California estimating the Yellow Pages subsidy at two dollars per line per month.

During the above mentioned hearing before the California Legislature, the CPUC staff estimated that the subsidy from Yellow Pages is "about three dollars per access line per month". The staff also stated that the "margin between the revenues and expenses is so great that the expense level is about fifty percent of the total revenue, so the net is the other fifty percent of the total revenue: three to four hundred million dollars" per year.

Whether the actual amount of the subsidy is closer to two dollars per line per month or three dollars per line per month needs not to be discussed here. What is important to recognize is that the amount is substantial.

Number of communities served and the number of books delivered

Appendix E lists both the number of communities served (called directory areas) and the number of books delivered by Pacific Bell Directory throughout the state. As a note, the number of books include the actual number of volumes delivered (i.e. for San Francisco, there were three volumes deliverd, White Pages, Yellow Pages A-L, and Yellow Pages M-Z .

MFJ history

The Modification of Final Judgement discussed the placement of Yellow Pages and presented arguments on its inclusion with the local exchange companies. A brief summary of those comments is presented here.

In an Opinion issued by Judge Harold Greene on July 26, 1984, it states the reasons for the placement of Yellow Pages into

the Operating Companies. Page 7 of the Opinion states that "the Court rejected two of [the] restrictions" listed in the proposed decree. The two restrictions that were rejected by the Court are the marketing of Customer Premise Equipment and the publication of the Yellow Pages by the Operating Companies. The Court explained its reasoning on page 17 of the Opinion stating that: "this was being done to ensure the viability of the local companies and to reduce upward pressures on local telephone rates".

On page 39 of that Opinion, Judge Greene discusses the requirement that AT&T turn over the Yellow pages operations to the Operating Companies. [Footnote 77 lists four reasons why waiver requests are different than line of business restrictions (one of which is Yellow Pages).] The first reason is that the impact of the publication of Yellow Pages and the marketing of CPE would have is much more limited than the waiver requests especially if the requests are "merely the beginning of a massive diversification program." Second, Yellow Pages and CPE "have been traditionally associated with the telecommunications business". Third, the "capital, personnel , and other resources" needed for Yellow Pages and CPE are "minimal and finite" as opposed to the waiver requests which "are not similarly limited; what is contemplated is broad-scale diversification". Fourth, "because AT&T would continue to be the most formidable provider of CPE for a considerable period of time", the Operating Companies were the "most likely entity to provide an effective counterbalance". In contrast, the waiver requests sought relief to enter markets that "are already competitive".

The July 26, 1984 Opinion cites the August 11, 1982 Opinion in which the Court ruled that AT&T should turn over its Yellow Pages operations to the Operating Companies. The 1982 Opinion gave its reasons for allowing Operating Companies to publish the Yellow Pages. It states that;

> "All those who have commented on or have studied the issue agree that the Yellow Pages provide a significant subsidy to local telephone rates. This subsidy would most likely continue if the Operating Companies were permitted to continue to publish the Yellow Pages.
>
> The loss of this large subsidy would have important consequences for the rates for local telephone service. For example, the State of California claims that a two dollar increase in the rates for monthly telephone service would be necessary to offset the loss of revenues from directory advertising."

The July 26, 1984 Opinion also made explicit the Court's intention that revenues from directory advertising should be considered by the Operating Companies to provide a subsidy to exchange rates. The Opinion stated that some Regional Holding Companies have "breached that understanding" that revenues should flow from Yellow Pages to the Operating Companies to provide a subsidy. The Opinion cites the following case regarding Nynex:

> "Thus, Nynex has guaranteed to provide its regulated telephone companies with only a publishing fee -- a fixed dollar amount -- from its Yellow Pages revenue. That company contends that the telephone affiliates will benefit from this arrangement because the publishing costs associated with the Yellow Pages will be shifted to the separate subsidiary, and these affiliates, as well as the ratepayers, will be insulated from the risks of the directory publishing business, possible financial loss, and any fluctuation in the economy. But the revenues from the Yellow Pages have always far exceeded the costs of publication. Moreover, if there ever should come a time when these operations are not profitable, the Regional Holding Companies could simply discontinue them. In short, the Nynex arrangement does not assist the ratepayers; it assists only Nynex."

In an Opinion by Judge Harold Greene issued on August 11, 1982, he discussed the issue of directory advertising. He stated that restricting the Operating Companies from publishing Yellow Pages lacks an appropriate basis and is not in the public interest. The Opinion goes on to explain:

> "Neither of the reasons underlying the other restrictions on the Operating Companies -- the need to prevent cross subsidization and the importance of preventing competitor discrimination -- has any relevance to the printed directory markets.

