

MINUTES OF THE House COMMITTEE ON Communication, Computers and Technology

The meeting was called to order by Representative Mike Meacham at
Chairperson

3:30 ~~am~~/p.m. on February 9, 1983 in room 522-S of the Capitol.

All members were present except:

Committee staff present:

Marlin Rein, Chief Legislative Fiscal Analyst, Committee Staff Director
Sherry Brown, Fiscal Staff, Research Department
Chris Stanfield, Fiscal Staff, Research Department
Betty Ellison, Secretary to the Committee

Conferees appearing before the committee:

Patrick J. Hurley, Secretary, Department of Administration

Chairman Meacham gave members copies of a proposed piece of legislation from the Department of Economic Development relating to the \$1.5 million that the Governor has proposed to be placed in the Board of Regents' budget matching research assistance grants.

Representative Chronister moved and Representative Dean seconded that this be introduced as a committee bill and request that it be referred back to this committee. The motion carried.

The chairman stated that this and a number of similar proposals will be considered by the committee probably during the week of February 28.

Secretary Hurley gave a review of how divestiture and deregulation have impacted on telecommunications with regard to how it affects the State of Kansas as a large business user. He said that today as a result of divestiture and deregulation, the new Bell company - AT&T, Western Electric, Bell Laboratories and American Bell - can offer the State of Kansas Bell's best technology at significantly reduced prices; in a word, the new Bell can and will compete. American Bell will bid on our system when it is put out for bid; they are anxious to do business with the State of Kansas and they do not have any major problems with our plan.

In relationship to the plan proposed for the state, Southwestern Bell is now prohibited from providing "Bell's best comprehensive system" to the State of Kansas, since they can no longer offer for lease or sell most of the necessary components manufactured by AT&T and its subsidiaries. Instead, since it remains jurisdictionally a part of the local service system, Southwestern Bell can only offer a Centrex switching system with any enhancements that it is permitted to attach to it. Secretary Hurley said, in effect, in non-technical terms, AT&T has divested itself of its obsolescent products and equipment, given them or left them with Southwestern Bell and the other 21 local operating companies for continued use in providing telephone service to residential customers. AT&T has retained for offering to its business customers such as the State of Kansas, through its new subsidiary, American Bell, all of its new and best products and services. (Attachment 1)

Chairman Meacham told the committee that tomorrow it will hear from Southwestern Bell, regarding their assessment of what has happened with respect to divestiture and deregulation.

The meeting was adjourned at 4:05 p.m. by the chairman.

The next meeting of the committee will be held at 3:30 p.m. on February 10, 1983.

Deregulation and Divestiture: Impact on Kansas State
Government as a Telecommunications User

This paper will present the Department of Administration's current understanding of: (1) the deregulation of Customer Premise Equipment and the divestiture of the A.T.&T. corporation; and (2) the impact of these actions upon Kansas state government as a major user of telecommunications services.

I. Overview

Federal regulatory and judicial actions taken during the last year will cause profound changes in the delivery and regulation of telecommunications services and equipment during the next 1-5 years. Until resolution of several remaining issues, the telecommunications industry will continue to be a volatile area. However, the general outline of the restructured telecommunications industry is emerging. It is evident that these changes will have considerable impact on large users such as Kansas state government. It will be to the benefit of such users to take positive action in anticipation of these effects.

II. Divestiture and Deregulation

The restructuring of the telecommunications industry is a result of the combined effects of two independent proceedings and orders:

(A) The order of the Federal Communications Commission (hereinafter referred to as "FCC") deregulating the acquisition and use of certain portions of basic telephone equipment and services; and

(B) The decision rendered by the United States District Court in the A.T.&T. antitrust suit.

A. The F.C.C. Order

The FCC ruled that customer premises equipment, or C.P.E., should be deregulated or detariffed. C.P.E. is telephone and data communications equipment used on a customer's premises, including telephone sets and those on-site switches commonly known as PBX systems. The effect of the order is that all new C.P.E. acquired after January 1, 1983 will have to be provided under "free market conditions". Competition between producers of C.P.E. will determine C.P.E. costs rather than regulatory

actions. "Existing C.P.E." will continue to be regulated by state regulatory agencies (the Kansas Corporation Commission in Kansas) until the FCC and state regulators make final decisions about continued regulation of existing C.P.E. A.T.&T. has requested deregulation of existing C.P.E. as soon as January 1, 1984. "Existing C.P.E." is defined as that equipment that was in place on a user's premises or in telephone company inventories on December 31, 1982.

