Approved: Carl Dean Holmes
Date 4-29-99

MINUTES OF THE HOUSE COMMITTEE ON UTILITIES.

The meeting was called to order by Chairman Carl Holmes at 9:08 a.m. on March 12, 1999 in Room 522-S of the Capitol.

All members were present except: Rep. Billie Vining

Committee staff present: Lynne Holt, Legislative Research Department
Mary Torrence, Revisor of Statutes
Jo Cook-Whitmore, Committee Secretary

Conferees appearing before the committee: Richard Lawson, Sprint
Shawn McKenzie, Southwestern Bell

Others attending: See Attached List

Continued hearing on HB 2539 - Telecommunications, universal service fund access.

Richard Lawson, Kansas Legislative and Regulatory Activities Manager for Sprint, who testified in opposition to **HB 2539** (Attachment 1). Mr. Lawson responded to questions from the committee.

Rep. Myers: In order to be fair to the opponents, I'm going to ask the same question I asked the Senator earlier in the week. Why is the Fund larger than other states in the Midwest?

Lawson: I think it's larger in Kansas than in other states because access rates and local rates are higher in the others states where they have a smaller fund. We could have a significantly small fund in Kansas if what we were drawing from the Fund today were actually rate re-balance, we actually put it into our local rates. We recovered those lost tax revenues from local revenues than through the Kansas Universal Service Fund. I get these two states mixed up, but it either Nebraska or Wyoming whose legislature just said, Twenty five dollars is a good basic local service rate and by assess $25 local service rate they're going to keep their state Universal Service Fund low.

Myers: So you're saying that it's the local service rate in Kansas that is low compared to other states?

Lawson: I believe that that is a significant factor in that, yes. It's how you let us recover our costs. In other states they recover it through higher access charges, through higher local rates rather than through a very large Universal Service Fund.

Myers: Ok, one more quick question. You said there is an ongoing docket to establish cost based fund. Would that lower the Universal Service Fund?

Lawson: It may or may not. We won't know until we get to those costs. For example, we take $14.5 million out of the fund today, and our first run is that what we would require, what we would request would be something over $30 million for us. Again, that's not new revenue, what you would do if you had a fund that size, is that you would reduce access in those other places where those implicit subsidies are built in. But that's what we're trying to get at. I can't say. It gets into rate re-balancing. Maybe you go back to higher, heavens forbid my long distance company would say, but higher access charges to again, to offset and help us recover some of those costs, or higher local rates, which would reduce, which is all part of the proceeding.

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Myers: You opposed **SB 290** and part of it was to drive the fund to a cost based fund. Why would oppose that?

Lawson: I don't oppose that. I think that we should get to a cost based fund. Sprint has always been an advocate of a cost based fund. The reason I opposed **SB 290**, in my view, it returns me to rate of return regulation and it artificially reduces, it simply takes away revenue, $10.5 million in revenue, in 60 days after this bill is enacted, that I need to run my business. That's the reason I oppose **SB 290**, not because it calls for a cost based fund. We're going to a cost based fund regardless of **SB 290** in my view.

Myers: Ok thank you.

Rep. Dahl: Mr. Lawson, when you went from access charges that made up 42% to 26%, who benefitted by that?

Lawson: Long distance consumers, long distance users in the long run. What it did was reduce long distance companies' cost of using my network and they in turn were required by the law to flow those cost savings to their end-user customers, resulted in lower long distance rates.

Dahl: So it was just the customer who benefitted?

Lawson: Yes Sir

Dahl: Individuals like Don and myself, none of the companies that provide that service benefitted?

Lawson: No sir, not to the extent that they flowed those costs to the end-user as they were required by law.

Dahl: Ok, just the small consumer profited by that. If you take away this KUSF, what are you going to do, where are you going to make up.

Lawson: What I would do, if I permanently lost $10.5 million, I would rescind price regulation and I would go in and file a rate case and ask to recover that money through local rate increases.

Dahl: And that was the purpose of the bill, wasn't it, part of the purpose of the bill, was to reduce that?

Lawson: To reduce the Kansas Universal Service Fund?

Dahl: No, I mean initially in '96. Local service, to reduce that price, to protect the consumer or not?

Lawson: No sir, it was to stabilize those rates, the price regulation part of it. There was nothing in the '96 act, that I'm aware of, that even would address lower local service. My local service rates today are well below the economic costs of providing the service.

Dahl: Okay, thank you.