All parties concede that the Yellow Pages currently earn supra-competitive profits. See, e.g., the Department of Justice Response to Comments at 71. There is no warrant therefore for proceeding on the premise that the advertising prices charged by the Operating Companies are artificially low as the result of a subsidy from exchange service. Similarly, there is no possibility of improper discrimination by the Operating Companies against competing directory manufacturers since access to the local exchange network is not required for production of a printed directory. In short, the Operating Companies would have little or no ability to discriminate against competitors in the

printed directory market, and this restriction thus has no procompetitive justification whatever."

CHAPTER 3

INTRODUCTION TO ELECTRONIC YELLOW PAGES

WHAT IS ELECTRONIC YELLOW PAGES?

The Market Needs

Electronic Yellow Pages (EYP) is being developed by Pacific Bell Directory (PBD) in response to the intersecting needs of three major California economic forces:

(1) National and regional manufacturers and marketers of goods and services;

(2) Local retailers and other direct providers of goods and services; and

(3) Consumers of these goods and services, who can be either businesses or consumers.

EYP is being designed to address significant information and/or marketing communications needs within each of these three customer segments.

National and regional manufacturers and marketers of goods and services need cost-effective access to a precisely defined target -- their customers and potential customers. They need the ability to measure with accuracy, the effectiveness of the dollars they spend to reach customers and prospective customers. They need to find effective ways to bring together the end users who desire to buy their products and services, and the retailers and service providers who sell them at the local level. EYP is being designed to assist national and regional manufacturers and marketers of goods and services meet these needs.

Local retailers and other direct providers of goods and services also need cost-effective access to their customers and potential customers. They need the ability to present their informational and promotional messages in ways which differentiate them effectively from their competitors, and which build sales volume. They need reliable feedback on the effectiveness of the limited number of dollars they are able to spend on advertising and promotion. EYP is being designed to support PBD's core printed product in meeting the needs of these local retailers and other direct providers of goods and services.

California businesses and households seek out shopping information in order to make better purchasing decisions. They demand information which enables them to differentiate meaningfully the comparative price-value relationships between similar goods, and comparative reliability and trustworthiness among competing providers of similar services. EYP is being designed to assist end users of information, both businesses and households, make better purchasing decisions by providing them information which is more current, more detailed, and more responsive to their individual needs than available alternatives such as the printed yellow pages today.

How EYP Satisfies Market Needs

EYP is a series of applications centered on a proprietary and comprehensive database which contains information about all business and government entities in the State of California. EYP will provide California businesses and households access to a vast amount of detailed and accurate and current information. It will also give them the ability to make purchases, reservations and other transactions, and it will enable them to communicate and interact in real time with others who use EYP.

To illustrate, EYP can give businesses and households answers to questions such as:

- Which of the available products, brands or service providers meet my requirements for the purchase I am considering?
- Where can I find a given product, brand or service in my community?
- What products, brands and services are sold at a given location?
- How do I get from where I am now to the location I am interested in finding?
- What kinds of services and facilities do the local, state and federal governments offer in my community? Which one of the myriad of government agencies do I call to find the information I need?

From the advertiser's perspective, EYP will provide improved tools for presenting commercial messages and measuring their impacts. Advertisers will be able to use text, graphic images, photographs, a wide variety of sounds, and, in some cases, full motion video, to describe their offerings to their customers and potential customers. EYP will make it possible for consumers who see information and commercial messages to take immediate action on them, by requesting additional information or by making purchases. EYP will enable advertisers to measure precisely the

number and critical demographic characteristics of the people who are exposed to, and who act on, their messages.

Four Principal Components of EYP

EYP is composed of four principal elements:

(1) Information. EYP comprises shopping information, mapping information, government information and evaluative information. The directory company can act as the primary originator and packager of information. Additional information sources may include third-party providers of objective and evaluative information in areas falling outside the directory's existing database.

(2) Hardware. Computer hardware will provide the storage and manipulation of the information in the EYP. The directory company may develop strategic alliances with hardware providers. PBD's original plan was to establish its EYP database as an essential bundled-in enhancement to selected hardware products.

(3) Software. Computer software will bring to life the information and services included in the EYP. The directory company may develop strategic alliances with developers of selected software products, may provide the graphical interfaces between EYP and its users, and may serve as the platforms for communication and transaction services which are included in the EYP.

