Approved: As distributed
April 3, 1998
Date

MINUTES OF THE SENATE COMMITTEE ON COMMERCE.

The meeting was called to order by Chairperson Alicia Salisbury at 8:00 a.m. on March 26, 1998 in Room 123-S of the Capitol.

Members present: Senators Salisbury, Barone, Brownlee, Donovan, Feleciano, Gooch, Jordan, Ranson, Steffes, Steineger and Umbarger.

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

Conferees appearing before the committee:
Jack Luschen, Citizen, Johnson County
Walker Hendrix, Counsel, Citizens' Utility Ratepayer Board
Shawn McKenzie, Southwestern Bell Telephone Company
Mike Reecht, Kansas Director, AT&T
Glenda Cafer, General Counsel, Kansas Corporation Commission

Others attending: See attached list

SB 666 - Telecommunications act; cost-based regulation; eliminating universal service requirements

Jack Luschen, Johnson County, testified in support of **SB 666** stating the sur-tax added to a telephone bill constitutes a tax on tax and taxes constitute 37% of the total bill. Mr. Luschen disputes rural areas being a higher priced area than urban areas due to land values and less population. Mr. Luschen submitted articles from the *Kansas City Star, Business Week* and letters from Senator Sam Brownback and Congressman Vince Snowbarger. (Attachment 1)

Walker Hendrix, Counsel, Citizens' Utility Ratepayer Board, testified in support of **SB 666** stating the 1996 Kansas Telecommunications Act. (KTA) created revenue neutrality, causing an increase in the bills of local service customers and cellular users. The KTA also resulted in the creation of the Kansas Universal Service Fund (KUSF); and with enhanced universal service, put into motion a system of charges which will be ever increasing.

SB 666 removes the revenue neutrality concept; removes the definition of enhanced universal service; gives the KCC authority to retain all of its regulatory authority when dealing with telecommunication issues; requires that any rate rebalancing be done only after an investigation of all rates and charges; deletes the requirement that the KCC cannot conduct an audit, earnings review or rate case; establishes consistency with FCC determinations on universal service requiring that the KCC conduct cost studies to determine the cost of universal service; and deletes infrastructure reimbursement and supplemental funding from the KTA, requiring that these items be funded in the discretion of the KCC as part of an exogenous component or rate case. (Attachment 2)

Mike Reecht, State Director for AT&T, testified in support of the concepts contained in **SB 666**; however, due to the complexity of the issues, there may be insufficient time for proper debate during this legislative session. Mr. Reecht testified in support of the KUSF being capped at its current 9.8% level on an interim basis until such time as the KCC completes audits to assure that rates and surcharges are based on costs before making the necessary modifications to the fund. Any surplus revenues in the current fund should be used to reduce access charges for intrastate rates in line with interstate rates, as required by the KTA to reduce access charges to the consumers. Mr. Reecht stated the KCC should be provided with the authority to freeze infrastructure deployment to insure the goals of enhanced service are cost effective. Mr. Reecht commented on the proposal that Sprint made regarding changing from an explicit charge to an implicit charge. Spring requested moving the support from the KUSF into their internal rates. AT&T believes that subsidies need to be explicit and they need to be portable. Section 254 of the Federal Acts state that subsidies need to be explicit. AT&T serves the customer, AT&T receives a subsidy. If Southwestern Bell Telephone Company

(SWBT) or Sprint serves a customer, SWBT or Sprint should receive the subsidy. This is how the Fund works today, on a portable and explicit basis. To change that would represent a major departure from existing policy. If the subsidy were implicit, as Sprint proposed, SWBT and Sprint would retain the subsidy even though they were not serving the customer who needs the subsidy, forcing the new competitor to seek a subsidy from the KUSF. The consumer, in effect, pays the subsidy twice, first to SWBT or Sprint because the subsidy could move internally into their rates, then secondly to the KUSF so that the competitor could offer a competitive service at a competitive price. Keeping the service and keeping the subsidy explicit and portable keeps the double recovery from occurring and ensures that the company who serves the customer receives the subsidy. (Attachment 3)

Shawn McKenzie, Southwestern Bell Telephone, testified in opposition to **SB 666** stating SWBT agrees with the testimony of both Carl Krehbiel and Ricahrd Lawson. (Attachment 4).

Mr. McKenzie recapped the history of TeleKansas I and II and the recommendations of the Telecommunications Strategic Planning Committee, the Consultant, Weber and Temin' and the Kansas Telecommunications Act (KTA) of 1996. The KTA clearly made price cap regulation a meaningful alternative for local telephone companies to promote a competitive marketplace and create investment incentives, while protecting consumers against cross subsidies. Price caps protect consumers against prices being set too high and protect against a company recovering competitive losses by raising other rates. Consumers served by a price-cap regulated company are doubly protected by the price cap regulation and competition. The KTA provided the necessary certainty regarding the regulatory environment for a company to make investment and other business decisions. A retreat from current policy would replace the structural form of price caps with regulatory review. Mr. McKenzie stated that in view of the present competitive environment, rate of return regulation is not now a viable regulatory mechanism. **SB 666** completely eliminates the pro-competitive, pro-investment, pro-consumer policies adopted in the KTA. SWBT does not believe legislation is needed.

Mr. McKenzie stated there have been two issues raised by consumers, the size of the KUSF and the assessment on cellular service. Mr. McKenzie proposed reducing the size of the KUSF from about $77 Million to about $39 Million by withdrawing the per line assessment (SWBT $2.00 and Sprint $1.35) as contributions to or withdrawals from the KUSF. The amounts that rural telephone companies have raised their rates to reach the statewide averagefor rural telephones would be treated similarly. Secondly, reduce the assessments for all carriers from about 10% to 4%.

Mr. McKenzie further proposed to offset future pressure to increase the KUSF by requiring the deployment of ISDN and broadband services only in order to meet a firm order; by deleting the pricing requirement for ISDN, and by deleting the requirement for 28.8 kb Internet access.

Glenda Cafer, General Counsel, Kansas Corporation Commission, stated she did not testify against enhanced universal service two days ago, rather testified in favor of deploying enhanced universal service in a fiscally responsible manner. Ms. Cafer stated it is not in the best interest of Kansas ratepayers to rebalance rates legislatively by shifting the SWBT and Sprint assessment out of the fund and into local rates. If the KUSF assessment decreases, customers of SWBT and Sprint will continue to pay the higher assessment because it will have been rolled into their basic local rates. Under the KTA, the KCC cannot lower the rates of a price cap company. Ms. Cafer stated the KCC staff has begun the process of making the KUSF cost based, and rebalancing rates based upon costs. The KCC staff proposal would lower the KUSF assessment rate from 9.89% to 6.8%, rebalance some of the fund to payphone rates. The KCC staff believes that the assessment can go even lower as it continues to get the KUSF cost based.

Ms. Cafer stated the only legislation the KCC believes is needed is that relating to enhanced universal service. The KCC suggests a working group be established which would study the issues concerning enhanced universal service and submit a report to the KCC. The KCC would submit the report, along with a recommendation, to the legislature at the beginning of the 1999 session. The KCC believes the deployment of enhanced universal service should be postponed for one year (from July 1, 2001 to July 1, 2002), and no payments made out of the KUSF until after the legislature takes action in the 1999 Session. Ms. Cafer stated the KCC has the authority to increase the basic local telephone rates of companies' whose present rates are below costs and unreasonably low.

The Committee adjourned at 9:15 a.m.

The next meeting is scheduled for March 27, 1998.

SENATE COMMERCE COMMITTEE GUEST LIST

DATE: March 26, 1998

NAME	REPRESENTING
David Dittemore	KCC
Jim Yonally	Cellular One
Jim Tackett	Southwestern Bell
Mark Caplinger	SITA
David Brevitz	
Terry Diebolt	SWBT
Denny Koch	SW Bell
Patrick J. Hurley	AT&T
John Petterson	CompTel
Ron Gaches	McGill & Asso.

The cost of service

KEVIN ANDERSON/The Star

Gus Meyer, president of Rau Construction Co. in Overland Park, has seen his company's phone bills increase $2,000 in the last year as the result of state legislation. Consumer complaints have prompted two days of hearings in Topeka.

Phone bills bring outrage

By ERIC PALMER
Kansas Business Editor

Gus Meyer, president of Rau Construction Co. in Overland Park, is not sure his company can afford competition in the telecommunications industry. He figures that his phone bill is up $2,000 in the last year as a result of legislation to deregulate local phone markets in Kansas.

"We consider $2,000 more than incidental. It is a good-sized lug," said Meyer, whose company has about 20 telephone, fax and computer lines. The company also uses extensive cellular service.

Under revised Kansas telecommunications law, Rau Construction pays a surcharge on each of those services.

Mounting up

Here's how much the Kansas Universal Service Fund has collected.

March 1997 through November 1997

Collected	**$63 million**
Spent	**$50 million**
In reserve	***$13 million***

"I was shocked at what it adds to our cell phone bills," Meyer said.

It has also shocked many other businesses and personal consumers who have inundated the Kansas Corporation Commission and some state legislators with complaints about the surcharge, which adds $2 for every telephone line and 9.89 percent to wireless phone charges.

Complaints prompted the Kansas Senate Commerce Committee to hold two days of hearings. On Thursday, Sens. Karin Brownlee of Olathe and Rich Becker of Lenexa, both Republicans, co-sponsored legislation that would effectively reduce the surcharge.

"I have a lot of concern about this," Brownlee said. "It is one of the top issues I have received comments from constituents on."

Senate Commerce Committee

Date 3-26-98

Attachment # 1-1 thru 1-18

Complaints follow deregulation of Kansas phone markets

Continued from B-1

areas of the state, where the costs might otherwise be unbearable for consumers.

The surcharges were slated to go higher this March, but the Kansas Universal Service Fund has been generating $1.4 million a month more than the state had estimated that it needed. There is now a $13 million reserve, so the state will reset rates at or below current levels, beginning next month.

Universal service has been public policy in Kansas since the 1930s. Until last year, however, universal service telephone fees in Kansas were paid from fees charged on long-distance calls and were not identified on bills.

The new telecommunications law reduced costs on long-distance calls and spread the cost of universal service among all telecommunications users, including wireless phone users, and the charges are now identified on bills.

Identifying those charges awoke a "sleeping dragon," said Jerry Lammers, managing telecommunication auditor for the Kansas Corporation Commission and architect of the universal fund. "The subsidy is no longer lost in a long-distance rate and some people are not sure whether that is a good idea."

The commission has received about 1,300 complaints since the charges have shown up on bills, Lammers said. People need to realize, he said, that the universal fund costs are being offset by lower long-distance rates and spread among more people. Big users of long-distance service are paying less than they were under the old system.

The initial battle

The Kansas skirmish over how those fees are figured and paid is just beginning for legislators in both Kansas and Missouri.

Missouri regulators this month adopted guidelines for setting up a universal service fund but have yet to debate over how the money will be collected and allocated.

For each utility opened to competition, consumer advocates say, there will be a debate over whether to create a mechanism to protect customers that nobody really wants to serve.

The debate stands to pit urban areas, which stand to gain the most from competition, against rural areas, which can be expensive for utilities to serve.

"This is just the initial battle over this, just the tip of the iceberg," said Walker Hendrix, counsel for the Citizens' Utility Ratepayer Board, a state-created consumer agency in Kansas.

The board has filed a lawsuit that challenges the way the state arrived at the surcharge fees. It won its case in lower court and the case is now pending before the Kansas Supreme Court, which has indicated that it will rule by March 6.

Kansas wrote its telecommunications bill in 1996 to bring state laws into compliance with new federal regulations.

State legislators agreed to let the local telephone companies shift the revenue they lost from long-distance access fees to local consumers to pay for universal service. They specified that the shift be "revenue neutral."

The legislation left to the Kansas Corporation Commission the task of deciding how much revenue was needed and how to collect those funds.