Rep. Loyd: Thank you Mr. Chairman. Mr. Lawson, I appreciate your comments and I understand, I believe, what I think you're saying. I think you said that you're positioned well (?). Me, personally, I sometimes get a little uncomfortable with people trying to suggest that the legislation comes out of the House, that somehow if that legislation gets changed that that's going to result in the loss of profit right or due process. You do understand that one legislature cannot bind another?

Lawson: I'm not an attorney, but I'm sure you're correct.

Loyd: I understand that for every rule there are exceptions so I probably shouldn't say that as a flat statement. But that as a matter of due process, what that really is talking about (sic) what is supposed to be done and an opportunity to respond and participate in some reasonable manner, is that right?

Lawson: Yes sir

Loyd: And so you have, in fact, had an opportunity to know what contained in these bills (sic).....

Lawson: If you, Representative, don't think that my due process would have been violated in that regard, I certainly respect that opinion.

Loyd: Thank you Mr. Chairman

Rep. Alldritt: Mr. Lawson, I have a couple of questions. I'm reading from 66-2008, sec D in the Statute books. "The commission shall periodically review the KUSF to determine if the cost of qualified telecommunications public utilities to provide local service justify the modification to the fund. If the commission determines that any changes are needed, the commission shall modify the KUSF." What does that mean to you?

Lawson: I think it means it's a cost based proceedings that we're going through today. I think that they are taking a look at the size of the KUSF based on cost and I think that at the end of the proceeds there will be adjustments to the Kansas Universal Service Fund based on my cost of providing local service based on the cost of other carriers.

Alldritt: So basically, all the companies, if we move over to 66-2010, where the statutes talk about the administrator and the duties, this is what I'm really (six). I'm reading from section d "the administrator shall be responsible for collecting and auditing all the relevant information from all qualified telecommunications utilities receiving funds or providing funds to the KUSF". Statutes declare the administrator of the KUSF shall collect all data, all information provided by the companies and audit that account. Is that being done?

Lawson: Yes it is, as a matter of fact, the auditor from the National Exchange Carrier Association, that the administrator of the fund, will be on premise next week to audit our books to make sure that what we've been report is correct.

Alldritt: Then I read on to subsection c "any information available or received by the administrator shall not be subject any provisions of the Kansas Open Records Act, shall be considered confidential and proprietary." Really the members of this committee, we do not have access. We have no legal right to see that data, the information collected, we don't have any right to see that audit in making determinations how disbursements are made. Is that true?

Lawson: That's the reason that you hired an outside, third party administrator to take a look at our books, to do that. I assume it was a function on your behalf, that this auditor did. Now the second thing, is if you want to take a look at that information, and even though it is proprietary and confidential, I feel confident that arrangements can be made to allow you to do just that.

Alldritt: You feel that the data that all the providers are giving to the administrator to make the determinations, that we could see that data, we could look at that audit?

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Lawson: Arrangements can be made to look at that information.

Alldritt: How would we go about doing that?

Lawson: I'm not quite sure. We could do it, I'm not an attorney again, there's a thing called "in camera", where you would look at, not divulge it and you would sign a non-disclosure agreement. Those kinds of things. I'm not an attorney so I couldn't tell you the ins and outs of that. But we make those kinds of arrangements with regulatory agencies all the time.

Alldritt: Mr. Chairman, I would suggest that you would make that request on behalf of the committee. I think that information is so vital to this debate.

Lawson: The reason the information is proprietary and confidential, it deals with demand, it deals with underlying cost information that your competitors would love to see.

Rep. Holmes: We'll make the request. I'm not sure we have, in our rules, authority to have a closed meetings. We may have to do it individually instead of as a committee, for those that want to participate.

Alldritt: I've been in two committees where we had close door meetings....

Holmes: I'm not sure, we'll have to do some checking.

Alldritt: ...concerning water rights. There is a mechanism. I asked for the request.

Holmes: Okay

Rep. Sloan: Thank you, Mr. Chairman. Mr. Lawson, I believe I heard you say the cost of serving your local customers is below the price that you charge?

Lawson: Yes Sir

Sloan: System wide?

Lawson: Across Kansas, on the average, yes. Now I'm looking at an average rate. I'm going to say that what we recover from local service rates does not cover the full economic costs of providing local service.

Sloan: Not even in Junction City?

Lawson: Now that part I can't tell you, we're getting into geographic. It could very well in Junction City.

Sloan: I'm just trying to get the urban/rural.

Lawson: Some areas are more high cost than others.

Sloan: I understand. Can Sprint, as a company, recognizing your long distance and local service, can you offer full local and long distance service to each of your customers?