(4) Telecommunications. Telecommunications products and services are required to enable customers to access and use the information and software elements.

EYP is shaped primarily by the information and marketing communication needs of its customers. Hardware, software and telecommunications will be integral elements of EYP, but they will support customer information and marketing communications requirements instead of defining or creating them.

Three Tiers of Information in EYP Database

The heart of EYP is the database. The database will contain information about every business in the State of California. It will also include information about facilities and services offered by local, regional and state and federal governmental agencies in California.

Database will include three distinct tiers of information on California businesses:

Tier I information includes the name, address, telephone number and SMART Yellow Pages heading of the business. This information is contained in PBD's current databases.

Tier II Information includes enhanced information of most California businesses such as hours of operation, products and brands sold, and the availability of delivery and parking. It is expected that desired Tier II information will differ by end user category (business versus consumer users) and by type of business (e.g., and users will seek different information about providers of professional services than about retailers of large durable goods).

Tier III Information consists of promotional messages from advertisers. Advertisers will be able to inform their current and potential customers of sales and specials, new offerings and locations, and other advertising information, via Tier III.

According to PBD, Tier I Information is widely available today; for example, American Business Information, Inc., offers a CD-ROM disk which contains Tier I Information for approximately 9.2 million U.S. businesses and costs about $349.

Tier II Information, by contrast, is information which by definition is widely desired by businesses and consumers, but is difficult or expensive to obtain.

EYP'S Two Revenue Streams

EYP is being planned to generate two separate revenue streams. One will include revenues from information users, both businesses and households.

The second stream will include only revenues from advertisers. At the outset, only advertisers for participation in Tier III may be charged.

Tier II represents the majority of the potential advertiser revenue stream in the long run. However, this stream is not likely to emerge until a significant number of businesses and consumers have become users of the EYP. It is proposed that Pacific Telesis Group invest in the creation of Tier II information during the EYP developmental years. This will enabl a critical mass of Tier II Information users to be generated. Once the value of those users has been proven to advertisers, users will be charged for continued participation in Tier II.

(For more detail discussion on this subject, please refer to Chapter 6)

A third significant element in the advertiser revenue stream is revenues from advertiser participation in the interactive services of EYP. Advertisers may be charged who use the EYP solution a) to target specific customer groups, b) to gather responses from customers, and c) to receive information on customer response to their messages.

EYP Delivery Channels

Users will interact with the EYP Database via four delivery channels:

(1) Operator-assisted. Anyone with access to a telephone will be able to dial 411 and query live operators for EYP information. For example, a caller would be able to find a nearby French restaurant that is open past 8:00 p.m. which accepts the Discover card, in addition to being given the restaurant's telephone number.

(2) Public access. California residents and visitors would be able to use attractive terminals located in high-traffic public locations to interact with EYP. Such terminals may include touch-sensitive screens, four-color information displays, linkages to laser discs containing full-motion video images, and transactions capabilities.

(3) Online. Owners of personal computers and modems would have the capability to dial into EYP to find the information they desire.

(4) Disks. Owners of personal computers could order a CD-ROM or floppy disks containing information tailored to their needs.

PBD sees the design of EYP delivery channel creating opportunities for cooperation between various Pacific Bell business units. For example, the EYP database may be sold to the Operator Services group within the RBOC, which in turn might retail information from the database to 411 callers. Similarly, the EYP database may be sold to Pacific Bell's Coin Services group, which could retail information to users of the public terminals.

EYP, A REFLECTION OF CHANGING YELLOW PAGE TECHNOLOGY

It can be said that the market drove the yellow pages into electronic. But the yellow page technology appears to have caught up with the market demand. In fact, the expansion from traditional printed yellow pages to electronic appears to be a national phenomenon:

"For one thing, every RBOC has to be positioning for an eventual move into electronic yellow pages" -- Electronic Services Update by Link Resources Corp., May, 90, titled; Bell Atlantic wants to be more like Prodigy.[5]

"To some extent, these transformations of the market undermine the traditional means of disseminating self-access advertisements. Rapid change means that the information in directories which are published at long intervals soon becomes out of date, while the market for media which contain fresh and up-to-date information grows proportionally." - The Yellow Line, Sept., 91.[6]

It appears that the directory industry has come to a point of evolution, a point to transit from its printed yellow pages into a more dynamic electronic publishing era. Even the definition of Electronic Yellow Pages may have evolved through the years. Today, Pacific Bell has changed the term Electronic Yellow Pages to Electronic Publishing Services (EPS). Pacific's definition change broadens the coverage of publishing services, EYP becomes a subset of EPS.