The commission estimated the phone companies had been collecting at a rate that would amount to about $106 million a year.

Programs for low-income and hearing-impaired consumers needed $5 million more. The commission initially determined that it needed to levy fees of 9.89 percent on cellular phone bills and charges of $3.21 per land line. The latter increase — from $2 per land line — would take place over three years.

With telephone service growing in the state, officials have determined they will not have to raise rates this year.

Complicated issues

Sen. Nick Jordan, Republican of Shawnee, said the Legislature decided to not reduce revenues for local telephone companies until it was clear how competition was going to play out. It was expected competition would reduce costs to all consumers. Jordan is on the commerce committee with Brownlee.

In its lawsuit, the Citizens' Utility Ratepayer Board argued that Kansas should have first audited the local companies to determine the specific costs of providing universal service. It argued that with technology reducing business costs, the local companies might not need as much as they had been getting under the old system.

Among other things, the legislation filed by Brownlee and Becker would require the audits of Southwestern Bell and United Telecom sought by the ratepayer board's lawsuit. Brownlee said the bill will not get any consideration, however, until the Supreme Court rules on the lawsuit.

Hendrix of the Citizens' Utility Ratepayer Board also warned the commerce committee that the Kansas law is too broad. He said it would allow telephone companies to install expensive "high-tech" telephone services in rural areas, then collect the expense from the Kansas Universal Service Fund.

"Unlike the Federal Universal Service Fund, the KUSF allows any telecom carrier to use the KUSF fund for virtually any construction, expense, loss of revenues with virtually no restriction on reason or purpose," Hendrix said.

'Plenty of complaints'

In addition to the lawsuit filed by the Citizens' Utility Ratepayer Board, AT&T's cellular company, Cellular One, filed a lawsuit in federal court, challenging the law and its inclusion of cellular phone companies in paying the surcharge. A federal district court ruled against Cellular One, which appealed the case to a federal appeals court, where it is pending.

Marc Elkins, Cellular One's attorney, told the Senate committee that the Kansas law is anti-competition. He claimed it protected the revenues of old monopolies while conflicting "with the public policies stated in (the law), which is to ensure that Kansans enjoy the benefits of competition."

Southwestern Bell and other telephone providers in Kansas have sided with the Kansas Corporation Commission in opposing the consumer board's lawsuit and audits of their operations.

Sandy Wagner, Southwestern Bell's executive director of regulatory matters in Kansas, said her company has provided the corporation commission with information on its costs of providing universal service. She said those costs are close to the $111 million the state intends to collect in 1998.

"The KCC sized the fund to be equal to the access reduction that local exchanges carriers made," Wagner said. "While it used that mechanism, the result is not all that far off from what was demonstrated as the cost of universal service. For our company, that is $107 million annually."

While the Legislature probably will wait for the Kansas Supreme Court ruling, Jordan is unsure if the Kansas law addresses the issues properly.

"I have been getting plenty of complaints to catch my attention," Jordan said. "Now that we have had the hearing, I have some concerns about the way the fees are being fixed."

Meyer, with Rau Construction, said he would be happy to address the Legislature if it again addresses the issue.

"I did some checking and we paid $2,300 last year in corporate income tax in Kansas," Meyer said. "We paid $2,100 into the universal fund. That is like taxation without representation."

STATE TAXES: A GUI

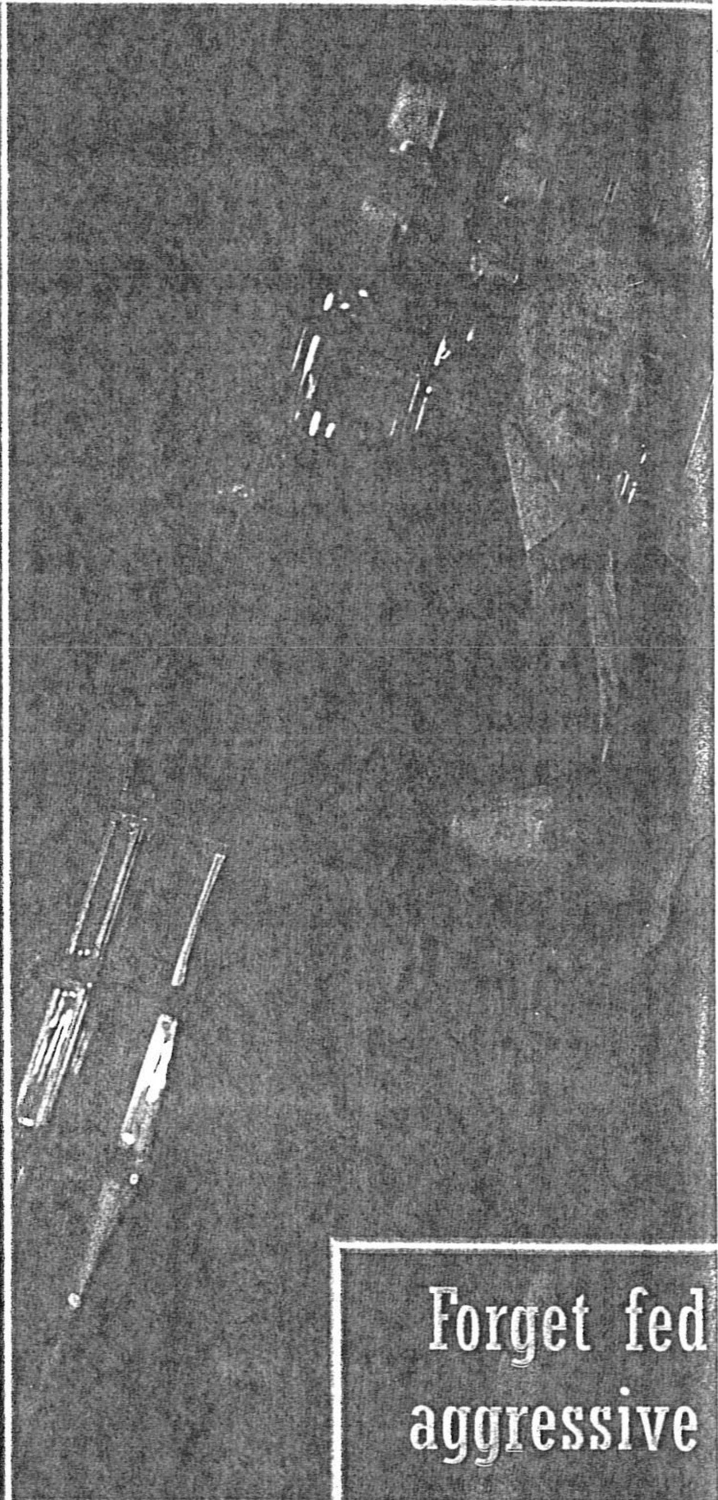
When Tenneco Inc. spun off its agricultural- and construction-equipment subsidiary, Case Corp., in June 1994, the new company's senior vice president and CFO, Ted French, knew from the start that Case's state tax payments might be substantial. Nevertheless, the $16 million that Case paid out to the states in its first full year took French by surprise. As a taxable spin-off, "we had to accept some handcuffs on our legal structures until January 1, 1997, to preserve federal and international tax benefits for Tenneco," says French. "But that doesn't mean we should be free game for state tax collectors."

A $5 billion company, Case had some heavyweight in-house talent to call on, including Steven Mielke, Case's director of federal and state taxes, and John Evard, vice president and general tax counsel. And they had plenty of options. Already the company has made preliminary moves, such as relocating some business operations out of high-tax states. And, Case could consider reducing franchise taxes by reorganizing its parent company and subsidiaries into different states; separating its operating entities according to profit levels to reduce income taxes; or even establishing a separate entity to receive intangibles income. "We have no shortage of ideas," says Mielke.

But the Racine, Wisconsin-based company still faces a major problem: how to implement a strategy that will not only reduce taxes, but will also withstand the rabid aggressiveness of state revenue departments. "We know we can manage our tax rate better," says Mielke, "but there's a lack of certainty right now about how states will treat particular structures and activities in future audits. So we're planning and documenting carefully. We just want to be ready for anything."

They need to be. Since the late 1980s, states have taken the offensive in expanding and enforcing their tax laws. Motivated by declining federal support and growing budget deficits, they have sought to close numerous "tax gaps"—the real and perceived amount of taxes owed each year that aren't collected. And given better trained audit agents and some creative legal minds, "states are doing the job they've been charged with," says George Bradford, director of taxes for U.S. Steel Group, in Pittsburgh, "and doing it better than they used to."

In fact, state taxes no longer take a back seat to federal tax concerns in terms of complexity or cost. "There are 50 states, most with three or four different taxes,



Forget fed
aggressive

BY IAN SPRINGSTEEL

1-3

"We know we can manage our tax rate better," says Case's Mielke. "But there's a lack of certainty about how states will treat particular structures and activities in future audits."

using 20 different models of taxation," explains John Forch, national partner for Coopers & Lybrand LLP's multistate tax practice. To complicate matters, says Michael Lippman, national partner in charge of state and local tax technical services at KPMG Peat Marwick LLP, due to a lack of legal precedent, "the states aren't just enforcing the rules, they are trying to enforce the rules as they wish they were."

The irony lies in the mixed message the states are sending: while state politicians and economic development officials bend over backwards to retain and attract employers, revenue commissioners are tracking down and squeezing corporate taxpayers for every available cent. According to a recent Coopers & Lybrand study, in fact, 58 percent of fast-growth companies saw their proportionate state and local tax bills increase by an average of 27.2 percent last year. And for all growth companies in the survey, state and local payments accounted for an estimated 22.2 percent of the total corporate tax payment, up from 19.2 percent in 1994.

In their defense, the states say they're only responding to the changing face of business. Over the past 50 years, says Harley Duncan, executive director of the Federation of Tax Administrators (FTA), in Washington, D.C., "sources of income and business practices have changed and the tax bases have been eroding. To do nothing would be unfair to the remaining taxpayers." As for the aggressiveness of their actions, the states make no apologies. Says Robert A. Judge, secretary of revenue for Pennsylvania, "The law is the law. Companies doing business in this state need to pay their fair share of taxes."

For companies, dealing with this increasingly unpredictable tax environment is akin to being attacked by a swarm of bees—you never know where you're going to get stung. Some states are clearly less predictable than others. According to an exclusive *CFO* survey of tax directors at the *Fortune* 100 and practice leaders at the top 10 accounting firms, the most capricious states are Louisiana, Massachusetts, California, Kansas, Pennsylvania, and New York (see chart, below). But the practices and theories of those states have been picked up by others, creating a corporate tax environment that is increasingly inequitable. The result, says Forch, is that "compliance, let alone planning, is very difficult, and companies are leaving money on the table."

The Nuances of Nexus

Companies are being stung most over issues of nexus—the amount or type of activity that gives a state the right to impose taxes. Certain states—Florida, Ohio, and South Carolina among them (see chart, page 30)—have become positively predatory about asserting nexus and demanding revenues. "They've realized that the payback on $1 in additional discovery and audit staff budget can be $5 or $10 in additional taxes," says Vincent Fong, vice president of tax at Levi Strauss and Co. "So why not go after it?" The result? According to a recent KPMG Peat Marwick survey, some 35 percent of CFOs and tax directors now say nexus uncertainty is their top state tax concern, outpacing apportionment and audit concerns.