Lawson: Yes we can.

Sloan: So you are fully competitive with every other carrier since you're able to offer both local and long distance.

Lawson: Indeed. Understand that the interstate or the InterLATA services are offered by Sprint Long Distance and local services are offered by us as a corporation, indeed. We can offer, what we like to say, a full compliment of services.

Sloan: In '96, was the KUSF created to make whole the revenues you lost with the reduction in long distance access charges?

Lawson: Yes sir.

Sloan: Is that number frozen? In other words, lets say you lost $10 million, just to pick a number, by having the long distance access charges. So the KUSF is going to pay you $10 million. Is that $10 million on into the future or does that $10 million rise and fall?

Lawson: My view and this is where I'm probably differ with some of my colleagues, is that when we get to the end of this cost based study, let's say I'm taking $10 million out of the KUSF today. And that cost based study, if it is a genuine, objective, legitimate cost based study and it shows that the cost of my service would require me to receive something less than $10 million, that's the way the cookie crumbles, that's what happens based on cost. But I have every confidence that when we do the cost based study, that it's going to demonstrate the cost of service and what I should draw from Universal Service Fund, any absence of the local rate increase or other revenue sources is going to higher than that.

Sloan: Yea, but what I'm struggling with is if the KUSF was to make you whole in 1996, then how can the number grow, how can the need for a subsidy grow, when we're making more than the money that you lost in '96?

Lawson: What you would do, is that it would demonstrate more subsidies implicit in access and other services so that the extent that the fund grows, revenues from other sources are going to shrink, so it's still a net sum gain. Am I making myself clear?

Sloan: I understand what you say. I'm struggling with allowing the fund and your collection to grow.

Lawson: It doesn't necessarily have to.

Sloan: I understand that. I just, implicitly does not make sense to me, that if we are making you whole in 1996, that in 1999 or 2000 you would have more money available to you.

Lawson: It wouldn't necessarily have to come from a Kansas Universal Service Fund. What we would, what we are trying to do, the revenues are not going to grow. The pie is going to remain the same size, it's the slices that are going to be different as to where I derive that revenue. And we're talking about a cost based fund. What we are talking about is establishing the cost of local service and then the Fund and other prices would be sized and established based on the cost of providing local service.

Sloan: I'll return to that. Thank you Mr. Chairman.

Rep. Kuether: Thank you, Mr. Chairman. Mr. Lawson, how many employees do you have in the state of Kansas?

Lawson: In the state of Kansas, I think we have 12,000. Now that's Sprint Corporation, that includes all of our employees at our corporate headquarters for Sprint PCS, Sprint Long Distance and Sprint Local.

Kuether: Well, you mention in your testimony here, there part where you say you are guilty before innocent and if you went into a hearing situation that your cash flow would be disrupted during that hearing time. Do you suppose during that hearing process, you would have to lay off people?

Lawson: No ma'am, I don't. I don't think we could afford to right now. We are a fairly efficient organization and what we would do is to borrow that money, we would get the cash flow in some other way.

Kuether: What you are alluding to, is short term borrowing down in the lower (sic).

Lawson: Exactly, those are the cost that our investors would have to bear because their cash flow had been disrupted.

Rep. Klein: Thank you Mr. Chairman. I looking at your little graph/table. I interested in the one that says "Recovered Total Cost", so I'm looking at a graph that is the cost of you doing business not all which has anything to do with the Universal Service Fund or local service. Is that right?

Lawson; Right.

Klein: Okay. This information, I'm interested more in, I would like to see a little pie of the cost of providing local service and the purposes for which you are drawing from the KUSF, that part of the graph that is buried in yours so I can tell what is going on. I know it is going to cost you, but I can't tell whether or not, what you are recovering for within the parameters of the KUSF. And I'm not interested in proprietary information, but I am interested in knowing how that number has grown or shrunk as a total and that's the one thing I think the committee needs before we can make a decision and we seem to be blocked a little bit for some reason. I'm not sure that I understand what the purpose of including a total cost graph cause that is really not what we are talking about.

Lawson: I agree with you. I don't think we're looking at the cost of local service versus access. And that's my point, is that, it's premature do anything until we better understand that. And that's what the commission is getting in their proceedings. We don't know explicitly, what the cost of local service is until this proceeding is done. What I'm trying to demonstrate is, historically, and when I talk about total cost, this is really kind of total revenues equals costs in this regarding, just recovering my costs. Historically, we've said, Sprint you have a bucket of costs and that's what we've said. Your total cost of providing cost service is X amount. Now historically, we've said and this is an exaggeration, but historically $10 is a reasonable local rate that will allow you 10 x 12 x the number of customers you have to recover a certain percentage of that total bucket of costs. Now go recover your other costs from some place else. Access, long distance, ancillary services, those kinds of things. So that's what we don't know and I agree with you and that's what we need to get to.