B. The Divestiture Decision

For several years, the United States government has been pursuing an antitrust settlement against American Telephone & Telegraph (A.T.&T.). In January, 1982, a settlement was reached and, with some modifications, was approved by the court. Under the court's order, A.T.&T. is to separate from its operations its 22 operating companies, including Southwestern Bell, in an action known as divestiture. Divestiture is to occur on January 1, 1984. The operating companies will become totally independent of each other and the remainder of A.T.&T.

As of January 1, 1984, A.T.&T. will consist of corporate headquarters, Bell Laboratories, Western Electric, and the Long Lines Division. A new subsidiary of A.T.&T., "American Bell Incorporated", came into existence on January 1, 1983. It was formed to sell primarily C.P.E. on an unregulated competitive basis. Most other types of telecommunications equipment, and maintenance and servicing of telecommunications equipment, will also be available from American Bell.

To summarize pertinent aspects of these actions, two charts are attached.

Attachment I, entitled "Providers of Telecommunications Services", outlines the shifting relationships between A.T.&T., its operating companies (the chart refers only to Southwestern Bell) and independent competitors.

Attachment II, entitled "Regulatory Authority," shows the known and possible effects of divestiture and deregulation on federal and state regulatory agencies.

III. Impact on the State as a User

There are still several unsettled issues arising from divestiture and deregulation causing some uncertainty about the impact of these actions on all users, including the state. For example, we do not yet know how long existing C.P.E. will remain regulated, how intrastate long distance services will be provided or regulated, or the degree to which the restructuring of local and long distance tariffs, and the introduction of access charges, will affect costs for local and long distance services. However, we do know some of the general effects of divestiture

and deregulation upon Kansas consumers. We can determine with some specificity the impact upon the three major types of services--(a) Customer Premises Equipment, (b) local exchange services, and (c) long distance services. A summary of the expected effects on the state for each type of service follows.

Customer Premises Equipment

1. Telecommunications users, including the state, will have to acquire C.P.E. equipment, including PBX systems. The replacement value of C.P.E. currently in use by the State of Kansas is about \$33 million. The State could agree to acquire equipment already in place; however, that equipment is rapidly becoming outdated and A.T.&T. appears anxious to introduce newer product lines. Services for the older C.P.E. could be difficult to obtain in the future.

2. Any new, deregulated C.P.E. acquired by the State of Kansas, and service contracts for that equipment, must be bid competitively. Southwestern Bell is prohibited from selling new C.P.E. until January 1, 1984; their re-entry into the C.P.E. market is uncertain. Southwestern Bell inventories of existing C.P.E., which are regulated and therefore not subject to competitive bidding, are expected to be depleted in a few months. Any state agency that requires additional equipment during FY 1984, and possibly the latter portion of FY 1983, will not be able to lease that equipment from Southwestern Bell. Such equipment will have to be acquired, under competitive bid, from American Bell or a competitor. Thus, the State can anticipate that acquisition of C.P.E. will begin in FY 1984.

Local Exchange Services

1. Following divestiture on January 1, 1984, Southwestern Bell will continue to be a regulated utility providing only those basic services connected with local calls, access to long distance services provided by A.T.&T. and others, and possibly intra-LATA long distance services.

2. Significant increases in charges for basic local services are expected, as existing A.T.&T. subsidies of local service by long distance revenues will be eliminated.

In a study by the National Telecommunications Information Administration cited in an October, 1982 U. S. House Committee on Government Operations report, it is estimated that local rates will increase an average of 12% per year over the next five years, or a total of 76.4% by 1986. However, the same study concluded that those states with largely rural populations, such as Kansas, may experience rate increases of 13-16% per year.

Long Distance Services

1. Considerable uncertainty remains about who will provide long distance services. A.T.&T. will have all interstate calls and will pick up some or all intrastate calls. Introduction of "Local Access Transport Areas" ("LATA's"), which define long distance service areas, will not simplify the matter. Kansas will be divided into three LATA's, roughly corresponding to existing area codes. A.T.&T. will be responsible for inter-LATA calls. Thus, Southwestern Bell will be the operating company for most of the state and yet will be prevented from providing inter-LATA calls within Kansas (e.g., Topeka to Wichita or Kansas City).

2. There are similar questions about who will regulate long distance calls within Kansas. Congressional action could place responsibility for inter-LATA service with the FCC. If so, the FCC will assume responsibility over some intrastate services which are now regulated by the Kansas Corporation Commission. Any such shift of regulatory authority could be quite controversial.