SUMMARY

According to PBD, the converging demands of the three market segments has made the opportunity of EYP a reasonably calculated venture. However, it appears that PBD's vision of EYP as an attractive opportunity has been matched by the desire of the Pacific Telesis corporate management to move this undertaking to a below-the-line affiliate to benefit its shareholders. In fact, beginning January 1, 1991, the EYP Project Director was transferred to Pacific Bell Information Services (PBIS). On November 12, 1993, Pacific Bell applied to the California Commission to have PBIS (instead of PBD) "enter the Electronic Publishing Services Market." On April 1, 1994, the EYP

---

[5]Electronic Services Update by Link Resources Corp., May, 90, titled; Bell Atlantic wants to be more like Prodigy. (PB Document #034707 - 709)

[6]The Yellow Line, Sept.91 (PB Document #034793)

development team was transferred again to the newly formed Pacific Telesis Electronic Publishing Services (PTEPS). Unlike PBIS, being a wholly owned subsidiary of Pacific Bell, PTEPS is an affiliate under the parent corporation, Pacific Telesis.

Another complication to the issue arose recently when PBD classified EYP under a presumably larger class of service, namely, Electronic Publishing Services. Pacific Bell defines Electronic Publishing as "the universe of services and products through which information, traditionally provided in print form (e.g., directories, newspapers, catalogs) is distributed or accessed over the basic telephone network using electronic devices (e.g., telephones, screen phones, personal computers).[7]

This audit sought to reveal the nature and issues concerning this new product, EYP, by finding and analyzing the perspective issues and by having a thorough understanding of what transpired on the long development road of EYP by Pacific Bell Directory. (For further information concerning EYP Vision and Development Strategy and Overview, please see Appendices A and B.)

[7] CPUC Pacific Bell Application 93-11-031, page 4.

CHAPTER 4

THE POTENTIAL IMPACT OF ELECTRONIC YELLOW PAGES ON TRADITIONAL PRINTED YELLOW PAGES

PACIFIC BELL'S DESIRE TO MOVE EYP OUT OF PBD

Pacific Bell has made its intention clear that it desires to move electronic yellow page out of the above-the-line Directory. This is borne out by Pacific Bell's pending application with the California Commission to have its affiliate to enter the electronic publishing services. Pacific Bell has already transferred EYP project personnel from PBD to its affiliate. In California, all revenues and expenses of the printed directory operation are considered "above-the-line" for ratemaking purposes. If the non-regulated affiliate were to enter into electronic yellow pages where the directory company is prohibited, the affiliate will be competing with the traditional printed yellow pages. The questions are what and how will printed yellow pages be potentially impacted as a result of non-regulated affiliate entering electronic yellow pages.

POTENTIAL REVENUE EROSION OF EYP ON PRINTED YELLOW PAGES

Of major concern is the potential revenue erosion of printed yellow pages by electronic yellow pages. According to Pacific Bell, the revenue erosion may be in the millions of dollars.[8] To comprehend the potential impacts of EYP on printed yellow page, an analysis of the following issues must be conducted:

1. The nature of printed yellow pages versus electronic yellow pages;
2. The future outlook of the two products;
3. The measure to mitigate potential erosion;
4. The competitive issues of electronic yellow pages; and
5. The business placement of electronic yellow pages.

NATURE OF YELLOW PAGES

A study of the nature of yellow pages will provide a guide in assessing the potential impacts of electronic yellow pages on printed yellow pages. The following questions must be answered:

---

[8]Pacific Bell Information Services 1992 Business Plan Overlay, August 22, 1991. PB Document #034894)

- What is the difference between printed yellow pages and electronic yellow pages?
- What are the primary functions and purpose of the printed yellow pages? of electronic yellow pages?
- Are the above differences dictated by the capabilities of the transmission media, paper copy and electronic media?
- Does the use of electronic media instead of paper change the basic functions and purpose of what has traditionally been Yellow Pages? How?
- Are electronic yellow pages a natural outgrowth and logical extension of printed yellow pages? If not, what would be the logical extension of the printed yellow pages in electronic form? Where do you draw the line?
- Why should the regulatory treatment of yellow pages change just because the media used to transmit it moves from paper to electronic format?

THE FUTURE OUTLOOK

- What is the future outlook of electronic yellow pages?
- What is the future outlook of traditional printed yellow pages if PBD were not allowed to provide yellow pages in electronic form?