Klein: Right, and that's my fear and of the whole committee, honestly, is that, I'm sure that you are not recovering all your cost for running the business through KUSF. What I am not sure of is whether or not you are recovering costs that got nothing to do with the intention of the Universal Service Fund. And I can't know that. Let me ask you another question. I know that some of the, you said before, certain amount of costs flow through to long distance people through the, or not the costs, but the benefits. How does that procedure work, using their lines, how does that money transfer to company to company?

Lawson: Basically, a long distance company pays me 'x' cents a minute, in my case it's probably about from 5 to 6 cents to use my local network. Let say, those are costs that they incur so those are costs they chose to pass on to their long distance customer through long distance rates. Through this process that I reduced, and I think I reduced almost by half my state access costs (END OF TAPE)

PROBLEMS WITH TAPE

Mr. Lawson continued to respond to questions from Representatives Klein, McClure, Dahl, Alldritt, Toelkes and Holmes.

Chairman Holmes: You elected to go to price cap regulation. You say it was because of court challenges and continued debate in the Legislature. I'd like for you to expand on that.

Lawson: Okay, any business will take a risk. There is a risk involved in what might potentially be higher earnings for a company under price regulation. But it needs to a reasonable risk. We were eligible to chose price regulation shortly after the 1996 Act was adopted. We looked at those options that there were some fairly immediate court challenges, and we just didn't know if the rules were going to be the ones contained in the Act or the ones that were promulgated by the commission. We didn't know what the rules were going to be. And then we got into the legislative session the year before last and last year and, again, the rules were shifting, it was an ever shifting landscape. I couldn't calculate my risks in choosing price cap regulation. As of the fall of this last year, after the legislative session had completed, after a very critical Supreme Court decision had come out, I felt like that I knew what the rules were going to be in the price regulations and felt like that was a reasonable risk to take. And so that's what I meant. I hope that wasn't a "how to build a clock" answer.

Holmes: With being under price cap, that means that your books are not looked at by the KCC as far as earnings?

Lawson: For the purpose of earnings.

Holmes: As a result of technology improvements, does that lower your cost of providing a service?

Lawson: Yes, we are a declining cost business. And that's reflected in the formula that I tried to explain a while ago. If I go in and adjust my rates next year in the year 2000, the formula says that I can adjust them by no more than the rate of inflation minus 2.3%. The 2.3% is supposed to represent that I am indeed a declining cost business and the consumer is going to benefit in those inherent cost savings.

Holmes: Where's the magic of the 2.3%? What's its' basis?

Lawson: It resulted from a proceeding and studies that were done of the efficiency of my business versus business in general.

Holmes: Is that KCC established 2.3%?

Lawson: And they were charged to do that by the 1996 Act.

Holmes: Okay, you moved out of being a price rate company, so your earnings as a result of technology may actually be going up right now compared to what they were before.

Lawson: I wish they were, they could be.

Holmes: They could be and if they were, because of the freeze that will be put in place on January 1, 2000, cost of inflation at 2.3%, those increased profits would be locked in forever until the Legislature changed the law. Is that correct?

Lawson: That's right.

Holmes: So whatever you can increase your rate of profit between Fall of '98 and January 1, 2000 is going to enhance your bottom line until the legislature changes the law.

Lawson: Yes it is.

Holmes: I think that's all the questions I have. If there isn't any other questions of the committee, Thank you.

Shawn McKenzie, President, Southwestern Bell Telephone Company-Kansas, presented testimony in opposition to **HB 2539** (Attachment 2). Mr. McKenzie responded to questions from the committee.

Holmes: Since Liberal been referred to in regards to competition, I'm going to ask the first question. What was there, ten or twelve companies listed there as competitors in Liberal. I've seen the page, but I haven't counted them.

McKenzie: I think there were 8, no there were 10, you're right.

Holmes: Who determines what the discount rate is that you sell the service to those companies?

McKenzie: There are two ways they can buy the service from us. Right now there is a 21.6% discount for those who simply want to resell our service. For those companies who want to have part of their own facilities and part of ours, the docket that I referred to that begin in December of '96 that we just got an order on a couple of weeks ago, that docket determined by the KCC based on forward looking cost, would set the prices of how much we have to sell, for example the loop from our central office to the customers premise, or how much we'd have to sell just the switching and so on for each element of our network.