3. Standard direct dial long distance rates could be lowered, or the rate of increase could be slowed, with the introduction of greater competition and as long distance subsidies for local operations are removed. However, private line long distance rates used for KANS-A-N will be affected differently.

TELPAK is a private line, long distance bulk rate; TELPAK and WATS rates form the basis for the KANS-A-N network. TELPAK will be withdrawn after 1985, if not before, and A.T.&T. has not proposed an alternative that would be as advantageous to the state.

Of the roughly \$5 million spent on long distance services in FY 1982 by state agencies, traditional direct dial long distance costs amounted to only \$300,000. The remaining \$4.7 million consisted of KANS-A-N expenses, with \$2.7 million attributable to TELPAK rates. Thus, a general decline in long distance rates probably cannot be translated into significant reductions in long distance expenses for the state.

4. Divestiture is intended to increase competition; theoretically, the state could obtain lower long distance rates from another vendor. But, as experienced during deregulation of the airline industry, competition does not universally benefit all users. Lower traffic areas are not as attractive to competitors, and therefore users in these areas may not realize lower rates. Currently there are no viable competitors in Kansas that could provide intrastate long distance services of the magnitude required by Kansas state government.

5. The addition of an access charge for long distance service is expected. This fee would be in addition to basic monthly charges for local service and long distance costs. As Southwestern Bell loses long distance subsidies from A.T.&T., they will pass this cost to the consumer. Four dollars per line, per month, has been proposed as the initial charge to commercial users for connection to long distance lines with regular increases in the charge over a period of seven years. Other types of planned charges not applied previously to private line services, such as KANS-A-N, may be instituted.

In summary, the State of Kansas can anticipate effects as outlined in the table below. As a frame of reference, the total FY 1982 telecommunications budget and percentages devoted to each type of service also appear on the table.

FY 1982 Telecommunications Expenditures

<u>Type of Service</u>	<u>Telecommunications (Total Budget \$14,000,000)</u>	<u>Effect of Dives. & Dereg.</u>
<u>C.P.E.</u>	\$3.6 million (or 26%)	A large investment in C.P.E. equipment will become necessary, beginning FY 1984.
<u>Local Services</u>	\$5.4 million (or 39%)	Sizable increases in rates are likely, as SW Bell is cut off from long distance subsidies
<u>Long Dis-tance</u>	\$5 million (or 36%) (\$300,000 - direct dial calls; \$4.7 million - KANS-A-N)	Long distance rates may moderate in some areas. The potential for increases in private line rates available to the state will probably offset those gains.

IV. The Kansas State Telecommunications System Plan

Divestiture and deregulation will result in overall increases in telecommunications costs for the State, although it is currently impossible to predict accurately the degree of increase. Clearly, it will become more difficult to anticipate and control telecommunications costs in the future. For this reason, many large commercial users are beginning to reduce their reliance on regulated telecommunications providers through

development of private telecommunications systems. Such private systems, made possible through technological advances, have proven to be simple, yet flexible and cost-effective means to provide both basic services and enhanced services that at this time are not readily available through A.T.&T./Southwestern Bell at acceptable costs.

Within the last three years, several Kansas companies, including Kansas Gas & Electric Co., Cessna Aircraft, and Fourth National Bank of Wichita, have replaced significant portions of Bell system services with their own systems. State governments in New Mexico, North Carolina, Kentucky, and Washington have some type of a telecommunications system in place and five other states are currently planning systems based on the Kansas telecommunications plan.

The Telecommunications System Implementation Plan, described below, provides a comprehensive package that meets the challenges inherent in the current telecommunications environment--controlling costs through a private telecommunications network; taking advantage of increased competition; and establishing the basis for meeting future telecommunications needs.

In 1980, \$150,000 was appropriated by the legislature to develop a comprehensive plan for the creation of a state-owned telecommunications network. The initial concept was developed by the Telecommunications Office of the Department of Administration. The firm of Booz, Allen and Hamilton reviewed and completed development of the plan.

The proposed state system would minimize reliance on regulated providers for two of the three types of services, Customer Premises Equipment and long distance services.

1. Customer Premises Equipment utilizing digital switching and transmission would be used throughout the state. Digital technology simplifies transmission; permits economies of transmission; and provides greater capabilities in voice, data, and video transmission.