MEASURES TO MITIGATE POTENTIAL EROSION

- Left above-the-line, revenues from electronic yellow pages will help offset erosion of printed directory revenues. Placed below-the-line, competition from electronic yellow pages will only further accelerate the inevitable erosion of directory revenues.
- Is there any justification for not taking measures to mitigate the potential erosion of directory revenues that have been subsidizing ratepayers?
- Should PBD get involved in competitive projects or not?

COMPETITIVE ISSUES

- Do risks of cross-subsidies which could harm both ratepayers and competitive markets exist by leaving electronic yellow pages above-the-line in PBD? What are they?
- How would these risks be lessened by placing electronic yellow pages in a non-regulated affiliate?
- How competitive would the market of electronic yellow pages be?
- How does electronic yellow pages differ from other enhanced services?

- Is electronic yellow pages speculative and risky? Why?
- Will PBIS have significant market power in the electronic yellow page business in either the short-term or the long-term?

BUSINESS PLACEMENT OF EYP

- Why should EYP be provided by a non-regulated affiliate?
- Who developed EYP?
- Who funded the development?
- How was EYP developed?
- Who has rights to EYP?
- How was the business placement of EYP decided?
- What are the reasons for moving electronic yellow pages out of PBD?
- Should Pacific Bell's non-regulated affiliate be allowed to leverage off the "PacBell" name for marketing electronic yellow pages services without compensating ratepayers for the use of the name?

WHAT THIS AUDIT REPORT ADDRESSES

This Audit Report does not answer all the questions and issues raised by the development of electronic yellow pages. These questions and issues were complicated by Pacific Bell's desire to move EYP out of PBD. What this report addresses are questions concerning who funded and developed EYP, how it was developed, what is the outlook of EYP from the perspectives of Pacific Bell, how Pacific Telesis corporate strategy was involved in the business placement of EYP, and whether safeguards preventing cross-subsidies work. The remaining questions and issues are expected to be addressed by the California Public Utilities Commission in Pacific Bell's pending Application.

SUMMARY

The issues and concerns presented above may carry different weight of importance in different state jurisdictions. Nevertheless, one way or another, these issues and concerns will have to be addressed by state regulators as technology and the market take publishing services to a new and dynamic era of electronic telecommunications.

CHAPTER 5

PACIFIC BELL DIRECTORY'S STRATEGY IN DEVELOPING ELECTRONIC YELLOW PAGES

WHY DID PACIFIC BELL DIRECTORY ABANDON ITS SINGLE PRODUCT FOCUS?

One may argue that PBD's traditional printed yellow pages has been for decades, a good and stable profit-making machinery. Why should PBD expend significant efforts into a new product venture of the unknown? The NARUC Audit Team discovered that it was not a rushed decision when PBD first abandoned its philosophy of single print yellow page product focus and entered into the development of EYP in 1987. Neither was PBD without a vision for the future and the market need for EYP.

Collapsing Margin and Difficult Business Growth for Printed Yellow Pages

According to documents obtained by the NARUC Audit Team, PBD as early as 1987, first saw the company's need for the electronic yellow pages. In September 1987 John Gaulding, President and CEO of PBD, reported to the Board of Directors that the printed yellow pages was experiencing collapsing margins as the California marketplace began "true consolidation with strong competitors chasing market share". As a result, business growth became difficult. For PBD to maintain its market leadership position, Gaulding argued, PBD not only must improve its cost efficiency, but also "must explore new opportunities in marketing and electronic information services in order to diversify single product focus."[9]

Gaulding said that PBD needed to:

> "aggressively seek horizontal combinations that bring new market opportunities as quickly as possible. PBD's focus on non-franchise markets is clearly an element of this strategy. A more aggressive response, and one we should build toward for 1989, should fully exploit the latitude available in the expanded print and advertising waivers received in 1987. The full development of this strategy will require PTG to

[9] "A BLUE PRINT FOR THE FUTURE", PBD Presentation to the Board of Directors, September 24, 1987 (PB Document #021545 - 021581)

acknowledge that the directive advertising business is no longer franchise or print defined, but is rather a game played by all others on an extra-regional basis, with attractive investment models designed to pursue opportunities along the full range of the industry value chain."