Holmes: But if you provide all the services, 21.6%?

McKenzie: Yes

Holmes: What is the monthly charge there in Liberal?

McKenzie: Probably between $8 and $10, I don't know off the top of head.

Holmes: I'm thinking $18, but I'm not sure.

McKenzie: Our basic rate in Liberal?

Holmes: I think, but I'm not sure. I think it's $18.50, including the taxes and stuff, I think it $18.53 or something like that.

McKenzie: They don't let me set tax rates, so I just think of our basic rates.

Holmes: But what percent are the taxes?

McKenzie: I think that if you just looked at a plain old telephone service, no additional services, roughly 30% to 31% would be taxes and other charges that we collect for entities.

Holmes: So we'll say it's around \$12 - \$14. That \$12 - \$14, how was it established? I mean, we know what, the discount is 21.6%, but how was the base rate established at \$12 - \$14.

McKenzie: Our average rate in Kansas is \$10, so I think Liberal is probably not more than \$10. That original rate was established under an old earnings regulation format prior to 1989.

Holmes: So the last audit that you've had was before 1989 to establish what that base rate is, is that correct?

McKenzie: That came to a complete conclusion, yes, but an audit was started and then stopped in, I believe in 1994.

Holmes: Right, but you can't use that because, those numbers were never determined. 1989 is the last time that the rate was established. And that's the same rate today and what your doing is taking 21.6%, so really the competitors, all they have an opportunity to do is to discount below what your charging by 21.6% if they want a discount.

McKenzie: If all they want to do is resell, I mean, they have the ability to buy of pieces of our network or build their own network as KMC is doing.

Holmes: Right, I understand that, but the 21.6% that's the only thing they can make smaller to go into competition with you. The base rate is still established there, whether it's \$12 or \$14.

McKenzie: Right, they have a 21.6% discount below that base rate. So if all they were selling was basic service then that would be the only advantage they have. But most of our competitors bundle products. They want to sell to you...

Holmes: I understand that, the bundling of products to try to make it more attractive. But still the base rate is locked in 1989 and the books have not been looked to make a determination whether that is too high or too low. Where is our technology today compared to where it was in 1989 in regards the cost of handling a phone call.

McKenzie: I can't break it down to the exact cost of handling a phone call, but I do know the difference in the prices of switches from 1989 to today. In 1989 we would have paid, for a medium sized city like Liberal, we would have paid \$1.7 million for the switch and then we would have paid about \$200,000 for the software right-to-use fees to operate that switch. So for a total of roughly \$1.9 million dollars. In 1999, and these are our costs figures not including installation. In 1999 that same switch cost us roughly \$1.5 million and the right-to-use fees for software, because there are services like caller ID and other services that we weren't attempting to sell back in 1989, the right-to-use fees for the software are now \$1.1 million, so the total cost of that same switch would be roughly, \$2.6 million.

Holmes: In 1989, did you offer caller ID, call forwarding, call waiting and all those things with your \$1.7 million switch?

McKenzie: Not in all towns, well, more than one question. No we did not provide caller ID because those systems would not have been equipped to do that at that time, but we were offering call forwarding and call waiting in some of our communities in 1989.

Holmes: But you switch today, the \$1.5 million switch does have that on it, doesn't it?

McKenzie: Yes it does.

Holmes: So really, the caller ID, call forwarding and, what you call 'The Works', is that regulated?

McKenzie: Our prices are yes, all of our prices are.

Holmes: What you charge for those?

McKenzie: I take that back, do we have some prices that aren't regulated?

(???) Recently rejected,

McKenzie: They rejected, so our prices are regulated.

Holmes: They're all regulated. How much of that $1.5 million plus $1.1 million or $2.6 million is the switch and the software, just to provide the service that you were providing in 1989? Regular telephone service.

McKenzie: Gosh, Chairman, I felt good that I could tell you the numbers to begin with.

Holmes: My point is that the switch you have there is by far more sophisticated, a lot more capabilities and, therefore, you're still using the 1989 numbers. The $2.6 million really is comparing apples to oranges, the capabilities are a lot more today than what they were then.

McKenzie: That's right, Signal System Seven was part of the '96 Act and that's part of what's built in here.

Holmes: I'm not going to be critical from the stand point that our telephone service today in this state is by far better than it was in 1989. I'm taking the entire state as a whole. I think that we've had something to do with pushing both the Kansas Corporation Commission and also the Legislature.

