Approved: 2-9-95
Date

MINUTES OF THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT

The meeting was called to order by Chairperson Bob Miller at 3:30 p.m. on February 8, 1995 in Room 423-S of the Capitol.

All members were present except: Rep. Nancy Kirk - excused
Rep. Kent Glasscock - excused
Rep. Kenneth King - excused
Rep. Greg Packer - excused

Committee staff present: Lynne Holt, Legislative Research Department
Bob Nugent, Revisor of Statutes
Bonnie Fritts, Committee Secretary

Conferees appearing before the committee: Susan Seltsam, Chair, Kansas Corporation Commission

Others attending: See attached list

The meeting was called to order at 3:30 p.m. by the Chairperson Bob Miller. The minutes of February 7, 1995 were distributed and approved.

Susan Seltsam addressed the committee regarding telecommunication competition and universal service (Attachment 1). A report was submitted detailing major matters before the Commission along with an executive summary (Attachment 2).

Meeting was adjourned at 3:50 p.m.

The next meeting is scheduled for February 9, 1995.

HOUSE ECONOMIC DEVELOPMENT COMMITTEE
GUEST LIST

DATE: 2-8-95

NAME	REPRESENTING
Roger Courtois	Sen. Janis Lee
Roger Franzke	KS Gov. Consulting
C. Skinner	KCAH
STEVE KEARNEY	KINI L.C.
Bob Courtney	Leadership Sumner County
James Crawford	Intern Rep. Wells
Doug Smith	SITA
Matt Holtt	KCC/Student
Charolette Shield	Intern for Rep. Al Lane
MARK J. Powell	Rep. BEGGS
JEFF RUSSELL	SPRINT/UNITED
DAVID B. SCHLOSSER	KCC
Michael Cmund	CGI / CompTel-KS.
Steva Powers	MCI
MIKE REECHT	AT+T
Penny Sue Johnson	KAPs Advisory Council, The Ks Coalition Inc
DENNY KOCH	SWB TEL.
Jack Alexander	KCC
Whitney Damron	Pete McGill & Associates
Mark Barcellina	KDOC+H

HOUSE ECONOMIC DEVELOPMENT COMMITTEE
GUEST LIST

DATE: 2-8-95

NAME	REPRESENTING
David Brevitz	KCC Staff
Don Low	" "
Mike Montero	State Keznney

Text of legislative testimony for
Kansas Corporation Commission Chair Susan Seltsam
in the House Economic Development Committee
regarding telecommunications competition
and universal service

I am pleased to present a progress report on the telecommunications study the Kansas legislature directed the Kansas Corporation Commission to undertake in Senate Concurrent Resolution 1627.

I would like my testimony to bring an understandable summary to the weighty volume the Commission recently presented to the chairs of the House and Senate committees.

Most policy issues before the Commission directly affect all Kansans, and involve highly complex legal, economic, accounting, and regulatory matters. Many of those matters are open to different interpretations by different parties, and it falls to the Commission to resolve such differences in a manner that protects the interests of all the parties.

Telecommunications policies may exceed the complexity of typical issues because of:

- dramatically and rapidly changing technologies;
- the size and influence of traditional providers;
- the size and aggressiveness of alternate providers;
- the increasingly indispensable role of telecommunications in our lives; and,
- Federal legal and judicial orders.

The Commission's responsibility, within the context of all this complexity, is to balance the needs of Kansas consumers with the needs of current and potential providers of telecommunications services.

To fulfill that responsibility, and to meet the charge presented to the Commission by SCR 1627, the Commission undertook a series of docket hearings that began in early 1994, and will conclude in late 1995. As with all issues before the Commission, the Commissioners and their staff have made every effort to solicit ideas, opinions, and positions from the broadest range of interested parties, so the resulting orders will reflect the best possible decision for all Kansans. The report I presented to your chair details the range of those interests.

HOUSE ECO. DEVO.
2-8-95
ATTACHMENT 1

The Commission first examined the regulation of long-distance services, as reflected in the first section of the Executive Summary, relating to what we call inter-LATA interexchange carriers and resellers. Most humans refer to those animals as AT&T, Sprint, and MCI, among others. We found that, contrary to conventional wisdom, the long distance market is not fully competitive. So, while we pursued the conventional wisdom course of deregulation and competition by streamlining our reporting requirements, the Commission maintained its right to review tariffs -- the agreements telecommunications companies have with the people of Kansas, which the KCC maintains and monitors -- in order to protect Kansas consumers.