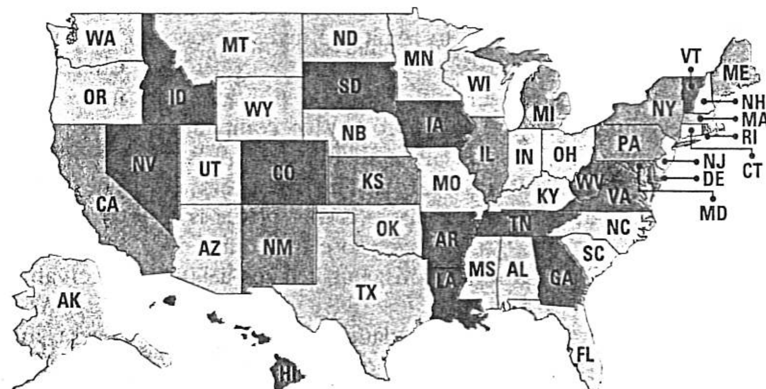
For years, states have relentlessly tried to lower nexus thresholds. In one early gambit, many states insisted that remote sellers, such as mail-order companies, should remit sales taxes simply because they targeted a state's market. In the now-famous 1992 decision, *Quill Corp.* v. *North Dakota,* the U.S. Supreme Court ruled that physical presence is required to create sales tax nexus. But the enthusiasm of tax collectors has hardly diminished, and confusion has ensued.

Recent court decisions have interpreted *Quill* in ways that have raised the nexus bar in some states, while

CFO STATE TAX SURVEY

Whose Tax Environment Is Fair?

A fair and predictable tax environment allows companies to plan and file with certainty. But respondents believe regulations and interpretations in several states lack definition. They ranked tax environments on a scale of 1 (fair and predictable) to 5 (unfair and unpredictable).



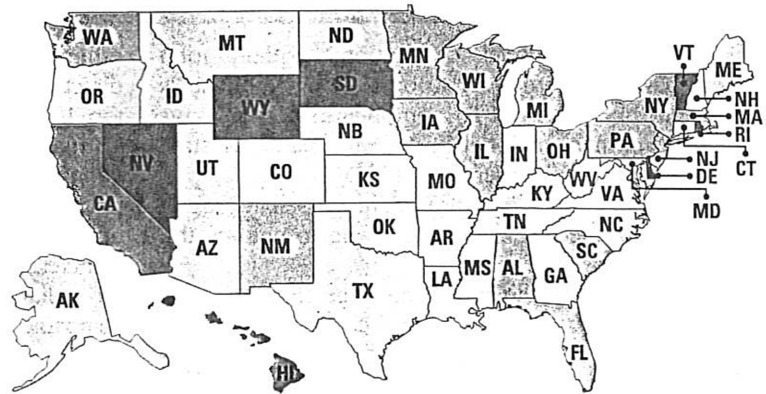
Where To Expect The Unexpected

Louisiana: 4.09
Massachusetts: 3.89
California: 3.79
Kansas: 3.70
Pennsylvania: 3.67
New York: 3.58

CFO STATE TAX SURVEY

WHO WANTS YOU ON THEIR TAX ROLLS?

States interpret nexus with differing levels of assertiveness. Some try to beef up their tax rolls in unconstitutional ways. Others use such practices as nexus questionnaires, outsourcing, and out-of-state audits. Survey respondents ranked states' use of nexus on a scale of 1 (not aggressive) to 5 (very aggressive).



WHERE NEXUS WILL GET YA

California: 4.15	South Carolina: 3.71
New York: 3.74	Florida: 3.58
Ohio: 3.74	Massachusetts: 3.57

lowering it in others. For example, more than a few visits a year by sales or service people into New York is now enough to incur sales tax nexus there, according to the New York Court of Appeals. But in Florida, three days at a trade show isn't enough to trigger tax, according to a state Supreme Court decision in *Share International* v. *Florida Dept. of Revenue*.

"For both states and companies, defining nexus is like trying to put your finger on a drop of mercury," says William McArthur, president and executive director of the Committee on State Taxation (COST), a lobbying and planning group based in Washington, D.C. "Just when you think you have it, it slips away."

Slippery definitions of nexus, however, have allowed states to explore numerous avenues in pursuing out-of-state companies. Many states, for example, now send nexus questionnaires to out-of-state businesses they discover through audits of in-state businesses, run out-of-state discovery and audit offices in major business hubs, and occasionally trade information with one another. For instance, the six states in the Great Lakes States Compact automatically query audited companies on nexus in the other member states. Even more drastic, a handful of states, including Pennsylvania and New Jersey, outsource discovery and collection work to out-of-state law and CPA firms—often referred to as "bounty hunters." And states with a heavy reliance on sales/use taxes, such as Florida, have turned up the heat on resident companies to remit use taxes on out-of-state purchases.

As Pennsylvania's Judge says, "We need to continue to be very aggressive in our discovery of companies with a presence in the state." That should be expected of any good tax administrator. The problem in Pennsylvania and many other states is that nexus isn't defined in regulations. "We're trying to clarify our definition and write nexus regulations, but it takes a little time," says Judge.

Yet, with or without clear regulations, once a state claims nexus, it is reluctant to let go. Take the experience of Atmel Corp. in Ohio: Five years ago, the semiconductor maker closed its sales office in Columbus, moved all assets and payroll out of state, and contracted with an independent firm to sell its products in Ohio, where sales amount to about $5 million a year. Atmel's finance and tax manager, Andy Wong, concluding the company no longer had nexus, stopped filing income and franchise tax returns in the state. But the Ohio Revenue Department insists that Atmel pay franchise taxes for 1992 onward, asserting that physical presence is not necessary to trigger franchise tax nexus. "They keep writing us letters demanding that we file, and we keep writing back explaining that we don't have nexus," says Wong.

To its credit, the Ohio Department of Taxation wants to make its tax structure more friendly to business. In fact, the department commissioned a study that suggested the elimination of the franchise tax. But until that happens, "the franchise tax is a privilege tax, and isn't protected by the same shield as the income tax," says John P. McAndrew, administrator of Ohio's income and franchise tax audit division.

Wong characterizes the whole experience as "harassment," and says, "it has tainted our view of locating operations in Ohio." His attitude is not unique. According to the *CFO* survey, state tax policies have a negative influence on location and expansion decisions in many states, especially California, Pennsylvania, and Louisiana (see chart, page 34). "Business decisions come first," says Atmel CFO Kris Chellam, "but if we can act in a neutral way that minimizes any tax, we'll do it."

Questions Over Intangibles

The fiercest nexus battles, however, are being waged over intangibles income—from both the sale of services and the use of intangible assets such as accounts receivable, patents, trademarks, and computer software. Asserting that *Quill* applies only to sales/use tax nexus, and that federal law offers some income tax protection for companies selling only tangible goods, some states now claim that income from intangibles

1-5

Atmel's Andy Wong and Kris Chellam

used in their states creates "economic nexus"—a virtual presence—for income taxes and franchise taxes. And they are taxing companies through "legislation, policy decisions, and audit positions," says Mary Jane Egr, national coordinator of state and local tax for Grant Thornton LLP. "It's all over the map."

Financial service providers, for example, are now subject to income or franchise tax in eight states that have adopted legislation that requires no physical presence and only a minimal economic presence. In Massachusetts, for example, banks or other lenders with as few as 100 customers or $10 million in assets or $500,000 in receipts attributable to sources within the state, must file returns on their income apportionable there. Upwards of a dozen other states are considering similar legislation.

States have headed in this direction ever since the controversial 1993 case *Geoffrey Inc.* v. *South Carolina Tax Comm'n*. In that case, the South Carolina Supreme Court determined that Geoffrey Inc., a Delaware holding company subsidiary of the Toys "R" Us Corp. set up to receive trademark royalty income, had an economic presence in the state that was enough to trigger income tax nexus even though the holding company had no physical operations there.

While the U.S. Supreme Court refused to hear *Geoffrey*, six states have adopted *Geoffrey*-like regulations and seven more have applied its precept through informal audit positions. Worse, most of the states adopting these new nexus guidelines have applied the standards retroactively, since there is no statute of limitations on the nonfiling of tax returns.

The fallout from *Geoffrey* is of particular concern to companies that sell or license intangibles. "It's something to be considered very carefully," says George de Urioste, CFO of Remedy Corp., a software firm in Mountain View, California. "Is software a tangible or an intangible product, a service to charge for or intellectual property to collect royalties on? Technology has always evolved faster than tax law, so we'll see how states find new ways of interpreting these things."

The sale of data and services over the Internet is also "too big now for states to ignore," says Karl Frieden, a senior manager and Internet specialist with Arthur Andersen LLP, in Boston. Illinois and New Jersey, for instance, now impose sales tax on electronic transmission of software, but not on other types of electronic data or services transmitted on the Internet.

Audit Angst

Not content with just expanding their tax rolls, many states have intensified their audit procedures. "State auditors have been running wild through companies in the past couple of years," says Kenneth T. Zemsky, Arthur Andersen's state and local tax practice lead partner for the northeast region. By playing fast and loose with the rules, auditors are trying to source as much income into their own states as possible, and challenging companies to take them to court. "It's not just the dollars involved, which aren't usually that material," he says. "Companies are just outraged to be treated this way."

Ivan Shandor, vice president of tax at $9.5 billion Baxter International Inc., in Deerfield, Illinois, sees it

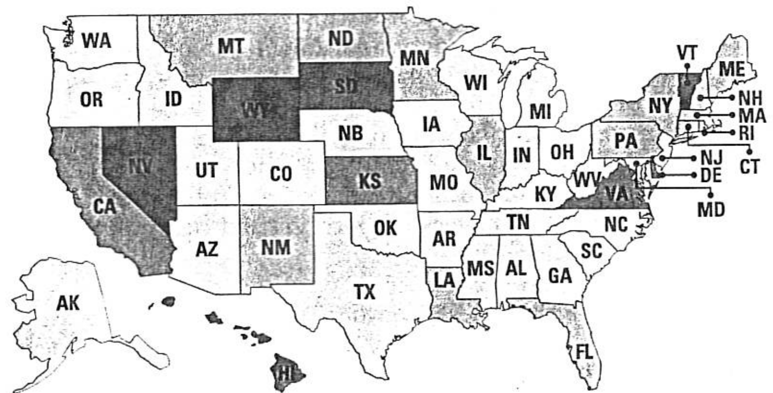
CFO STATE TAX SURVEY

WHICH AUDITS ARE TOUGHEST?

Increasingly, states challenge apportionments and the sourcing of income during audits, and use discretionary powers to adjust returns. Survey respondents ranked the states on sourcing of income on a scale of 1 (not aggressive) to 5 (overly aggressive).

WHERE YOU'LL BE CHALLENGED

Kansas: 4.17	**Pennsylvania: 3.75**
California: 4.13	**Maine: 3.73**
Louisiana: 3.88	**Massachusetts: 3.65**
New York: 3.81	**Illinois: 3.59**
New Mexico: 3.79	**Minnesota: 3.59**



GARY LAUFMAN

1-6

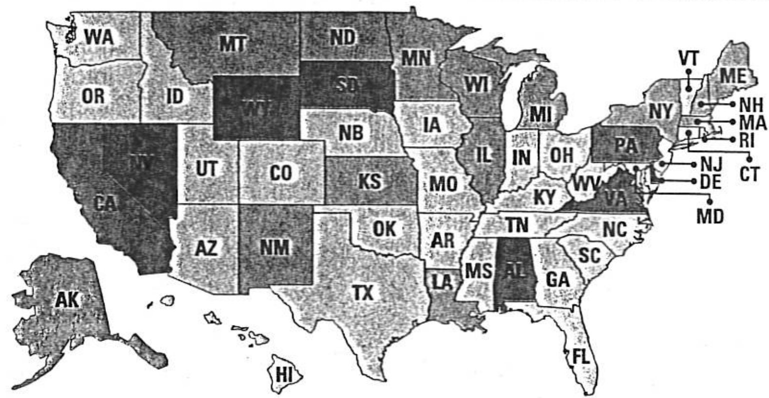
CFO STATE TAX SURVEY

WOULD YOU LOCATE OR EXPAND HERE?

Fiscal policy has always influenced business decisions, but unfavorable policies and attitudes are turning companies against certain states. Survey respondents rated tax policy influence on business decisions on a scale of 1 (very positive) to 5 (very negative).