McKenzie: No question.

Holmes: I don't want to downgrade this, because I feel telephone capabilities are very important in this state. But there are some factors to take into consideration.

Rep. Dahl: Thank you Mr. Chairman. Mr. McKenzie, I'm follow on with some of the questions I asked Mr. Lawson, but first of all I'd like you to explain on your first page of your testimony on the third line from the bottom where it says, "For SWBT both rural and urban residential service is provided below statewide average cost." Are you losing money or is this smoke and mirrors, what's going on here?

McKenzie: We lose money on local service in the state of Kansas. We make up for that loss with access the long distance companies pay us and the long distance we sell to customers.

Dahl: Okay. What are you talking about, you mentioned $57.2 million dollars. What are you talking about there?

McKenzie: If you take the $36.88 and you multiply it by the number of high cost lines that the KCC says that we have by their definition of exchanges of 10,000 or less access lines. For us that's 211,000 access lines. Multiply the 211,000 by $36.88, you come up with, roughly, a draw of $7.8 million. That's what they say we would be entitled to under that formula.

McKenzie (cont): We currently received $65 million of our revenue from the KUSF. Subtract $7.8 from $65, you should get $57.2 and my son did understand that last night.

Dahl: Well, I'm not going to tell you whether I understand that or not, but which figure there, $57.2 or $65 equates to $10 million?

McKenzie: The $57.2 is our reduction, the $10.5 is their reduction.

Dahl: Okay, so you're going to be reduced $57.2 million.

McKenzie: Yes, if this were enacted into law.

Dahl: Okay, $57. Are you going to lose or make money if that happens?

McKenzie: In the short time, I'm going to make much less than I now do, but it will not bankrupt me.

Dahl: Okay, so it's not going to bankrupt you?

McKenzie: It would roughly cut our earnings in half, in just using very broad terms and trying to disclose anything that is proprietary.

Dahl: Your earnings, that's not the same as profit?

McKenzie: Yes it is.

Dahl: Okay, so we're talking the same thing, so it would cut your profits in half?

McKenzie: Yes

Dahl: Okay, so you're in a different shape than Sprint, Sprint says they'll go bankrupt.

Lawson: No sir, I did not make that statement.

Dahl: Oh, so we were talking, so you were talking about profits also?

Lawson: No sir, I was talking about cap, the money I need to run my business on a daily basis. If I don't have that money, I'll have to borrow it.

Dahl: Well, I understand, but if you borrow long enough, what's going to happen?

Lawson: I can pay the interest on it, not much.

Dahl: If we keep the rates where they are and you have to keep borrowing, what's going to happen?

Lawson: Well, we hope it won't get into that.

Dahl: I understand that, that's what we're talking about here. What I'm trying to down is the bottom line, what we're doing here. And it seems like what we're doing here is regulating your profit margin.

McKenzie: That's the way I see.

Dahl: And I'm saying here we're a bunch of legislators in a free enterprise system and we're telling the corporation or something like that, how much money they can make. And

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Dahl (cont): basically, let's say Sprint then if they have to keep borrowing money, I would think in my case I would go bankrupt. I can't continue to do that and which means I vanish from the scene. Which means Kansas could no longer have Sprint, now you may be different, but we'd lose Sprint in Kansas. What does that do to competition? I'm asking. Does it increase competition or reduce competition. If you have increased competition, are the rates going to down or up? You know, those are the things I look at here. And I'm saying if we reduce competition, if we are sitting here saying how much an entity can make for profit, I have to question the whole process and I'm just wondering if that's what we're doing is determining how much profit can make.

McKenzie: That's the way I see it. Competitors are attracted to any market, not just telecommunications market, but any market by the potential to profit. You take $67.7 million out of the market place and you have taken a lot of incentive that would have previously brought competitors to it.

Dahl: I'm sitting here wondering how much each legislator here thinks is fair for a company to make, 2%, 10%, 50% profit, I personally don't know. I'd have to ask every legislator here, if we're getting involved with this, how much they think is fair for, in a free enterprise system. Thank you very much, that's all I have.

Holmes: I have a follow up question. Since we talked about competition, and really, we've been in a regulated monopoly up until a few years ago, what would it cost you, if a competitor wanted to come in and build a system identical to what you have to compete against you, what would it cost to replace your system today?

McKenzie: We have, in rough terms, $2.3 billion invested in our network in Kansas.