Long distance, however, is a relatively minor aspect of telecommunications when it comes to reasons the Legislature and the Commission are exploring the issue. When most people think of telephones, they think of a dial tone -- a gateway to their friends and community, and a necessary tool in case of an emergency. The best way to insure that everyone has access to at least some level of telephone service was the subject of the Commission's investigation into universal telecommunications service, Kansas' telecommunications infrastructure, and quality of service standards. The parties who responded to the Commission's request for testimony suggested a broad range of services that should be available to all Kansans, and a variety of methods of financing the guarantee of those services.

Under traditional regulatory plans, the Commission used its authority to regulate monopolies to support basic residential service through such methods as higher-than-cost rates for businesses and for such exotic, non-essential services as call waiting, call forwarding, and caller ID. Those of you with teenagers at home may not consider any of those services non-essential, but traditionally those services carried higher profit margins, and the difference paid for lower-than-cost rates for basic residential service.

However, traditional methods of subsidizing low residential telephone rates -- particularly in rural Kansas -- are disappearing as competition in telecommunications erodes profit margins and limits the ability of competitors to charge prices that do not accurately reflect costs.

As non-traditional providers of telecommunications services -- such as cable and direct-broadcast satellite television companies, cellular phone companies, new and existing smaller competitors that can exploit technologies that are rapidly dropping in price, even your electric company -- enter the business, they naturally look for the highest profit-margin areas of service, because that's where they can be most competitive, and get the most business. I'm sure you are familiar with the term cherry-picking -- taking the most lucrative business aspects of a market, and leaving your competitors with less desirable features.

This is a normal part of doing business . . . except for regulated monopolies, which our society has decided have an obligation to serve the people of Kansas. For a monopoly provider of telephone service, who traditionally subsidizes low residential rates with more expensive services, losing the more expensive services means there is less money -- or no money -- to support basic telephone services.

That scenario is why the Legislature and the Commission launched a general investigation into competition within the telecommunications industry in Kansas. The Commission divided the investigation into two parts: Phase I will address general and policy-related questions, while Phase II will explore issues of implementation of the policy decisions made as a result of our Phase I findings. The Commission is in the midst of completing Phase I, with a final public meeting on the issue tentatively scheduled for February 8, 1995, before the Commission will issue an order regarding Phase II. The Executive Summary contains the explicit details of the Phase I testimony in the body of the report, so I will briefly cover them here before making myself available to answer your questions:

There is now general agreement among most parties to the hearings that competitive entry into all aspects of the telecommunications industry is in the best interests of Kansas consumers. Competition requires that, to the extent possible, the prices for services accurately reflect their actual costs. Therefore, the desire for competition challenges a more important goal: the guarantee of universal access to affordable, basic local telephone service.

Such basic service probably includes a dial tone, connection to the consumer's long distance company of choice, listing in the white pages, and 911 service, to name a few of the options discussed in our hearings.

There will always be some geographic or business areas of the market that will not attract competition. Given the dramatic changes in technology and Federal rules, it is not entirely clear what those areas will be . . . and that situation is likely to prevail for the future. The Commission's role in these circumstances will be to balance the needs of consumers and businesses as it always has. However, during the transition to competition, and in areas where some, or less-than-perfect, competition exists, the Commission must carefully consider its role and the funding mechanisms to guarantee affordable local service.

The Commission recognizes that, under conditions of technological change and greater competition, we can more effectively discipline competitive market forces by competitive pressure in concert with some regulatory oversight, than by regulation alone. These demands call for alternate regulatory plans, which the Commission and its staff will more thoroughly analyze in Phase II of the investigation. Meanwhile, participants in the competition docket proposed a variety of methods to classify levels of competitiveness in markets, and to identify existing barriers to effective competition.

Parties to the hearing identified at least 15 barriers to entry into telecommunications markets, among them: number portability, or the ability to use your existing phone number if you change carriers; interconnection issues, such as the ability to conveniently call both locally and long distance, even though you may be calling people serviced by another carrier; and, the use of rights of way and easements by competitors. The Commission believes industry task forces should -- and can -- resolve many of these issues by reporting their findings to the Commission during Phase II hearings.

The Commission will then be able to address, through regulation or proposed legislation, the needs of Kansas and any further measures that aim to complement the goals of universal service and the consumer benefits of enhanced competition.

Mr./Madame Chair and members of the committee, thank you for the opportunity to share our progress in the investigation of competition in the Kansas telecommunications industry. The other Commissioners and I, and the staff of the Kansas Corporation Commission, look forward to completing our study, and using the findings to expand the range of services available to Kansans throughout the state.