WHERE TO AVOID

California: 4.12	Kansas: 3.69
Pennsylvania: 4.00	New Hampshire: 3.67
Louisiana: 3.75	Michigan: 3.53
North Dakota: 3.71	Illinois: 3.50
Massachusetts: 3.70	Maine: 3.50



Average responses: 4.00+ 3.25-3.99 2.50-3.24 1.75-2.49 1.00-1.74

every day. "Auditors are asking more questions, requesting more documentation, taking inconsistent approaches, creating aggressive interpretations of statutes and rules," recites Shandor. Since the health-care-supplies giant operates and sells everywhere in the United States, nexus isn't an issue. But the flood of recent audits certainly is. "Our biggest problem is the time we have to spend on audits and the time we spend gathering the data," says Shandor. "We can have 8 to 15 states in here at any one time auditing us. The worst is when they want documents that are spread out around the world, because they don't trust or understand our internal financial information systems."

"Some state auditors are stretching for the outer limits of taxation right now," agrees Paul Frankel, a well-known state tax practitioner, and a partner at Morrison & Foerster in New York, "and bigger out-of-state companies are sometimes getting hit the worst."

At The New York Times Co., for example, vice president of taxation Thomas Nied has wrestled with the increased use of discretionary adjustment powers among the three main states the publisher files in—Massachusetts, New York, and New Jersey. "More and more, the states want to allocate or reallocate interest and other expenses between entities," Nied says, adding that "dealing with such income tax challenges is often very hard due to the lack of precedent and clear regulation at the state level."

Nied, like many tax watchdogs, is often willing to settle small issues with states. But when states become more aggressive, Nied fights back. For example, the company finally won an entity combination case last year against the State of New York, on an audit that would have had significant cost. "Not only were they wrong, but the case would have had great precedent value for the state," says Nied.

Daniel Langford, vice president of tax at Sonat Inc., headquartered in Birmingham, Alabama, has also felt forced into the courts. "The state of Alabama for the past two years has been taking positions in income and franchise tax audits that it can't really support in code or regulation," says Langford, vice president–tax at the $2 billion gas and oil concern. "You can do something sanctioned by the code that you've done for seven years running, and all of a sudden they're disallowing it." As a result, the company has brought three lawsuits against the state. And in one instance, the state handed Sonat a $12 million assessment after it disallowed a $185 million deduction for intercompany dividends received from a subsidiary.

"Auditors are asking more questions, requesting more documentation, taking inconsistent approaches, creating aggressive interpretations of statutes and rules," says Baxter's Ivan Shandor.

RALF-FINN HESTOFT/SABA

Riding the Tidal Wave

Challenging audit positions may be cathartic and precedent setting. But tax directors, faced with tight head counts, zero-growth budgets, and limited time, can fight over only the most important issues. Consequently, many companies are rethinking their legal structures and operating policies to lower their effective rates. Others are moving large operations and headquarters out of high tax states; witness Scott Paper Co.'s (now part of Kimberly Clark Corp.) planned move from Pennsylvania to Delaware and Florida.

1-7

Some are cutting "incentive" deals to remain where they are (see "There's No Place Like Home," January). Still others are trying to work with the states to streamline the audit procedure. As Kendall Houghton, general counsel of COST, likes to say, "Just because state tax is a tidal wave doesn't mean you can't ride it."

At the U.S. subsidiary of ABB Asea Brown Boveri Ltd., the $34 billion international power and engineering giant, for example, the tax function was completely overhauled five years ago, resulting in state and local tax savings. According to Julietta Guarino, vice president of taxes and customs, one reason was a significant reduction in legal entities, which in turn lowered the company's effective state rate. "The reduction in complexity not only saves us money, it saves us time," says Guarino, pointing out that ABB now files far fewer state tax returns.

On the audit front, ABB went a step further. "We approached our home state—Connecticut—first, and asked if they'd undergo a quality initiative on sales/use tax audits with us, and they said, 'A what?'" recalls Guarino. But once the initiative was explained, the state agreed: Guarino and the ABB tax team discussed with Connecticut sales tax representatives what the auditors needed, how they interpreted state regulations, and what the company's information systems could provide. The initiative with the state "helped more than halve the audit cycle from about two years to seven months, and the final assessment was immaterial, whereas in the previous cycle it was substantial," says Guarino, who has repeated the process with other states, saving "hundreds of hours."

Other companies are just starting the process. FileNet Corp., a $300 million seller of document management software and services, recently allowed a team from KPMG Peat Marwick to review its operations for potential tax savings. "The last thing we want to do is create headaches for our accounting and operations people, but if changes can be made in our legal structures that will save us money and work with our business plans,

State Tax Reform: Only Small Victories

Focused state tax reforms and limited unifications are possible. "When business and state interests can agree on an issue, change can occur," says William McArthur, president and executive director of the Committee on State Taxation (COST), which lobbies for its *Fortune* 500 members at the state level. "But even then, it is a long, slow process."

One group that's been at it for 30 years ago is the Multistate Tax Commission (MTC), a group of 40 states and the District of Columbia dedicated to promoting unification of state tax codes and regulations. While the MTC now limits its agenda mostly to multistate cooperation, it has made some inroads. For instance, the National Nexus Program allows companies that have likely triggered different types of nexus, but not filed, to anonymously negotiate voluntary compliance agreements. Not surprising, the program has gained quick acceptance with companies cleaning up their tax histories and states looking to add taxpayers to their rolls. In 1993, just 11 companies reached 105 agreements with participating states; last year, 27 companies made nearly 300 such deals; and this year 40 companies are already in the pipeline.

The MTC also pushes for administrative uniformity and puts forward model regulations. Working with COST, for example, the MTC recently created the Multistate Alternative Dispute Resolution Program, the only forum for interstate tax conflict relief. In addition, its model regulation for financial institution net income apportionment has been adopted by nine states over the past year and a half. And it is also working with COST, the Federation of Tax Administrators, and the Tax Executives' Institute on a model regulation for electronic tax payments and tax return filing. They hope this will answer many questions companies have about retaining records from purchasing card and electronic payment transactions for state tax purposes.

William McArthur

State Attempts

For their part, a handful of states are trying to clarify their application of tax laws. For instance, lawmakers in Alabama just passed two bills clarifying the deductions for subsidiaries of out-of-state companies located in the state. And in the area of discretionary adjustments of intercompany transfers, Illinois and Connecticut last year issued new regulations outlining when and how such powers would be used. "This state had a reputation for ambushing taxpayers and making aggressive interpretations of statutes," says Gene Gavin, commissioner of revenue services in Connecticut. "Now that we've issued regulations in this area, at least taxpayers know where we're going to be looking and how we'll interpret what we see." The result, he says, has been significantly reduced audit assessments over the past year.

So it appears some aspects of state tax may become simpler, or at least clearer, with time. As Bob Hanson, tax commissioner of North Dakota and chairman of the MTC, explains, "Revenue departments have become more proactive in explaining what state interpretations are, but still need to do more. No one wants to take the 'gotcha' approach anymore." ■ I.S.

1-8

we will consider them," says Brian Colbeck, director of taxes at the Costa Mesa, California-based company. Specifically, because FileNet generates revenues from several types of sales—software, hardware, and service—and has grown by acquisition, the company now has some flexibility about where it registers corporate entities, and how it interprets state apportionment formulas. "In the end, it may reduce our overall rate by a percentage point or so, but that's not insignificant," says Colbeck, who managed to keep FileNet's effective state tax rate at a below-par 3 percent last year.

ABB's Julietta Guarino

Reinforced Confusion

Still, planning strategies and court challenges are just plays in a game with ephemeral rules and no time limit. Worse, there are no substantive improvements on the horizon. The obvious solution is uniform tax laws—as members of both the Multistate Tax Commission and COST would like to see (see sidebar, page 37). But while some progress has been made on such issues as financial service income apportionment and telecommunications taxes, the whole is still a confusing mishmash.

"Uniformity in tax laws would eliminate cost and confusion for companies," says Timothy Higgins, national partner of state and local tax services at Ernst & Young LLP. "But it's a political quagmire at the state level." Indeed, state legislators and governors continue to see fiscal policy alternately as bait to promote their state economies and as a trap to raise tax dollars. Even the FTA's Duncan agrees. "It's not the way of the states to sit down and work out a common direction," he says. "They all go at their own pace and in their own direction. The result, predictably, is a huge burden on taxpayers."

But the states are not solely to blame. The truth is that many companies *like* the in-state favoritism, the different apportionment formulas, the complex nexus rules, and the variable models of taxation—when it favors their situation. And companies quietly approve of the status quo for the same reason—the perception that the differences create opportunities for tax rate arbitrage that are greater than the cost of compliance, audit defense, and planning combined.

The current drive by tax administrators and accounting firms to focus on planning opportunities assumes that this cost-benefit equation can still be tipped in favor of corporations. However, if the states continue to apply aggressive interpretations of tax law, that may no longer be the case. Taxes saved may soon be offset by the time and expertise needed to fight a multifront battle. And at that point, experts say, corporate interests may be better served by a simpler, nationwide approach to state taxation. ■

Ian Springsteel is CFO*'s staff writer.*

Where to Go for Help

For advice on state tax planning or for complete overhauls, the following consulting services are available:

Committee on State Taxation. This well-respected lobbying, legal advocacy, and planning group based in Washington, D.C., counts nearly all of the *Fortune* 500 among its members, but it also welcomes smaller companies; (202) 484-5222.

Arthur Andersen. State Tax Analysis and Reduction Process, William Curley, managing director; (213) 614-6560.

KPMG Peat Marwick. State and Local Tax Practice, Douglas Green, national director; (212) 758-9700.

Coopers & Lybrand. The State Tax Minimalization and Recovery of Tax (SMART) program. John Forch, partner in charge, Multistate Tax Services, at (202) 822-4035; or Bill Coe, national director, SMART Program; (212) 259-1693.

Price Waterhouse. Multistate Tax Consulting Services, Ruurd Leegstra, partner in charge; (212) 596-7000.

Ernst & Young. SALT (State and Local Tax) Value Analysis, Timothy J. Higgins, partner in charge; (202) 327-9601.

Deloitte & Touche. Multistate Tax Practice, Jack Cronin, national partner; (213) 688-6969.

Grant Thornton. State and Local Tax Consulting, J. Thomas Johnson, national director; (312) 565-3471.

Publications:

State Tax Notes, published weekly by Tax Analysts, Arlington, Va. Offers technical articles and arguments on varied state tax issues; $949 a year; (800) 955-2444.

State Income Tax Alert, published biweekly by Professional Newsletters Inc., Atlanta. Offers general articles and breaking news in state tax arena; $247 a year; (770) 457-1000.

Multistate Tax Portfolios, book or CD-ROM of expert analysis for state tax planning, from Tax Management Inc., a division of the Bureau of National Affairs; (800) 372-1033.

1-9

by contaminating the cluster and spoiling perhaps thousands of hours of work.

After the fixed files return from California, the Mutual team and its E&Y assistants begin testing—a process that soaks up 45% of total remediation time. Finally, each repaired cluster is removed from freeze and placed into a clean area of the mainframe, called a "library." This is segregated from the dirty library, where the two-digit files are still awaiting their fix. And woe to the employee who absentmindedly shuttles a dirty file into the clean library. "It's a danger that we face—making sure that what gets renovated stays renovated," says Sidon. Today, three of seven clusters reside in the clean library. Sidon intends to fix the remainder by June, so that Medical Mutual can close the books on 1998 with the new system—and make sure that it works.

FALSE HOPE. But if this sounds like a tidy finish, it's not, as Mary Libens can testify. Take the sliding window. Libens originally planned to use this shortcut to deal with two-digit dates on electronic files that are used to track annual deductibles on claims. Since nothing in these files other than birthdates refers back as far as 1950, the team wrote a program that instructed computers to simply interpret all year dates up to 50 as postmillennial.