The state plan includes three main switching centers in the high use areas of Topeka, Wichita, and Kansas City. These switching systems would replace KANS-A-N switching and Centrex. Centrex is a switching system for interoffice service in a localized area, such as the Capitol Complex. Unlike traditional PBX switches on the customer's premises, Centrex is located on telephone company premises.

2. Most long distance transmission via A.T.&T. within the State of Kansas would be largely replaced by fiber optic cables servicing major population and state activity centers. The fiber optic transmission system could carry video signals in addition

to voice and high speed data communications signals. These capabilities are currently available only on a special order basis and at a very high cost from A.T.&T./Southwestern Bell.

3. With regard to local service, Southwestern Bell would continue to provide local, nontoll calls, and access to long distance services not provided by the state telecommunications network. Local service is the only major portion of the state plan that can be provided by Southwestern Bell after divestiture and deregulation.

A companion report provides further information about the proposed state system and an evaluation of its cost effectiveness.

V. Conclusions

Two issues arising from divestiture and deregulations require legislative consideration and action this year: (1) the acquisition of C.P.E. and (2) the need to achieve maximum control of future telecommunications costs. These two factors, in combination with the anticipated growth of demands for advanced telecommunications services not currently available from A.T.&T./Southwestern Bell, make serious consideration of the telecommunications plan both appropriate and necessary at this time.

In reviewing the impact of divestiture and deregulation upon each of the three major components of telecommunications services, the advantages of the proposed telecommunications plan, as compared with the current methods of service delivery, become apparent. Cost advantages are particularly apparent in C.P.E. and long distance services.

(1) Local Services (40% - \$6 million)

Costs to the state for basic local services currently comprise 40% of total state telecommunications expenditures, or approximately \$6 million. As noted previously, with or without implementation of the state plan, the state will continue obtaining local services from Southwestern Bell and other independent local phone companies operating in Kansas. Rates for local services will be rising rapidly as a result of divestiture and loss of A.T.&T. subsidies. Control of rising costs for the largest segment of the telecommunications budget cannot be readily achieved as rates are set by the Kansas Corporation Commission for all users. Therefore, any significant savings must be realized in C.P.E. and long distance services.

(2) Customer Premises Equipment (26% - \$4 million)

C.P.E. costs are 26% of state telecommunications expenditures, or about \$4 million. Although the state has begun purchasing some C.P.E. in recent years, most C.P.E. used by the state is leased from Southwestern Bell.

Due to divestiture and deregulation, the state must acquire its C.P.E. over the next one to five years, and must do so under competitive bidding statutes, beginning in FY 1984. The acquisition of C.P.E. has the potential for producing significant savings in future telecommunications costs due to the economic advantages of owning over continuous lease. When compared to the costs of continued leasing, the purchase of eight PBX systems since 1981 is expected to result in a net savings to the state of \$1,237,455 over the first five years of ownership. (See Attachment 3.)

The need to acquire C.P.E. is imminent and independent of the decision to implement the state plan. However, systematic, planned acquisition of C.P.E. is necessary to assure: (1) an integrated C.P.E. system designed to meet long-term needs; (2) lower overall acquisition costs through use of quantity prices; and (3) the avoidance of multiple service and vendor contracts. The C.P.E. and switching component of the state plan constitutes such a coherent, thoughtfully designed plan. It can serve as a framework for acquisition of C.P.E. following divestiture and deregulation. The Department of Administration recommends that the acquisition of C.P.E. and switches proceed according to the state plan. As the acquisition of C.P.E. proceeds, the state will be able to realize substantial savings in this area.

(3) Long Distance (36% - \$5.5 million)

Long distance services total 36% of state telecommunications expenditures, or about \$5.5 million. If the current methods of delivering long distance services to Kansas state government are maintained, A.T.&T., rather than Southwestern Bell, will provide most long distance services. While traditional direct dial rates may decline, TELPAK, a private line bulk rate that forms the basis of KANS-A-N, will be discontinued. For this reason, the costs to the state for long distance rates can be expected to rise in the future. Currently, there are no viable competitors to A.T.&T. in Kansas that could provide long distance services of the magnitude required by the state. Therefore, the only way for the state to significantly reduce future long distance costs is to install its own transmission system between the major points in the state system, as described in the state plan.

The acquisition and installation of C.P.E., now made necessary by divestiture and deregulation, represents the largest segment of costs associated with implementation of the proposed state plan. C.P.E. currently in use by the State of Kansas has a

present replacement value of approximately \$33 million. The purchase and installation of the transmission segment of the system would cost a little under \$12 million. These portions of the state plan offers the greatest potential for reduced reliance upon regulated telecommunications providers and thus greater control of state telecommunications costs. In addition, the design of the system would allow the provision of enhanced services as needed in the future, particularly in the transmission of data and video signals.