Major Competitors Already Had Started Investing Into Electronic Yellow Pages

Gaulding put an urgency in this pursuit of electronic directory services development as he claimed that "a more insidious and dangerous form of competition" was seen and through public policy freedoms enjoyed by both R. H. Donnelley and General Telephone Directory in California, each had invested heavily during the past two years in electronic directory capability, and each was legally free to pursue electronic services. From a corporate perspective, Gaulding saw both had a more attractive investment model than PBD, passing either all or a large part of earnings through to the public shareholder.

Electronic Yellow Pages Was Seen As "The Fastest Growing Source Of Profits During 1990'S"

Gaulding claimed that the EYP was an attractive opportunity and believed "that electronic marketing services, closely aligned with directive print advertising, represents the growth business of the 1990's." "Our analysis has convinced us that, although electronic directory services do not yet have a viable market, they will be the *fastest growing source of profits during the 1990's*."

Major Preparation For Entry Into EYP Started In 1987

Gaulding reported to the Board of Directors that already "considerable planning work had been initiated in 1987" in two "important" areas: expansion of the core SMART Yellow Pages product to non-franchise California markets; and, product and market development in preparation for entry into *electronic directory and marketing services.* He pointed out that "these two represent the most significant areas of business growth for PBD *over the next 5 years*, and would therefore receive "*concentrated attention*" in product and market development during 1988.

Gaulding summed up that this 1988 Business Plan should be viewed as a "blueprint" for continuity of existing initiatives, and for

focusing on those areas that will allow PBD to achieve "superordinary growth in earnings through the 1990's."

FEEDBACK FROM 1987 EYP DEVELOPMENT

Market Calls For EYP

Since the inauguration to initiate development of EYP, in September 1988, Gaulding reported to the Board of Directors[10] that there was strong evidence from the marketplace that consumers were changing their purchasing behavior: what they bought, where they made their buying decisions, what stimulated that decision, and a complex array of factors that ultimately influenced the effectiveness of advertising expenditures.

In response, PBD had attempted to respond to these shifts through research-based scooping changes and the addition of sufficient consumer oriented information to make the SMART Yellow Pages a more comprehensive consumer reference vehicle. However, Gaulding came to recognize and reaffirm the need for developing EYP:

> "The yellow pages medium is, a relatively monolithic vehicle to the marketplace -- a fact that is both its greatest strength and its most profound market liability. As market segmentation becomes more sophisticated, the need to develop more targeted advertising messages becomes increasingly important to the advertiser. More targeted circulation or reach, tighter messages that convey a product or business superiority, more promotional capability -- these are needs in the marketplace *that have not, and cannot, be met by the traditional yellow page medium.*" (emphasis added)

Obviously, EYP is the answer to fulfill what the traditional YP medium cannot.

Sizing The EYP Market In 1988

Gaulding envisioned that the market potential for these types of services had already been steadily growing in the decade, and promised to fundamentally change the nature of business advertising in the future. He reported that PBD's recently

---

[10] 1989 Business Plan
FOUNDATION FOR THE FUTURE
PBD Presentation to the Board of Directors
September 30, 1988
What Does the Future Look Like? (PB Document #021231 - 242)

completed work indicated that the size of the California market, which consisted of medium and large businesses, was approximately $1.5 billion in purchased service, and five times as large when in-house capabilities were considered. These estimates did not include the then very small and small businesses served by the SMART Yellow Pages and there was strong circumstantial evidence that PBD's current customers were already diversifying their vehicles to the market as well.

EYP Development Was Also Found To Serve Existing Printed Directory

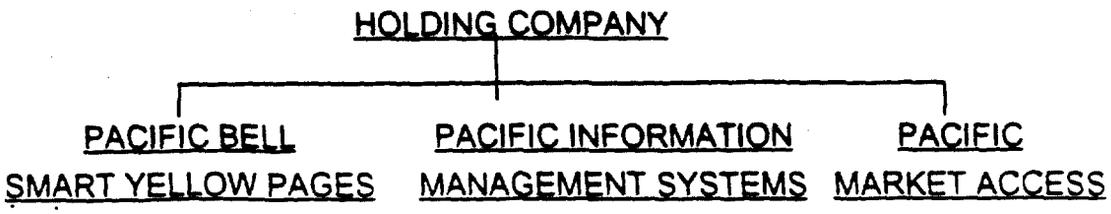
Gaulding reported that it had been two years since 1987 that PBD had begun developing the basis for entry into the marketing services industry. He stated that the yellow page business was a highly specialized group of integrated marketing services targeted at a particular segment of the market, in which PBD needed to use many marketing services skills to further enhance its core business. Gaulding found that *"New product development, creative services, specialty publishing, direct mail, large scale database management -- are disciplines that can be used to both meet the needs of the markets we do not reach today, and improve our effectiveness in the core yellow page business."* In other words, the development of EYP was a venture justified anyway you look at it.