This solution almost worked. Programmers who tested it in Costa Mesa said the computers were no longer confused about which century the files addressed. But there was a different, unexpected snag: Whenever the computers bumped into the number 00, they would assume that they had reached the bottom of the deductible file. "There was no way to code around it," says Libens. If they let it go, the computer could easily make an incorrect payment, by assuming, for example, that the deductible hadn't been paid, when in fact it had been. The program had to be scrapped, and Libens is back to inserting four-digit dates in every file.

Libens perseveres, because she knows Mutual will make it through. But what of the large companies that are just getting started? In a recent survey of 450 businesses in North America, the Information Technology Assn. in Arlington, Va., found that 45% of them are still studying their systems and have yet to start fixing them. A year from now, they'll begin hitting the same kinds of hitches and delays that Mutual has been living with for four years. It's inevitable. It's software. To one and to all... Godspeed.

By Stephen Baker in Cleveland

KENNARD: NO MORE "BLAME GAME"

DANUTA OTFINOWSKI

TELECOMMUNICATIONS

LESS SOUND AND FURY AT THE FCC

New head Bill Kennard plays telecom peacemaker

When William E. Kennard had his first get-acquainted meeting with powerful House Democrat John D. Dingell (D-Mich.) on Feb. 12, Dingell wasted no time in criticizing the new chairman of the Federal Communications Commission and his agency for a long list of sins, including not allowing the Baby Bells into the long-distance business. "It was the verbal equivalent of a horsewhipping," says Kennard. Citing what he considered the agency's policy missteps, Dingell more recently told the National Association of Broadcasters that the FCC chief "may be a few affiliates short of a network."

Some 100 days after Bill Kennard took over as FCC chief, the laid-back 41-year-old Californian is squarely on the hot seat. He faces vein-popping pressure from Congress, industry, and the states—all steamed that two years after the Telecommunications Act of 1996, the law designed to promote competition has yet to bear fruit. Worse, he has stumbled politically—in one case by not notifying Senate Commerce Committee Chairman John McCain (R-Ariz.) of a White House initiative to give political candidates free airtime.

Now Kennard, the FCC's former general counsel and its first African-American chairman, needs to regain momentum just as the commission faces perhaps the toughest challenges in its history. "The fights we've seen so far are hard," says Anne K. Bingaman, se-

1-10

nior vice-president at long-distance carrier LCI International Inc. and former Assistant Attorney General for Antitrust at the Justice Dept. "But we ain't seen nothing yet."

Instead of fighting fire with fire, though, Kennard is playing the peacemaker. While his predecessor, Reed E. Hundt, frequently warred with state regulators, Kennard has gone out of his way to work with them—and even made a point of giving his first speech as chairman to their trade group. That "was a real turning point," says Jolynn Barry Butler, president of the state regulators' association. After the speech, so many state officials wanted to chat with the new chairman that original plans for a small dinner party grew to a table of 20. "Our challenge is to get out of the blame game," says Kennard, a Yale Law School grad. "We need to get everybody invested in the success of the Telecom Act."

That attitude comes as no surprise, given Kennard's role model. As a teenager, he had a complete set of Martin Luther King Jr.'s speeches on records that he would listen to repeatedly. Now, he's using many of King's values of cooperation at the FCC. "In another 20 years, all the noise will be forgotten and we'll all be judged by what we did," he says. "I'm confident that I'll be on the right side of history."

Kennard is starting to make his mark with a down-to-earth attitude that puts him in sharp contrast with the imperious Hundt. At the FCC, he arranged one- to two-hour "Bible readings" of the Telecom Act so he could get others' opinions on the often-abstruse law. And he has begun a regular coffee klatch with the four other commissioners after formal meetings.

"INNER COMPASS." Kennard's ability to work with differing views and backgrounds stems from his parents and from his childhood in the interracial Hollywood Hills. His mother grew up among Hispanic migrant workers and became a bilingual schoolteacher. When his father, Robert, was nine, his parents sent him to a nearby whites-only school instead of a black one farther away. Although he was harassed by the kids and repeatedly denied admittance by the principal, Robert returned daily and eventually was accepted. Robert Kennard later founded the largest African-American architecture firm in Los Angeles. Says the younger Kennard: "You have to have your own inner compass and know where you want to go."

To find his way at the FCC, Kennard will have to overcome huge obstacles. Two years after the 1996 act, local phone competition is still just a promise for the vast majority of consumers. In the cable industry, lawmakers want the FCC to keep a lid on rising rates without extending a rate-regulation law that expires next year. And broadcasters are dragging their feet on the transition to digital television. "I can't remember a new chairman with the depth of problems he has to deal with," says Robert T. Blau, vice-president of Atlanta-based BellSouth Corp.

Another potential snag: rivalry from up-and-coming Republican Commissioner Michael K. Powell, who is the son of General Colin L. Powell. In January, the younger Powell took the unusual step of issuing his own paper detailing how the FCC can help the Bells with their as yet unsuccessful applications to enter the long-distance market. With that kind of initiative, Powell could grab the leadership role on key policy issues. "Powell is a real force to be reckoned with," says Kennard's former law partner Lawrence R. Sidman, a telecom lobbyist.

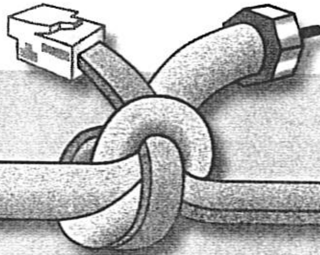
Both men downplay the prospect of a clash. Powell says his paper was designed to advance discussion on a critical issue. It "was intended to encourage companies and regulators to get back to the table and redouble their efforts," he says. For Kennard's part, he notes that he suggested the same policy months earlier: "I'm more than happy to give other commissioners credit as long as the bottom line is consistent with my agenda. I reject the notion that the other commissioners must live in fear of the chairman."

Such confidence is bolstered by the fact that Kennard has had a stellar Washington career. As former FCC general counsel and a dealmaker before that at the heavyweight D.C. law firm of Verner, Liipfert, Bernhard, McPherson & Hand, he was known for his ability to craft a consensus in contentious situations.

As Kennard grapples with the challenges of leadership, he has even less time for favorite pursuits with his friends and family. Returning home by 10 p.m. means he had a "slow day at the office," says his wife of 14 years, Deborah D. Kennedy, an attorney for Mobil Corp. whom he met while both were at Yale. When he can, Kennard relaxes by fishing for small-mouth bass in the Shenandoah Valley.

Kennard won't have much time for angling while he's at the FCC. Besides completing the work left over from Hundt's tenure, Kennard wants to add his own imprint by "infusing [my] agenda with opportunities" for minorities, women, and the disabled. That's an objective he has pursued throughout his career—he has provided legal advice to black-owned companies and done *pro bono* work for homeless youth. "We need to make sure the telecommunications revolution brings us together as a country," he says. That's a tall order. But in this era of rancor, Kennard will make a contribution just by forging peace among the titans battling at the FCC.

By Catherine Yang in Washington



ALBERTO MENA/BW

UNSNARLING THE FCC'S PROBLEMS

PHONE COMPETITION The FCC is taking heat for not making telecom deregulation happen faster. Kennard must now push the Baby Bells to open their local markets more quickly while resisting pressure to let the Bells into the long-distance business right away.

UNIVERSAL SERVICE Kennard is caught between farm-state Senators, who want to keep subsidies for rural and needy customers, and Vice-President Al Gore, who wants to use the money to fund schools' Net access.

CABLE RATES Despite opposition from cable operators, he must keep a lid on rates, even as the FCC's regulatory authority expires in March, 1999.

DIGITAL TV The FCC must accelerate the adoption of digital TV even as broadcasters drag their feet and complain that the new equipment is too pricey.

1-11

Tuesday, January 20, 1998 The Kansas City Star

1996 telecom bill fails to meet expectations since its approval

Predictions of lower cable, phone rates have not become a reality.

The Associated Press

WASHINGTON — These were the promises of the telecommunications bill: lower cable TV rates, lower phone bills and a dazzling array of work and entertainment choices only a touch-tone away.

Two years later, the reality is higher prices and not much competition.

The average American doesn't have another local cable or phone company to switch to. And the promised explosion of innovative new services is more a whimper than a bang.

"This new law is truly revolutionary legislation that will bring the future to our doorstep," President Clinton said when he signed the measure Feb. 8, 1996.

He predicted that "consumers will receive the benefits of lower prices, better quality and greater choices in their telephone and cable services." Supporters in Congress, at the Federal Communications Commission and in industry made the same claims.

But those optimistic forecasts have yet to come true. In 1997, cable TV rates rose 6.9 percent, local phone rates rose 1 percent and in-state toll call rates went up 2.8 percent while interstate long-distance rates declined 4.3 percent, according to the government. Consumer prices for all goods and services went up 1.7 percent during the same period.

In 1996, the Labor Department's Bureau of Labor Statistics reported across-the-board increases in cable and phone prices.

It also costs more to make a call from most pay phones.

Rep. Thomas Bliley, a Virginia Republican who was co-author of the bill, predicted it would break up "two of the biggest government monopolies left — the monopolies in local telephone service and in cable television. Beside lower rates and better service, the result will be innovative new products and services."

Instead, long-distance companies have had trouble building local phone businesses, and local phone and cable companies have scaled back plans to invade each others' businesses.

And key provisions in the 1996 law aimed at opening the $100 billion local phone business to competitors were overturned in federal court rulings last year.

Federal regulators are now scrambling to find ways to boost competition for cable and local phone companies and to lower soaring cable rates.

AT&T has stopped marketing local phone service, and MCI has suffered steep losses from local phone investments. Both companies in part blame regulations they say make it too expensive to provide local phone service.

Consumer groups, which want the government to do more to hold down cable and phone rates, call the law a failure.

"Virtually none of the promise of price reductions and competition has materialized. On the contrary, these industries are becoming more entrenched monopolies with rates spiraling upward," said Gene Kimmelman, co-director of Consumers Union's Washington office.

1-12

JERRY HEASTER

Another excuse for obligation

The new year brought a new tax, which most Americans probably aren't aware of. Congress didn't authorize it, and the media watchdogs have mostly ignored it.

The tax isn't called a tax, of course. It's called a contribution and will be paid by telephone users. The estimated cost per household will be about $15 a year. This sounds like nickel and dime stuff of little consequence, but the take from residential and business users this year is expected to be $2.25 billion.

Even if most Americans were aware of the new tax, it probably wouldn't cause much fuss. It's one of those politically correct depredations government has become so adept at devising.

The new phone tax is a creature of the 1996 Telecommunications Act, which led to a regulatory policy initiative requiring telephone company contributions to underwrite universal access to the Internet for schools and libraries. The language of the law didn't carry a mandate to extort money from the telephone industry and its customers for this purpose, but the idea was conceived by regulators with an agenda.

A political problem developed when some companies revealed plans to list the tax as a separate line item on bills, which prompted the FCC to reduce the levy by about 40 percent. The industry, however, couldn't afford to be too rebellious because it was challenging its regulators. As a result, while the companies are expected to list the tax on business phone bills, the regulator may have succeeded in getting the item listing dropped from residential bills.

Regardless of how anyone feels about the merits of wiring schools and libraries to the Internet, the development raises legitimate questions about officialdom's growing penchant for sidestepping democratic niceties when pursuing pet projects.

A recent analysis by the Institute for Research on the Economics of Taxation concluded that the universal access program is bad policy for several reasons. For one thing, even if it weren't of questionable value, it shouldn't be a concern of the federal government, said Stephen J. Entin, executive director and chief economist. Beyond this, Entin noted, the tax is a "distortionary cross-subsidy of Internet users by telephone users."

Its worst aspect, though, is government's duplicity in trying to hide the tax from the public as an unspecified charge in telephone bills. This is not only a case of taxation without representation, but also another example of how the bureaucracy usurps congressional prerogative at whim because Congress has become so indifferent.

Congressional Democrats are apparently happy with this arrangement, while Republicans seem to lack the political courage necessary to provide a countervailing balance of power. The situation is devastating to the economic interests of citizens whose only protection is a bipartisan balance in elected government.