Holmes: So if I wanted to compete against you, I'm going to have to have access to $2.3 billion before I could really compete against you in an equal playing field.

McKenzie: Some would argue that we have done things that weren't the most efficient way of doing them and would argue that it could be done for less than $2.3 billion.

Holmes: So basically, it's going to take me $2.3 billion if I want to go into competition with you? And duplicate everything you have in place.

McKenzie: Door to door, yes.

Rep. Myers: I think in response to what Rep. Dahl said awhile ago, I think we had handed out to us a month ago and AG opinion that the Legislature has basically the same authority and responsibility as the Kansas Corporation Commission. So we are responsible to our constituents as well as responsible to make certain that companies can grow, thrive and prosper in the state. So it's not, I don't think, a matter of legislators do not have any reasons to be looking into the regulation process and maybe even give direction to the Kansas Corporation Commission. That's just a side line. What you mentioned awhile ago, you probably answered this question. Why is that you don't received Federal Universal Service Fund?

McKenzie: When the federal government looks at Southwestern Bell's cost in Kansas, they look at all, roughly, 1.3 million lines together. And when you look at all of them together, our average costs don't rise above the threshold to receive the Universal Service Fund. Did I not say that very well?

Myers: Say it again, may I'm not listening as fast as you're talking.

McKenzie: Essentially the FCC has a threshold you have exceed the national average cost by 125%, it would 125% of national average cost. And when you take all of Southwestern Bell's lines in Kansas together, we don't exceed that. Now if you took just our high cost line, the 211,000 per the KCC definition, it would be a different picture, but that's not what the FCC does. The FCC looks at all of our access in Kansas. So the lower cost lines in the densely populated areas bring down that average cost. Is that?

Myers: Yes, I think that's clear. Sprint does receive funds from the Federal?

Lawson: Yes, we do.

Myers: Is it the reverse then, situation of what....

Lawson: Yes, our costs in the aggregate for providing local service is higher than the national average and that's what determines how much Federal Universal Service Fund support we get.

Myers: Is that because, you maybe have more high cost lines than the other?

Lawson: Other than Junction City, sparsely populated rural service territory and (sic).

Myers: Shawn, why did you, I think this is a basic question, why does a company chose cap regulation versus regular. Why did you?

McKenzie: Why did we? Because we would like to make investments and be the most efficient company we possibly can. And there's no incentive to do that under earnings regulation. Because the better your investments and the more efficient you are, the lower your rates get. We would like to turn that around and have the incentive to invest more and operate more efficiently, so that our share owners receive the benefit financially and that our customers receive the benefit of the most competitively prices products and the best products available.

Myers: So you're saying, through efficient operation, you have more investment money to make your service better?

McKenzie: We are convinced, in the long run, that we will be financially healthier business under price cap regulation than under earnings regulation.

Myers: Okay, I'm going to ask you one last question, this is the broken record question. Why is it, and this will probably help you make your case, why is it that our fund is bigger than other states?

McKenzie: I was waiting for that question, since you've asked everybody else. In the KUSF Working committee's document, some of you may have seen, there was the document that showed that, you know, we have the highest. And that is a document that the KCC staff prepared and when we saw that, we thought, that is not an apples to orange comparison, because those are states that have higher business rates than we do, those are states, for the most part, I think with the exception of one, have higher access charges than we do and all of them have a higher local rate than we do. So we made one adjustment to it, we just said if all local rates were equal, what would the fund situation look like. We would no longer have the largest fund if you just made local rates equal. You don't even have to address local residential rates, you don't even have to address the difference in our business rates, you don't have to address the difference in access charges, if you just make local residential rates equal, then we have the lowest fund. Just to give you an example, Kansas per line would be $66, if you did that. Colorado per line would be $85, if you did that.

McKenzie (cont) Wyoming per line would $192, Nebraska would be $123. So when we tried to make it apples to apples with just that one adjustment, it makes a dramatically difference picture. And thank you for asking that questions, since you asked everyone else here.

Myers: Thank you.

Holmes: Was that the same number that you had.

Lynne Holt: That was Attachment 4 in the report.