PACIFIC BELL DIRECTORY GEARING UP FOR THE NEW VENTURE

Restructuring Pacific Bell Directory

In response to the call for EYP development, Gaulding obtained approval to restructure the Directory Company along "three distinctness of business":

PBD ORGANIZATION STRUCTURE



We create information products and provide marketing services that give business cost-effective access to their target markets, and consumers valued information organized in a useful way.

1. Pacific Bell SMART Yellow Pages -- an entity responsible for the sales and marketing of yellow page advertising in the Pacific Bell franchise area;

2. Pacific Information Management Systems -- an entity responsible for the end-to-end manufacturing of print information services to support both the core yellow page business, and *a new set of emerging marketing services that will serve existing and new markets with newly developed products*. The Information Management unit was charged with the responsibility for technology planning, database acquisition and management, paper and print strategy and procurement.

3. Pacific Market Access (PMA) -- an entity responsible for the creation, development, and marketing of a broad range of marketing services, both for the core Yellow Pages and for commercial markets. It was to be responsible for developing the national market for all relevant media advertising buys, including the yellow page medium. PMA would be managed as a profit center and was charged with the development of marketing products and services for commercial markets, three of which went to market trial in 1989. PMA' business scope specified Directive marketing services with which businesses accessed or could be accessed by consumers likely to buy their goods and services. The media specification included both *Print and electronic media* which would be used for packaging and distribution of information products and marketing services for various situations and needs

Restructuring Was A Result Of Sensing Changes In the Marketplace

The purpose of the restructure was to bring new effectiveness and accountability to the core yellow page business, "develop an information infrastructure that can serve multiple product and business needs, and focus entrepreneurial energy on high growth marketing services markets."

Gaulding emphasized that the restructuring was "*a result of sensing changes in the advertising marketplace, and acting to preserve the health of the core yellow page business*, while responding to the needs of the market through new services that carry a higher competitive and risk profile." PBD believed this restructuring was both "strategically and operationally sound," and would materially assist profitable growth in both its traditional and "emerging activities" in the advertising industry.

Change In Corporate Single Product And Risk Averse Philosophy

Hence, Gaulding inaugurated this significant change of PBD's policy:

> "We will need many product ideas in motion at all times. And like other portfolio concepts, this one will have winners and loser. Our bias should not be on perfection, but rather progress and production. To the greatest extent possible, we will need to create an environment that refines product from market response and does not allow risk averse processes to suffocate innovation.
> In summary, all facets of this business -- new and revitalized -- hold promise for sustainable growth in attractive industries. The business carries greater risk than it has in the past -- no matter what -- but we are excited by its prospects and are in full motion toward our future." (emphasis added)

EYP Development Continued By the New CEO in 1990

John Gaulding's vision for EYP development continued even after he was replaced by Van Allen as the new Chief Executive Officer of PBD in 1990. Mr. Van Allen was quoted that EYP was "at the top of his 'build for the future' agenda, and appeared very supportive of the project". Mr. Van Allen requested the EYP Tas

Force "to provide more detail on the costs associated with pursuing the aggressive 1991 development option."[11]

SUMMARY

In summary, what drove PBD into developing EYP was the recognition of the pressure building on its declining profit margin and business growth, the realization of the change in the marketplace, the attraction of the EYP opportunity and the subsequent abandonment of PBD's single product focus to diversified ones, from monolithic print to versatile electronic.

[11]Memo to EYP Task Force dated June 25, 1990, titled EYP Progress Report (PB Document #034588 - 623)