More's the pity that this depredation is occurring even as the wiring of the country's classrooms seems to be proceeding apace. It's happening without Washington's help as a result of cooperative efforts between growing numbers of local school districts and aggressive computer marketers subsidizing such efforts in hopes of nurturing future customers.

This isn't about a need for money, but about Washington's obsession with intruding itself into every nook and cranny of commercial life.

1-13

BY PAUL CRAIG ROBERTS

CONGRESS SHOULD GRAB BACK THE REINS OF POWER

USURPED: Judges and federal agencies now make laws –and levy taxes. This violates the Constitution and subverts democracy

The U. S. Congress in the 20th century has not been jealous of its powers. Under pressure from President Franklin Delano Roosevelt and the New Deal, Congress delegated to federal agencies the lawmaking powers expressly reserved to Congress by the Constitution. As a result, the American people are no longer governed by statutory law from bodies accountable to them. Both Theodore J. Lowi in the 1960s at the University of Chicago and, more recently, Yale University law professor David S. Schoenbrod have made the same point: The requirement in Article I of the Constitution that Congress make all laws has been ignored for the greater part of the 20th century. The country has become accustomed to legislation enacted by regulators guided by little more than their interpretation of congressional intent. The federal judiciary still gives occasional lip service to the prohibition against delegated powers, but it never finds any specific delegated power to be unconstitutional.

Since Congress has given away so much of its power to the regulatory agencies, one might expect that it would especially guard its power of the purse. Under our constitutional system, the elected legislature alone has the authority to tax. But Congress has remained silent in recent years while federal judges usurped the power of the purse from state and local democratic bodies. To equalize payments to public schools, federal judges have raised taxes in Yonkers, N. Y., and Kansas City, Mo. Just the other day, a federal judge ordered a tax hike in Rockford, Ill.

DISGUISED. The federal judiciary is gaining the power of the purse simply by exercising it. Therefore it is little wonder that agencies of the executive branch are starting to do the same thing. The Federal Communications Commission has imposed a tax on telephone companies, beginning this month, in order to finance Internet services for public schools and libraries. The FCC wants the phone companies to pass the tax on to customers in the form of higher charges.

The phone companies balked. They wanted to itemize the charge on their bills to customers as a tax—but they caved in to the FCC. MCI Communications Corp. had the important regulatory matter of its WorldCom Inc. merger before the FCC and the Justice Dept., and AT&T hopes the FCC will keep the Baby Bells out of the long-distance market. Now, an agreement has been reached: Business customers, but not residential customers, are going to be told that the FCC has imposed a tax.

The rate-making authority of regulatory agencies is supposed to apply to the prices that regulated monopolies charge their customers. This power is not supposed to be used to enact revenue measures in order to finance educational expenditures. Congress does not have the Constitutional authority to delegate the power of the purse to the FCC. Certainly this is not a time of national emergency that would justify violating the separation of powers. The FCC may argue that there is language in the 1996 Telecom Act that permits it to assess "fees." But a delegated power cannot itself be delegated. The FCC shouldn't be taxing anyone.

THIN VEIL. The vast delegation of legislative power to executive agencies that we see today stems from the temporary expediency of the 1930s' national emergency—and should be ended. The reason is that the executive branch cannot indefinitely function as lawmaker without becoming lawmaker in name as well as fact. The veil provided by the delegation doctrine has worn thin when the FCC imposes through regulation a tax on telephone customers. What is at stake is not good or bad policy, but self-rule—which has been achieved by a 1,000-year-long struggle.

Democracy in America is being hollowed out, not because of organized interest groups or the way campaigns are financed. Democracy has become the exercise of holding a plebiscite on the economy every four years: We the People cannot rule ourselves when our elected representatives do not make the laws or impose the taxes. The unraveling of the separation of powers is leaving power unrestrained. This is the opposite of liberalism and repudiates its historic achievement.

Congress is empowered to make laws. It is not empowered to make other legislators by placing its lawmaking mandate in other hands. Political clout is up for grabs when the U. S. Supreme Court reads into the Constitution all manner of rights nowhere mentioned in it but does not enforce the right to self-rule and the separation of powers that are explicitly stated in the document's main articles. Eventually, unrestrained force becomes, in Lenin's words, "unlimited power, resting directly on force. Nothing else but that."

Paul Craig Roberts is John M. Olin Fellow at the Institute for Political Economy in Washington, D.C., and Research Fellow at The Independent Institute in Oakland, Calif.

KATHERINE LAMBERT

1-14

SAM F[illegible]NBACK

(202) 224-[illegible]521 PHONE
(202) 228-1265 FAX

United States Senate

WASHINGTON, DC 20510-1604

COMMITTEES:
COMMERCE, SCIEN[illegible]
AND TRANSPORTAT[illegible]
FOREIGN RELATIONS
GOVERNMENTAL AFFAIRS
JOINT ECONOMIC COMMITTEE

February 6, 1998

Mr. Jack Luschen
8267 W. 116th Terr.
Shawnee Mission, KS 66210

Dear Jack:

Thank you for sending your note, as well as sending in a copy of Paul Craig Robert's articles "Congress Should Grab Back the Reins of Power" from Business Week and the article in the Kansas City Star on the 1996 Telecommunications Act. I appreciate hearing from you on these important matters.

First, I agree with you and Mr. Robert's sentiments. There are far too many agencies with far too much power to add to this country's already enormous regulatory code. For years the Congress has delegated its most fundamental responsibility—the creation of laws—to Executive agencies which are supposed to be responsible only for the enforcement of laws. Consequently, rather than just enforce, these government bureaucrats also have the power to write the law. Something must be done to end this practice.

Recently I introduced the Congressional Responsibility Act of 1997 as a means of reigning in renegade regulators. This bill would require Congress to vote on every proposed rule or regulation in an expedited manner, unless a majority of Members vote to send it through the normal legislative process before it could be enacted. The effect of this legislation will be to return the sole authority of making laws back to the legislative branch; where it belongs.

The Founders clearly understood the dangers of delegating legislative powers to the Executive branch. In fact, the opening sentence of the Constitution after the preamble in Article I, Section 1 reads, "All legislative powers herein granted shall be vested in Congress." The practice of allowing the Executive branch to both create and enforce laws is not only bad governing, but a violation of the Constitution as well.

Second, I understand and agree with your concerns over the 1996 Telecommunications Act. Increased competition and reduced government regulation must occur in order for consumers to experience a substantial reduction in cable and telephone rates. According to estimates by some economists, if all communications markets were opoen to competition on January 1, 1998, the American economy would create 3.4 million additional new jobs, save consumers nearly $550 million in lower communications rates, and increase the average household's annual disposable income by $850 by the year 2006. In addition, 2.1 million of those new jobs will be created by the year 2002.

612 South Kansas Avenue
Topeka, KS 66603
(913) 233-2503 Phone
(913) 233-2616 Fax

1001-C North Broadway
Pittsburg, KS 66762
(316) 231-6040 Phone
(316) 231-6347 Fax

116 E. Chestnut, Suite 104B
Garden City, KS 67846
(316) 275-1124 Phone
(316) 275-1837 Fax

225 North Market, Suite 120
Wichita, KS 67202
(316) 264-8066 Phone
(316) 264-9078 Fax

11111 West 95th, Suite 245
Overland Park, KS 66214
(913) 492-6378 Phone
(913) 492-7253 Fax

1-15

Regulations rarely reduce consumers' costs. I believe Congress must continue to enact laws that unleashes competitive market forces and truly reduces cable rates.

Once again, thank you for contacting me to express you frustrations with the myriad regulations being arbitrarily promulgated out of Washington every week. Hopefully, with the passage of the Congressional Responsibility Act of 1997, these problems will be solved.

Thank you again for sharing your concerns. Please do not hesitate to contact me again in the future.

Sincerely,

Sam Brownback
United States Senator

SB:gc

VIN[illegible] [illegible]NOWBARGER
3[illegible] [illegible]STRICT, KANSAS

509 CANNON HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
(202) 225-2865
Rep.Snowbarger@mail.house.gov
http://www.house.gov/snowbarger

Congress of the United States
House of Representatives

BANKING COMMITTEE
CAPITAL MARKETS, SECURITIES
GOVERNMENT SPONSORED
ENTERPRISES SUBCOMMITTEE

GOVERNMENT REFORM AND
OVERSIGHT COMMITTEE
VICE CHAIRMAN,
HUMAN RESOURCES AND
INTERGOVERNMENTAL
RELATIONS SUBCOMMITTEE
NATIONAL ECONOMIC GROWTH,
NATURAL RESOURCES AND
REGULATORY AFFAIRS SUBCOMMITTEE

SMALL BUSINESS COMMITTEE
TAX, FINANCE AND EXPORTS SUBCOMMITTEE

ASSISTANT MAJORITY WHIP

February 5, 1998

Mr. and Mrs. Jack & Joyce Luschen
8267 W. 116th Terrace
Overland Park, Kansas 66210

Dear Mr. and Mrs. Luschen:

Thank you for taking the time to contact me about regulators in the executive branch usurping Congressional authority in imposing taxes. I appreciate hearing from you about this very important issue.

Recently the Federal Communications Commission (FCC) decision to increase universal service fees on telephone service. The most recently passed telecommunications bill included an obscure provision which allowed the FCC to increase these fees to promote "universal service." The FCC has assumed the broadest possible interpretation of this language, and after Congress adjourned for the holidays announced that it would be hiking rates to pay for one of the pet projects of the President and Vice-President — wiring the nation's elementary schools with Internet access.

While giving Internet access to schools may be a good thing, it is hard to figure how the federal government can justify getting so involved in how local school districts run their own schools. Furthermore, if is not the FCC's role to make the decision to expand internet service. This decision belongs to the Congress and the Congress alone. When it comes back into session in January, Congress should revisit this FCC decision.

Again, thank you for taking the time to write. I hope this answers your questions. Please feel free to contact me again, on these or any other issues, at any time.

Sincerely,

Vince Snowbarger

Vince Snowbarger
Member of Congress

VS/jf

DISTRICT OFFICES:

182 FEDERAL BUILDING
500 STATE AVENUE
KANSAS CITY, KS 66101
(913) 621-0832

8826 SANTA FE DRIVE
SUITE 350
OVERLAND PARK, KS 66212
(913) 383-2013

647 MASSACHUSETTS
SUITE 207
LAWRENCE, KS 66044
(913) 842-9313

MIAMI COUNTY
(913) 294-4122

B

Wednesday,
March 25,
1998
JO

www.kcstar.com/biz/biz.htm

JERRY
HEASTER

Frittering away our tax dollars

In fact, there is no moral justification for using other people's hard-earned money for such purposes. Legislators who do so reveal nothing but contempt for the taxpayers in whose name they serve.

1-18

Not unlike many of my counterparts, I would like an ISDN subsidy for all the people I represent. Unfortunately, there would be no one to pay the bill. As you know, I represent the residential and small commercial customers. The 1996 Act addressed everything but their concerns, and I suspect that is why we are afforded this forum today. The House Utilities Committee has already taken action which would address some of the concerns of consumers.

As you know, the 1996 Act created revenue neutrality, which caused an increase in the bills of local service customers and cellular users. It did this at the same time it denied the Corporation Commission the ability to audit the revenues of price cap local exchange carriers. Consumers felt helpless and registered their complaints to their providers, legislators and the Commission. As part of the 1996 Act the KUSF was created, and with enhanced universal service, put into motion a system of charges which would be ever increasing.

The 1996 Act distinguishes itself by implementing some of the highest charges in the country for intrastate universal service. It

Senate Commerce Committee
Date 3-26-98
Attachment #2-1 thru 2-10

does so without any accountability or cost studies.

S.B. 666 was drafted to give consumers some hope of accessing the process and to enable them to have input over their rates. No state to my knowledge has been so sweeping in its refusal to allow companies like SWBT to avoid an earnings review.