The Department of Administration believes that the state telecommunications plan is the only prudent means to minimize future costs for telecommunications services while providing for the growing telecommunications needs of Kansas state government. All cost-benefits studies of the plan have concluded that it would be the most cost-effective means to provide present and future telecommunications services for the state.

In order to begin implementation of the plan, the Department of Administration proposes to:

1. Proceed with preparation of final design and specifications in FY 1984. For this purpose, an appropriation of \$450,000 is requested;

2. Purchase and install C.P.E., and switches and fiber optic links, for the major-use areas of Topeka, Wichita, and Kansas City during FY 1985 and 1986. Projected capital outlay for this phase of the plan is \$18.8 million; and

3. In two succeeding phases, bid and install the remainder of the system from FY 1986 to FY 1989. Projected capital outlay for the final two phases is \$7.5 million.

Other than the initial \$450,000 required to complete design of the system, the entire telecommunications system will be financed through user service charges. The Department of Administration anticipates that those user charges will be at least comparable to, and probably lower than, the projected costs of continuing to rely on regulated providers.

With a firm legislative commitment to carry out the entire state telecommunications plan, the purchase of C.P.E. can be effectively coordinated with the transmission component of the plan. Approval of the plan as a whole will provide a framework for decisions about the purchase of C.P.E., a means to establish greater control over future telecommunications costs, and a cost-effective method to take advantage of technological advances in the telecommunications industry.

PROVIDERS OF TELECOMMUNICATIONS SERVICES

Prior to Deregulation/
Divestiture

After Deregulation/Divestiture

C.P.E. (includes PBX or on-site switches)

--SWB & emerging competitors provide CPE.

--Existing CPE: SWB may sell or lease through 1983, or until depletion of existing inventories. SWB expects to run out of CPE in a few months. Existing CPE will be transferred to AT&T books for phase-out. If FCC approves earlier deregulation, AT&T would "flash-cut" existing CPE in early 1984.

New CPE: Provided by AT&T's American Bell and competitors.

--SWB required by AT&T to purchase CPE from Western Electric.

--SWB cannot enter new CPE field until after 1/1/84. SWB cannot manufacture CPE or purchase from AT&T.

--CPE generally leased, although purchase has been possible in last few years.

--User acquisition of CPE at some point appears inevitable.

Local Exchange/Basic Services

--SWB, as an AT&T subsidiary, & scattered independent companies provide local service.

--SWB as an independent, fully regulated utility, and scattered independent companies continue to provide local service.

Prior to Deregulation/
Divestiture

After Deregulation/Divestiture

Long Distance Services

--AT&T (Long Lines Div.) & emerging competitors provide interstate services.

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--Long lines & competitors provide some intra-state services; bulk of intra-state services provided by SWB.

--Provision of intra-state services unsettled. Development of "Local Access & Transport Areas" or "LATA's" proposed. Kansas would have 3 LATA's roughly corresponding to current area codes. SWB may provide intra-LATA service; AT&T could provide inter-LATA service. Competitors unaffected by LATA's.

--SWB receives subsidies from AT&T Long-Lines. These subsidies have been used to help support local operations & keep local service charges down.

--SWB will lose subsidies from AT&T. Institution of "access to long distance" charges to compensate. Proposed rate: \$4/month/line with regular increases over 7-year period.

Enhanced Services

--AT&T/SWB prohibited from participating in certain unregulated areas such as data processing services.

--AT&T free to enter previously restricted areas with other competitors. May now manufacture & sell computers. SWB still barred from these areas.

<u>Type of Service</u>	<u>Regulatory Authority</u>	
	<u>Prior to Divestiture and Deregulation</u>	<u>After Divestiture and Deregulation</u>
C.P.E.	KCC	<u>New C.P.E.</u> Deregulated <u>Existing C.P.E.</u> KCC regulates as long as existing C.P.E. remains on AT&T books AT&T has requested FCC approval of earlier deregulation of existing C.P.E.
Local Exchange/ Basic Service	KCC	KCC
Long Distance Services	FCC regulates inter-state toll services KCC regulates intra-state toll services	FCC regulates inter-state toll services KCC may continue to regulate some or all intra-state or intra-LATA toll calls; FCC may pick up some or all intra-state or intra-LATA services.