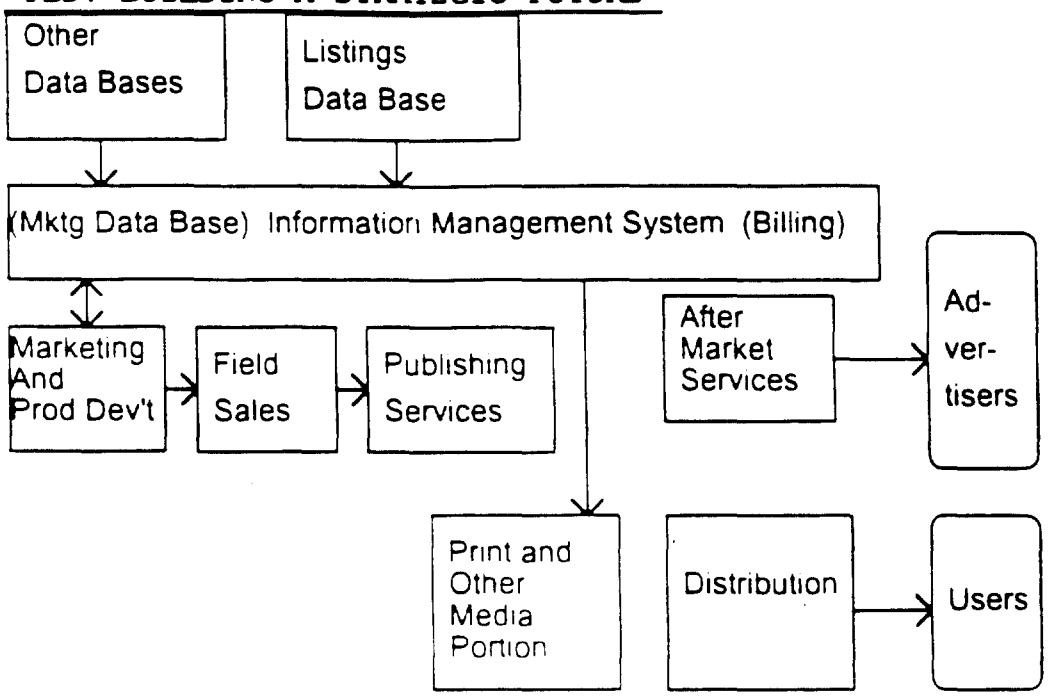
CHAPTER 6

CHRONOLOGY OF PACIFIC BELL DIRECTORY'S ELECTRONIC YELLOW PAGES DEVELOPMENT

PBD'S EARLY VISION OF EYP TRACED BACK TO 1986

Even before the RBOCs applied for their waiver of MFJ restriction in information services, as early as 1986, PBD already was eager to venture into new products and services beyond the boundary of Yellow Pages which was restricted to printed form. The 1986 Presentation to the PBD Board of Directors proposed building a new PBD BUSINESS SYSTEM. A multi-media, print equivalent product and distribution was already envisioned as something PBD would enter into under its main goal of "Building a Strategic Future"[12]:

"PBD: BUILDING A STRATEGIC FUTURE"



- o Stand-Alone Information Company
- o Marketing-Driven
- o Primary Data Systems
- o **Multi-Media, Print Equivalent Product and Distribution**

[12] July 24, 1986 Presentation to PBD Board of Directors (Document #021612)

On November 5, 1987, the PBD Information Management System Project Review[13] cited one of the major contribution of the new Information System would be to "Provide increase flexibility to migrate into *new information products as the opportunity arises.*"

A comparison between the then existing old data system and the new IMS system highlighted the importance of new product, one of which should be reasonably inferred to as the electronic yellow pages. (See John Gaulding's 1988 Business Plan in Chapter 4) While the old YPS system was not "positioned" adequately to meet new business demands for the future, the new IMS' increased flexibility and enhanced system capabilities has effectively allowed for the efficient migration into "new lines of business." Although the structure of the old YPS database was flexible, it could not be readily altered to accommodate new applications or new features, the IMS database would provide increased flexibility to migrate into "new products and/or lines of business."

The Review also noted one of the IMS Qualitative Benefits was "Improved Flexibility to *Rescope Directories and Create New Products.*"

On May 2, 1988, the SMG (Senior Management Group) Meeting cited *"Selling electronic or paper media with customer at his terminal/his location (terminal to terminal)"* as the Sales Model, a "Shared Vision of the Future under IMS Vision of the Future"[14]

The documents related to the data system offer a confirmation of the presentations by John Gaulding in the previous chapter, that by 1987 and 1988, PBD's development of electronic yellow pages was undoubtedly clear.

EARLY ATTEMPTS TO PROVIDE DIRECTIVE MARKETING SERVICES

Crucial to the push of PBD into developing electronic yellow pages was the need of customers to access updated information similar to newspaper advertisements on the one hand and the need of advertisers to reach their targeted customer on the other hand. This is called Directive Marketing which the printed yellow pages intrinsically could not deliver nor could PBD

[13]November 5, 1987, the PBD Information Management System Project Review (PB Document #021531 -536)
[14]May 2, 1988, the SMG (Senior Management Group) Meeting (PB Document #021483)