Report to the Kansas Legislature
by the Kansas Corporation Commission
Regarding the State of Telecommunications Competition
and Universal Service

January 30, 1995

EXECUTIVE SUMMARY

The Kansas Corporation Commission has furnished to the Chair of each committee designated by Senate Concurrent Resolution 1627 a full copy of this Report. Additional copies of that full report are available on request. The structure of the Report provides information in increasing levels of detail. This Summary is the first level, then there are general and more detailed levels in the Report, along with attachments.

General Investigation Into Revised Rules and Regulations Governing InterLATA Interexchange Carriers and Resellers (Docket 187,168-U)

The Commission, in an Order dated March 21, 1994, modified its regulatory practices regarding intrastate long distance companies. Certification, annual reporting, and tariff requirements were simplified. However, tariffs are not insulated from review. Geographically deaveraged rates continue to be prohibited by the Commission. Promotions may not be offered for only one customer. The Commission did not find that the long distance market in Kansas is fully competitive. The Commission expressed concern about the recent trend of the major IXCs to increase rates in lockstep.

General Investigation Into Competition Within the Telecommunications Industry in Kansas (Docket 190,492-U)

I. **Phase I.** Parties to this proceeding included large and small long distance companies, large and small local telephone companies, consumer groups, Cable TV companies, new competitors, and, Commission Staff. Certain issue areas were addressed by the submission of **written comments,** and others were addressed by **written testimony**. The Commission split the proceeding into two phases, with Phase I addressing more general and policy-related questions. Phase II will address implementation considerations subsequent to Commission findings in Phase I. Phase I hearings were held from November 28 to December 5, 1994, for the Commission to receive testimony regarding the following issues in Competition in Telecommunications. There were varying positions among parties. Some of the significant points were:

   A. **Public interest considerations for increased competitive entry**. There was some consensus that the Commission find that it is in the public interest to allow competitive entry in all segments of the telecommunications industry, including the local exchange market, provided that appropriate mechanisms and procedures are instituted to encourage and allow the development of effective competition, and ensure and promote reasonable rates, efficient and sufficient services and universal service. In order to allow time to address the goal of universal service, the Commission should only authorize increased competition for switched local services in Southwestern Bell Telephone Company (SWBT) territory prior to February 1, 1997, if: 1) an application to provide such service is found to be consistent with the public interest, taking into account the then current status of new universal service mechanisms; and, 2) the applicant is found to possess the necessary technical, financial and managerial resources. Because in service territories of other local exchange companies (LECs) the potential for effective competition is not as apparent and universal service issues may be more difficult to address, the Commission should not necessarily authorize competition that soon for those territories.

   An alternate position to assure the continuation of universal service and carrier of last resort obligations was that another mechanism must be in place of the current supports to local residential rates, prior to authorization of further competition in local markets.

HOUSE ECO. DEVO.
2-8-95
ATTACHMENT 2

One overall view expressed was that universal availability of affordable local service is the necessary foundation upon which all telecommunications regulation must be built.

B. **Effect of competition on universal service.** There was significant belief that the Commission should find that universal service continues to be a fundamental policy goal. To make a network available to all customers, local exchange rate levels have been supported by revenues and practices such as ratemaking rules, interstate and intrastate access charges, geographically averaged toll rates, Yellow Pages revenues, and explicit supports like the Universal Service Fund and "Link-Up" programs. Most parties agree maintaining the present support system is not a sustainable option for supporting universal service goals in a competitive environment. New universal service mechanisms are needed that will be competitively neutral and compatible with local exchange competition. However, the Commission should also prevent erosion of the network subscribership and reasonable prices during the transition to competition.

SWBT believes that universal service support must be addressed in advance of allowing competition. SWBT estimates its universal service obligation, not recovered in local rates, to be approximately $128 million.

C. **Implications of competition and technology for rate and tariff structure.** Some agreement exists that the Commission should find that in order to encourage competition, prices for telecommunications services need to reflect the cost of services, to the extent reasonable. Phase II of this docket should therefore include a review and analysis of the cost and pricing of telecommunications services for purposes of possible rate restructuring ("rebalancing"). Any rate restructuring would also reflect possible new mechanisms for cost recovery to promote continuation of universal service.