Now the telephone local exchanges complain that this would take us back to rate of return regulation, as if rate of return was an obscene term. The truth of the matter is that all businesses conduct rate of return analyses, because their managers have to be measured on some level of performance. Every cost study has a rate of return component and it is unrealistic to suggest that rate of return does not matter. By turning rate of return into some form of slur, the telephone companies would have you believe that there should be no measurement by which the consumers of this state are charged for their telecommunication services. Such an argument means that we are developing telecommunication policy in this state in the blind and are permitting the companies to go completely unchecked, even though they still possess monopoly control over the local exchange markets in this state.

The independent telephone companies complain that if S.B.

666 is enacted and the Commission has discretion over the funding of enhanced universal service, nobody in the rural areas will be afforded advanced telecommunication services. Although we dispute this assertion, it looks to me as if we have developed subsidized advance services for rural areas under current law, at the same time we have denied advanced services to most consumers in urban areas, e.g., faster rates of transmission and video. Why is this? First, we have raised the rates of urban customers for basic phone service to provide for advanced services in rural areas. Second, we have blocked competition in the local exchange markets in urban areas by providing subsidies to incumbent providers to permit them to keep competitors out of their urban residential markets. As such, we have placed a higher priority on rural Kansas than the urban areas and have made urban areas less desirable from a communications point of view.

If this policy continues it places Kansas at a tremendous disadvantage. While other parts of the country are more quickly advancing their telecommunications networks in urban areas, we are permitting policies which create no incentive for urban incumbent providers to upgrade their systems, except where major business consumers are involved. In fact, we are paying incumbents more in the form of subsidies to assure that competition

definition we put into law obsolete.

S.B. 666 makes reference to forward looking cost studies. Even though the independents will be required to come forth with studies in the near future, probably 2001, the independents say this is problematic because no methodology has been prescribed. The same problems exist for the non rural carriers, but yet in every jurisdiction I know of, carriers are determining costs on a forward looking basis. In the rapidly changing telecommunications markets, what is more likely to be correct, current prices or future cost projections?

Finally, we support S.B. 666 because it takes into account future growth in determining price subsidies. Current law not only prevents an earnings review, but also fails to permit provider rates to be redetermined based on increased revenues. As such, under current law, the providers are permitted a windfall in the form of subsidies when the growth in revenues would adequately compensate them for the rendition of service.

In conclusion, we support S.B. 666 because it allows consumers a forum to be heard. We don't understand what telecommunication public utilities have to hide. It would seem to

me that an orderly process before the Corporation Commission is much more preferable than 50 lobbyist strategically located in every corridor of the capital. What's at stake, the people of this state or the unregulated revenues of the incumbent monopoly providers?

2-5

State of Kansas

BILL GRAVES	GOVERNOR
FRANK WEIMER	CHAIRMAN
A.W. DIRKS	MEMBER
GENE MERRY	MEMBER
RALPH SOELTER	MEMBER
FRANCIS THORNE	MEMBER
WALKER HENDRIX	CONSUMER COUNSEL

Citizens' Utility Ratepayer Board

1500 Southwest Arrowhead Road
TOPEKA, KANSAS 66604-4027
Ph. 785-271-3200

SENATE COMMERCE COMMITTEE
SENATE BILL NO. 666
March 24, 1998

In 1996, the Kansas Legislature passed H.B. 2728 as part of telecommunication restructuring for the state. The law, as enacted, created a prescriptive set of rules which in part were designed to fund universal service. Unfortunately, the Corporation Commission was given little leeway in developing a telecommunication plan and failed to provide regulatory flexibility to spur competition in the local exchanges. S.B. 666 clearly addresses these deficiencies and gives the Commission discretion to make determinations for the entire state.

CURB supports S.B. 666 because it does the following:

(1) Removes the revenue neutrality concept in K.S.A. 66-2005 and 66-2008. (Revenue neutrality causes significant shifts in the charges of telecommunication services, which to date have resulted in increases based on a 9.89% assessment. It fails to establish universal service on the basis of its cost and does not adequately identify the level of profit built into access and other rates. Moreover, it does not recognize that access and other rates were set to provide contributions for the support of the local loop. See, *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930).)

(2) Removes the definition of enhanced universal service in K.S.A. 66-2005 and 66-2008. (The funding of enhanced universal service will place great pressure on the universal service fund and may cause customers to reimburse carriers for services and facilities which will be out-of-date by the time distributions are requested from the fund. Although enhanced universal

service is a noble concept, it should be implemented after careful study and in recognition of the standard that rates for local service be affordable.)

(3) Give the KCC authority to retain all of its regulatory authority when dealing with telecommunication issues. (The consuming public has a right to know the level compensation which is required to fund universal service and enhanced universal service. It has a right to know the amount of subsidy that is provided, and the level of subsidy should have some correlation to actual earnings experience of the company.)

(4) Require that any rate rebalancing be done only after an investigation of all rates and charges, an examination of the growth of revenues which have been experienced by a local exchange carrier and a determination that other revenues are not sufficient to replace revenue being reduced by the change in access charges. (As it stands, a local exchange carrier can experience dramatic growth in revenues which are not taken into account to cover shortfalls from reducing access charges.)

(5) Delete the requirement that the KCC cannot conduct an audit, earnings review or rate case. (How can the KCC or the legislature make a meaningful decisions without basic information from which to determine the need for subsidy income.)

(6) Consistent with the FCC determinations on universal service, require that the KCC conduct cost studies to determine the cost of universal service.

(7) Delete infrastructure reimbursement and supplemental funding, and require that these items be funded in the discretion of the Commission as part of an exogenous component or rate case. (Otherwise indiscriminate funding requests can be made from the fund for any infrastructure deployment, whether it is outdated or not.)

Although CURB is an enthusiastic supporter of S.B. 666, the Committee should note that the House Utilities has implemented an interim plan to address some of the more pressing

matters with the KUSF. The House Committee has placed a ceiling on expenditures from the fund, has modified enhanced universal service to require a demand order before implementation, has confirmed the Supreme Court authority to conduct an audit and formed a working group to discuss the impact of enhanced universal service and other issues which will impact customers. This approach is acceptable to CURB and may provide a compromise for those that want further deliberations concerning the scope and magnitude of S.B. 666.

This concludes our remarks, and we would appreciate your comments.

KCBJ 3-20-98

IS ADSL WORTH THE PRICE?

Experts debate the need for rapid-fire Internet connection

STORY BY SUZANNE KING, STAFF WRITER, GRAPHIC BY JIM HINDS

A Web page dedicated to ADSL — the technology that promises to deliver high-speed Internet connections over telephone lines — makes the point pretty well.

"If you had ADSL," it contends, "this page would have downloaded in a fraction of a second."

But over the plain-old modem you might have been using, it takes many seconds, if not minutes, for the ADSL Forum Web page (www.adsl.com) to appear on your computer screen.

With asymmetric digital subscriber line (ADSL) technology, every Web page would load faster, and data would download faster. In some cases, an Internet file that would take 60 minutes to download over a 28.8 kilobit per second modem could take as little as 72 seconds using ADSL technology.

The high-speed Internet connection carries data at speeds that beat many other data connections. And its infrastructure is one most people already have: twisted-pair copper telephone lines.

"It's essentially the ability to give digital telephone service, similar to ISDN, using only the single twisted pair," said Jerry Place, a business professor at the University of Missouri-Kansas City.

Coming to Kansas City

ADSL, available in other parts of the country for more than two years, has been promised in Kansas City for some time but still hasn't arrived. Southwestern Bell, the local telephone company most likely to provide the service first, will complete a trial in Texas this summer.

After that, Southwestern Bell spokesman Michael Powell said that the company will seek regulatory approval to offer ADSL to all Texas customers, and only then move toward offering the service to customers in Kansas or Missouri.

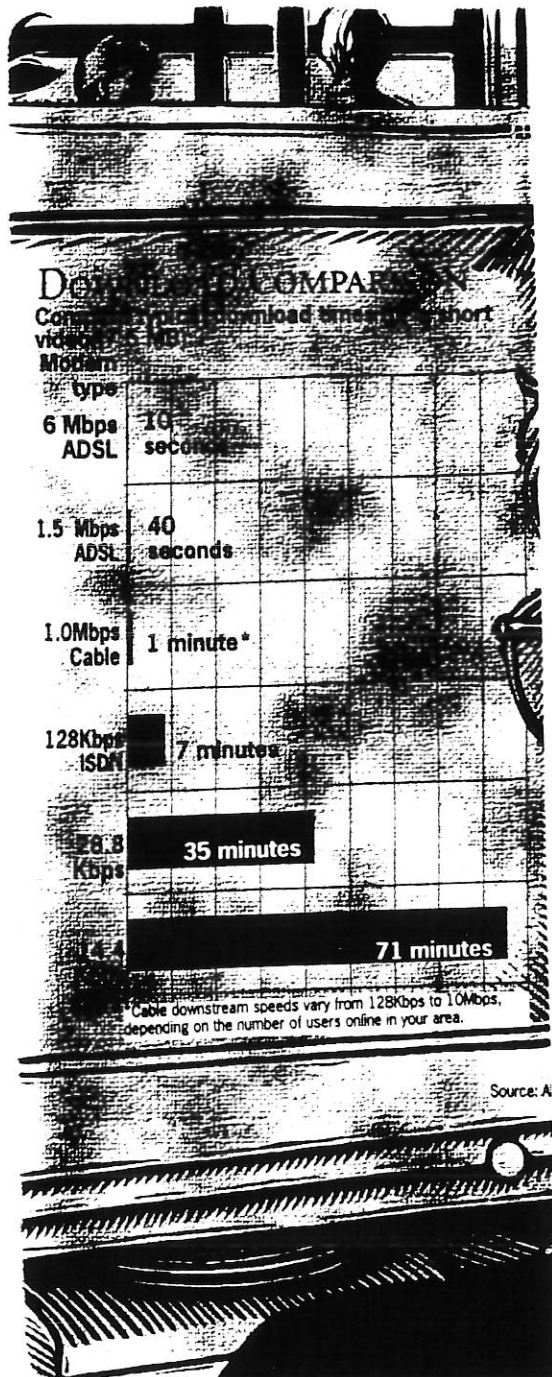
But ADSL is far from universal and some technology experts question whether it ever will fit that description. Although fast, an ADSL network is expensive to build, the technology is relatively costly to subscribers and it lacks the infrastructure to carry it across the country.

The Gartner Group estimates that ADSL won't grow beyond 5 million lines before 2002. That year, the firm predicts, only 12 percent of 41.7 million data access lines will use ADSL technology. According to the firm, 18 percent of those lines will access data using ISDN connections, 10 percent using cable modems, 5 percent using wireless data connections and 55 percent using analog modems.

ADSL is just one of several flavors of DSL, or digital subscriber line, technology. But the differences are not all that important to most consumers because ADSL has the most practical applications.

"You can get very high rate of speed using DSL technology, but the technology that is best suited for a broad coverage for businesses and consumers

See ADSL, Page 25



Pg 1 of

2-9

ADSL

Continued from Page 17

For one thing, ADSL will allow more distance between the consumer and the ADSL source.

"Those others (DSL technologies) require the customer to be located a lot closer to the central office," Powell said.

John Girard, Gartner Group vice president and research director, described even ADSL technology as "a niche service" that "won't meet all needs of all businesses."

But, where it's offered, it seems to be popular.

"The customers who have the product (in Austin) like the speed, because it is significantly higher than what many customers at home are accustomed to," he said.

Customers also like that the connection is "always on," Powell said.

Unlike a traditional modem that dials into a phone line, halting voice traffic, ADSL modems carry data on a different frequency, so voice and data can be carried simultaneously.

"It is a permanent connection," Powell said.

Channeling the data

According to the Web site ADSL Forum, ADSL modems, which connect to both ends of a telephone line, create three information channels: a downstream channel, a duplex channel and a POTS (plain old telephone service) channel. Filters separate the POTS channel from the other channels, which receive and send data.