SWBT set forth a framework to recover universal service support and stated significant changes to residential rates should not be contemplated at this time. SWBT's framework included the pricing flexibility for a LEC to geographically deaverage toll and access rates, restructure intralocal support flows, bulk bill its competitors for accelerated capital recovery for LECs who are carriers of last resort. Also explicit support may be required for interservice support. SWBT suggests competitors could recover the funding amount from a customer surcharge to its customers.

D. **Effect of competition on regulatory focus**. Under conditions of technological change and greater competition, market forces can be disciplined more effectively by competitive pressures in concert with some regulatory oversight, than by government control and regulation alone. Specifically, during transition from monopolistic to competitive conditions, care must be taken to minimize any uneconomic market distortions caused by government regulation, and maximize the potential benefits from increasing competition. There can be less emphasis on traditional rate base/rate of return regulation, and greater emphasis on the economics of the industry, including incremental costs and prices. The need to consider engineering and economic matters will increase, at least through what could be an extended transition period. For example, engineering or technical matters will include interconnection. Economic matters will include determinations about what constitutes relevant markets and effective competition therein, conducting appropriate long run incremental cost of service studies for use in pricing, and ongoing monitoring of concentration in various markets.

The Commission should find that alternative regulatory plans may be desirable in an increasingly competitive environment. SWBT indicates that historic rate base/rate of return regulatory policy is no longer appropriate because telecommunications markets are no longer a stable environment. The Commission should implement a permanent change to price regulation for SWBT; price regulation is appropriate for non-competitive services in the Kansas telecommunications markets.

E. **Effect of competition on obligation to serve and investments.** Staff recommended, until such time as effective competition has developed, the Commission should have a rule against abandoning a customer or territory, thereby leaving no other provider to offer service to customers. Staff recommended the Commission should not allow revenue replacement for incumbent LECs if they lose business to competitors, or equivalently, the Commission should not guarantee recovery of investment stranded by competition. Another position on the issue was that authorization of competition for rural local exchange service, if granted, must be subject to a mechanism providing the existing company continued opportunity for recovery and return on investments made in reliance on present policy.

F. **The structure and sustainability of competition in telecommunications markets.** There is agreement that some level of alternate telecommunications service provision will occur in Kansas. Some parties argue that the emergence of powerful competitor and market forces have swept away the "natural monopoly" of local exchange service. Significant differences exist however regarding the depth, pace of development, and impact on prices of such competition. For example, it is not at all clear that competition is or would be sustainable in the rural areas of Kansas. As another example, it is agreed that Personal Communications Service (PCS) spectrum is being auctioned by the FCC and will attract substantial bids from large players. However, there is not agreement regarding the consequences of this. Systems will take time to build out, and there are still some technological issues to be addressed. Pricing and "mass market" appeal will not firm up until those matters are closer to resolution. Cellular telephone service does exist today, and is popular. Given current prices and quality however, its use appears to reinforce and complement the landline telephone network, rather than directly compete with it. There are indications of intent and ability for cable TV systems to be converted to allow telecommunications use. The depth of subscriber willingness to switch from the local telephone company to the CATV company for telephone service is not clear at this time. Competitive Access Providers (CAPs) exist in Wichita (Multimedia Hyperion) and Kansas City (Kansas City Fiber). Also, Metropolitan Fiber Systems has an application pending to serve the Kansas City area. CAPs generally provide high capacity dedicated lines to large entities such as interexchange carriers. Many CAPs are affiliated in some way with CATV companies, and have indicated interest in providing switched telecommunications services. Electric companies generally have substantial internal communications networks, and a "wire" to most customer premises. Accordingly, some electric companies around the country and in Kansas have some level of interest in the telecommunications business. The conditions and timing of their entry appears the least clear of the potential entrants. Overall, there is no effective competition in the local exchange today.

There are strongly held differences as to whether or not "potential" competition equates to effective competition. The issue is whether the potential for competitive entry alone can discipline incumbent behavior and ensure reasonable prices.

G. **Evaluating the level of competition for each service, corresponding regulatory classifications to be used, and appropriate regulatory requirements for each such classification.** Several proposed classification methods were identified in the hearing. They are:

1. Non-Competitive/Potentially Competitive/Competitive
2. Essential/Potentially Competitive/Competitive
3. Non-Competitive/Competitive
4. Discretionary Services/Non-Discretionary Services, with Non-Discretionary Services further subdivided between Competitive/Non-Competitive.

Other recommendations include:

The Commission should maintain its ability to review LEC costs to determine if rates are just and reasonable.