To access ADSL service, customers need a DSL modem, which costs $400 to $600, and they pay the telephone service provider for the service.

In the Texas trial, Southwestern Bell customers pay $250 a month for data speeds of 1.5 megabits per second downloading and 384 kilobits per second uploading, or $150 a month for 384 kilobit uploading and downloading.

But the price of the service is likely to drop as the service becomes established.

"This is a very new technology," said Powell. "The standards are all being finalized, relative to production of modems. Like any other technology, once that's settled, those prices will drop."

Many companies are working to make the technology more accessible. In January, Kansas City-based Sprint Corp. and SBC Communications — Southwestern Bell's parent company — announced they would work as part of a broad alliance of local telephone companies to come up with a universal standard for ADSL technology.

Sprint spokesman Russ Robinson said last week the process is still ongoing and, as yet, the alliance can't report any measurable progress.

Technology experts predict that ADSL should be the next step after ISDN, another type of high-speed data technology. But Powell said ADSL and ISDN serve different purposes:

• ISDN is switchable, meaning you call someone using a telephone number; ADSL is a permanent virtual circuit.

• ISDN caps out at 128 kilobits per second, compressed it could reach 512 kilobits; so far, ADSL has reached speeds of 1.5 megabits per second — almost eight times faster than the compressed ISDN speed.

• ISDN is digital voice, capable of doing dial up video conferencing; ADSL is high speed data over analog voice.

• ISDN is available almost everywhere now; ADSL is limited today and might eventually reach only about 70 percent of the population.

Some industry watchers say the apparent limitations of ADSL mean it might remain useful only in limited parts of the community.

"I'm not sure that this is so much a business technology as it is a residential technology," Place said.

"DSL is the telco solution, it's not an Internet solution."

IN SOME AREAS, CABLE COMPANIES ARE LEASING MODEMS TO CUSTOMERS FOR BETWEEN $2 AND $5 A MONTH.

Remember cable modems

Place said the telephone company's solution might be "too little, too late." He said that he believes cable modems will be a more comfortable solution for many residential customers.

"I've got a relatively high-speed modem," he said. "I'm not going to fiddle around with emerging technology when I know on the horizon, American Cablevision will eventually come to me with a cable modem."

And ADSL is relatively expensive for the provider, said Nathaniel Pool, president of Q-Networks an Internet service provider in Lee's Summit.

"DSL is probably going to be a little cost prohibitive to the end user because of the capital cost for equipment," Pool said. "The ISP (Internet service provider) will have to make a fairly substantial investment in equipment, if they're not geared up for it already."

And Pool, whose company is working on an arrangement with Jones Intercable to provide Internet service over cable lines, said that high-speed service has some advantages over ADSL.

"You're going to have more bandwidth off the bat," he said.

Pool said cable also will be less expensive. "Your equipment cost will really be a cable modem."

In some areas, cable companies are leasing modems to customers for between $2 and $5 a month, Pool said. But the devices can cost anywhere from $300 to $500, he said.

Comparatively, the monthly cost for ADSL is much more.

The other disadvantage of ADSL, Pool said, is its limited reach. Data carried over both cable and using ADSL technology can only be carried so far before it has to be re-amplified.

"But the infrastructure is already in place with cable," Pool said. "It's not with phone companies."

ADSL does offer a different choice, but many in the industry agree it is not the only choice.

"A customer will always be able to select an analog modem and use an analog phone line," Powell said.

KCBJ
3-20-98

Pg 2 of 2

2-10

Mike Reecht
Kansas Director
State Government Affairs

800 S.W. Jackson, Suite 1000
Topeka, KS 66612
Phone (913) 232-2128
Fax (913) 232-9537

TESTIMONY ON BEHALF OF AT&T
BEFORE THE SENATE COMMERCE COMMITTEE
SENATE BILL 666
MARCH 26, 1998

Madam Chairman and members of the Committee:

My name is Mike Reecht and I am the State Director for AT&T in Kansas. I appreciate the opportunity to appear before the committee regarding SB666.

The Kansas Corporation Commission was required by the 1996 Telecommunications Act (HB 2728) to establish the Kansas Universal Service Fund (KUSF) in order to provide access to a full range of telecommunications services, including advanced telecommunications services to both rural and urban areas.

The bill provided for:

- The Kansas Corporation Commission to be responsible for the implementation and ongoing oversight of the KUSF;
- Advanced telecommunications infrastructure to all Kansas consumers irrespective of their location;
- Advanced telecommunications for education, health and safety;
- Access to be lowered to interstate parity levels. This brings Kansas long distance prices more in line with interstate prices. In the past, access has been an implicit subsidy support which was only available to local exchange providers. With the new law, all providers of local service will have an equal opportunity to receive this explicit support through the KUSF;
- Contributions to the Fund from all telecommunications users in the state which is consistent with the Federal Telecommunications Act (FTA);
- And distributions from the Fund on a fair and equitable basis to all providers of local service consistent with the FTA.

Senate Commerce Committee
Date 3-26-98
Attachment # 3-1 thru 3-2

In response to this law, the Kansas Corporation Commission issued an Order on December 27, 1996 which established the KUSF.

The commission's order was appealed on the basis that revenue neutrality and rate of return forbearance were contrary to the 1996 FTA. The Court of Appeals overturned the commission's order but the commission's order was upheld on March 13, 1998 by the Kansas Supreme Court.

This left the legislature with very little time to make any changes it deemed necessary to the 1996 law. During previous hearings, it became apparent that there were well-founded concerns regarding the current and prospective levels of support for local exchange companies required by the law. Although the Supreme Court decision seemed to question many public policy decisions contained in the 1996 legislation, it is unlikely that time exists in this legislative session to consider all of the changes that SB666 would suggest. AT&T does support the concepts in SB666 and feels that these issues should be addressed, however, the complexity of the issues may not allow sufficient time for proper debate.

Therefore, at the very least, the Legislature should consider the following suggestions:

- Cap the KUSF at the current 9.89% level on an interim basis until such time as the Commission completes its audits to assure that rates and surcharges are based on costs and make the necessary modifications to the fund.

- Use any surplus revenues in the current fund to continue to reduce access charges to bring intrastate rates more in line with interstate rates. These access charge reductions are required to be flowed through to Kansas consumers by the 1996 law;

- And provide an interim freeze on the infrastructure deployment to insure that the goals of enhanced universal service are cost effective. However, the KCC should have the flexibility to approve specific enhanced universal service requests if a cost benefit analysis proves to be in the best interest of consumers.

The above suggestions will place a temporary hold on additional increases to the KUSF and provide time for the legislature to review some of the public policy considerations that were included in the 1996 law and SB666.

KANSAS TELECOMMUNICATIONS COALITION

Blue Valley Telephone Company
Home

Columbus Telephone Company

Craw-Kan Telephone Coop., Inc.
Girard

Cunningham Telephone Company, Inc.
Glen Elder

Elkhart Telephone Company, Inc.

Golden Belt Telephone Assn., Inc.
Rush Center

Gorham Telephone Company

H&B Communications, Inc.
Holyrood

Haviland Telephone Company, Inc.

Home Telephone Company, Inc.
Galva

JBN Telephone Company, Inc.
Wetmore

KanOkla Telephone Assn., Inc.
Caldwell

LaHarpe Telephone Company, Inc.

Madison Telephone Company, Inc.

MoKan Dial, Inc., Louisburg

Moundridge Telephone Company, Inc.

Mutual Telephone Company
Little River

Peoples Mutual Telephone Company
LaCygne

Pioneer Telephone Assn., Inc.
Ulysses

Rainbow Telephone Coop. Assn., Inc.
Everest

Rural Telephone Service Company, Inc.
Lenora

S & A Telephone Company, Inc.
Allen

S & T Telephone Coop. Assn.
Brewster

South Central Telephone Assn., Inc.
Medicine Lodge

South Central Telecommunications of Kiowa, Inc.
Medicine Lodge

Southern Kansas Telephone Co., Inc.
Clearwater

Southwestern Bell Telephone Company
Topeka

Sunflower Telephone Company, Inc.
Dodge City

Totah Telephone Company, Inc.
Ochelata, OK

Tri-County Telephone Assn., Inc.
Council Grove

Twin Valley Telephone, Inc.
Miltonvale

United Telephone Association, Inc.
Dodge City

Wamego Telephone Company, Inc.

The Wheat State Telephone Co., Inc.
Udall

Wilson Telephone Company, Inc.

Zenda Telephone Company, Inc.

Response to Senate Bill No. 666

Senate Bill No. 666 would turn back the regulatory clock almost a decade for my company. The uncertainty of possible reversion to rate of return regulation and a regulatory environment which does not accommodate increasing competition, would create uncertainty, chilling potential investment.

- Southwestern Bell has served Kansans for many decades under rate of return regulation, and every rate in place is the result of regulatory oversight. Since 1990, my company's rates have continued to be regulated through **price regulation**. Moreover, the revenues formerly recovered from access charges that are now recovered from the KUSF were the subject of continuous oversight and modifications from 1990 through 1996 based on formula approved by the KCC.

The state corporation commission and the legislature, approved TeleKansas and its extension (1990-1997).

- Price cap regulation and an assurance of no earnings reviews created the incentive for SWBT to invest in facilities in Kansas, bringing the resulting benefits to the citizens of this state. We have participated in a win-win-win in which customers have benefited from price stability for basic services, my company has benefited from flexibility in pricing other services and the state has benefited from the economic development resulting from our investment in the state.

During the two year extension of TeleKansas, Kansas policy makers worked under legislative leadership to determine state telecommunications policy.

- The Telecom Act of 1996 clearly made price cap regulation a meaningful alternative for local telephone companies to promote a competitive marketplace and create investment incentives while protecting consumers against cross subsidies. **Price caps protect consumers against prices being set too high and protect against a company recovering competitive losses by raising other rates.** The price cap company has the potential to earn a competitive return on investment, but also shoulders the risks of losing customers to competition if rates are too high.
- Consumers served by a price-cap regulated company are doubly protected by the price cap regulation and competition. Price cap regulation will not allow prices to exceed their cap. And since competitors enter where prices are set too high above costs, a price-cap regulated company charging too much will see competitors drive prices toward cost and take their customers.
- The Telecom Act of 1996 also provided the necessary certainty regarding the regulatory environment for a company to make investment and other business decisions.

Now that these changes have been made, even the uncertainty of a possible reversion to rate of return would be a "take back" from the TeleKansas agreement, which expressly said "It is the intent of the parties not to merely return to rate based rate of return regulation." That agreement and its extensions were made in good faith with policy makers. A retreat from current policy would replace the structural form of consumer safeguards (price caps) with the labor intensive, highly bureaucratic form (regulatory review). It would also make Southwestern Bell less flexible to be competitive, and establish a huge competitive disparity in which our competitors are virtually unregulated while we are not even allowed pure price regulation like we already have at the Federal level.

- We've taken the steps necessary to open our local markets to cor

Senate Commerce Committee
Date 3-26-98
Attachment # 4-1 thru 4-2

- In the competitive environment that has begun in our exchanges, rate of return regulation is not now a viable regulatory mechanism. **The hazard of rate of return regulation would mean, essentially, that regulators would have to increase rates to offset lost customers.**

I submit to you that Senate Bill 666 completely eliminates the pro-competitive, pro-investment, pro-consumer policies adopted in 1996 after years of work by the Legislature.

We don't believe legislation is needed. The Supreme Court has affirmed those legislative policies to accommodate competition and streamline regulation in a manner that relies more on market forces and less on government command and control policies.

In any event Senate Bill 666 address the real concerns I'm hearing from members of the legislative community and from customers. In response to requests by legislators to propose a constructive solution to the two concerns of their constituents, we prepared the proposal that is attached for your consideration. We thank you for the opportunity to appear here today.