Regulation of SWBT should be commensurate with its degree of market power. The Commission should audit any incumbent LEC seeking price regulation and adjust current rate levels downward if necessary to ensure that the starting point of the price regulation plan does not build-in excessive profits. The Commission should weight the relative merits of pure price caps versus price caps with sharing of excess earnings. The Commission should adopt a productivity factor that reflects the full expected level of average annual LEC productivity gains under price regulation. Ratepayers should receive the full benefits of savings associate with increased productivity.

"Discretionary services" should be regulated by market forces to the maximum extent possible. Local switched residential and business service is not currently competitive; for any other service the service will be deemed competitive in certain geographic areas upon a showing by a provider that there are one or more alternate suppliers offering an effective substitute, considering its features and prices, in those areas. Price regulation with price caps eliminates any incentive to cross subsidize or to price below incremental costs of service. The rate should be capped and subject to an adjustment/index factor change. The price plan should also include pricing flexibility to enable LECs to meet specific targeted sub-markets selected by competitors who do not have statewide service obligations. Price regulation should not include any sharing functions or a periodic re-evaluations of rates or the price regulation formula based on earnings.

H. **Specific Pricing or Tariff Practices**, including Individual Case Basis (ICB). Some argued that ICB pricing could produce efficiencies that would benefit all customers. A reduced rate may keep some customers on the system, making at least a partial contribution to common costs. Others recommended that the Commission not allow ICB pricing for LECs at this time, since no LEC has been shown to be other than a dominant carrier, and no markets have yet been determined to be competitive. If ICB is used by a dominant firm, such price discrimination is harmful, because it leads to arbitrary price differences not based on costs, and it can forestall possibly efficient entry.

I. **Existence of barriers to entry and exit.** There has been extensive discussion regarding barriers to effective competition perceived by potential providers of telecommunications services. At least fifteen barriers to entry have been identified in the general areas of: Interconnection of Competing Networks, Telephone Numbering Resources and Portability, Pricing and Compensation issues, Policy issues, and Market Power issues. Although not all parties agree, there is substantial belief that these barriers must be addressed if effective competition is to be promoted in Kansas. It was recommended that these barriers be addressed in Phase II, and that industry Task Forces be utilized to the greatest extent possible in resolving barrier issues.

II. **Phase II.** The Commission will explore implementation issues such as: service pricing, universal service support mechanisms, and potential rate rebalancing; costing and cost study policy; network interconnection matters (including tariffs, standards and procedures); resolutions regarding barriers; and changes to local resale and sharing restrictions.

General Investigation Into Universal Service, Telecommunications Infrastructure, and Quality of Service Standards (Docket 191,206-U)

The 1994 Telecommunications Infrastructure Study compiled by Staff with the assistance of the industry shows:

Kansas has a very high penetration level for local telephone service. More than 96% of residences and businesses in Kansas have local telephone service. This ranks among the best in the United States. The state is 96% served by digital or electronic central offices (on an access line basis). 99% of customers are served with one party service. 100% are served with "Touch Tone" service, with 86% actually subscribing. The rural nature of Kansas is shown by the fact that 53% of the wire centers in the state serve 5% of the state's total access lines. From the other direction, 7% of the wire centers (the metropolitan ones) serve 49% of the state's subscribers.

Within the filed comments of parties, there was varying discussion of the actual definition of Basic Service, with components identified by the parties collectively (but not necessarily individually) as follows:

A. Local Dial Tone (voice grade), single party, digitally served
B. Standard white pages listing
C. Standard intercept service
D. Access to/Availability of **or** Inclusion of:

   1. Local Calling or Usage (limited or otherwise)
   2. 9-1-1, operator, directory assistance, and relay services (for the speech and hearing impaired)
   3. Tone Signalling ("TouchTone")
   4. Access services/Access to a chosen long distance carrier

E. Other similar elements or capabilities suggested include:

   1. Extended Area Service (grandfathered)
   2. Provision of a directory
   3. 900 services blocking available
   4. Transmission quality to support low speed data (9600 baud)
   5. Repair service
   6. Capabilities including: equal access to long distance providers and digital interconnectivity

There were a variety of comments regarding the definition of universal service and universal service objectives, and regarding what, if any, policies regarding modernization of facilities and services may be appropriate.

The need for quality of service standards may be proportional to the degree of deregulation of telephone companies. Experience in the fourteen states served by US West seems to indicate that service quality problems and response times seem to increase as companies undertake cost cutting measures that are encouraged in part by regulatory review of prices but not profits.