Rep. Franklin: Thank you Mr. Chairman. I appreciate your testimony Mr. McKenzie. I'm fighting with how to ask the questions. First of all, it's very clear to me that you very much the KUSF and want to keep it. That's the reason you're here. I've been beat a little bit on forums about this issue. Let me just give you a little background. (END OF TAPE SIDE A).....pile of money that 90% for rate re-balancing that goes to other customers and then the other 10% is to give nice switches or whatever you call then that was cultivating all that, caller ID, but they're not getting anything else, that's the perception, in a nutshell. How are you supposed to react this, this is a hot issue in my district and I've been beat on. I don't know how to answer them. I could say, well, in this case we're doing a little bit of 'Robin Hood' cause that's a good thing cause these people need these services or these switches. But they'll come back, and here's the killer that they come back, they'll site some company with it's rate re-balancing like Clay Center or some place like that, that has $12 and they're paying $20. So where's the parity of rate re-balancing to pay for all for these switches out there to keep their rates at $14 and then our rates are at $20. We've gotten nothing out of the KUSF. That's kinda of what we're dealing with and that's why you're probably getting phone calls from legislators.

Holmes: Before you answer, I think this is going to be a long answer. I don't think you can explain this in two or three minutes.

McKenzie: I'll make it as short as you like or I'll come back.

Holmes: It's ten minutes to eleven. Would it be okay if we postponed the answer to that until Monday morning?

Franklin: That would be fine.

Holmes: I have some other people who have questions. We will continue the hearing Monday morning.

Rep. Klein: Maybe I'm getting ahead of you here, but it was my understanding that we were going to work some bills Monday.

Holmes: We will have to postpone that, because I want to finish this hearing before we work any bills. My intent will be to continue. So what I'm asking is the conferees to return Monday and we will continue the questioning and we will let you answer that question. But I have a question of you. Sprint made an offer to open up confidential records to the committee members, if they would sign a statement that it was private confidential information and could not be divulged. Could you make that same offer?

McKenzie: Last year, Chairman Myers from last year's Utilities Committee, I brought the confidential documents with me and I had confidentiality contracts with me and I offered any member of the committee who was willing to sign one of those Confidentiality Agreements that I

McKenzie (cont) would let then look through the information and I would do that again. But, I think it's already been pointed out that that needs to be done on an individual basis. Perhaps, if everyone on the committee signed it, then we could make it an open committee meeting, but I would want.....

Holmes: It wouldn't be an open, because the public would have to know.

McKenzie: I misused the word 'open'. I would want everyone exposed to the information to have signed the confidentiality agreement.

Holmes: That's fair. My question is, of the committee members, how many of you, and I'm not requiring every committee member to say they want to do this or don't want to this, we've had one committee member make that request, I'd take a show of hands of how many committee members would be willing to sign a confidentiality agreement to see those records.

Kuether: I'm not sure I'm comfortable with the question.

Klein: I'd have to see it, Mr. Chairman, to whether or not I could use the information.

Holmes: It could not be used, it would be for your own purposes, basically, the way I understand the confidentiality agreement.

Klein: I'd have to see it.

McKenzie: You want to see the agreement?

Klein: Yes

Kuether: I have a problem with that

McKenzie: You want me to have copies of the agreement sent to all the members?

Holmes: Would you bring a copy of the agreement Monday? And would you also do that?

Lawson: Yes sir

Holmes: Make enough copies for the committee members so that they can take a look at the agreement and they can, individually, decide if they want to do that.

Lawson: The information they seek is the information we have already provided to the Commission, is that correct? In determining what our draw is from the Fund.

McKenzie: Last year I brought in annual reports that I have to file with the KCC, which are confidential documents and that was what I was offering last year. It's probably more information than you'd ever want to see.

Holmes: Could you also make an outline so the committee members would know what they'd be looking at if they signed? Make an outline of what they would be exposed to, not numbers or anything, but just an outline of what they would be exposed to if they signed the agreement?

McKenzie: Are we talking about specifically, as it relates to the KUSF? Or do you want broader than that?

MINUTES OF THE HOUSE COMMITTEE ON UTILITIES, Room 522-S Statehouse, at 9:08 a.m. on March 12, 1999.

Holmes: KUSF only, KUSF is what's on the table right now.

McKenzie: That would be much easier to do that what I was thinking.

Klein: Okay, but I don't see that information having a lot of value to the committee.

Holmes: That's what I want the committee decide and before you can make a decision, if they're only going to give you a balance statement you're not going to be able to tell anything from it. And that's the reason a list of what would be included, if you signed that confidentiality agreement. The other questions I have is, the Staff is not appearing on the bill, but I would like the Staff, Monday, to make itself available for questions of the committee. Is that agreeable? Realizing that the Staff is not testifying on the bill as a proponent, opponent or neutral, but be here for information purposes, to ask questions of. What we will do Monday, disregard the calendar that is printed. We will continue the hearing on this bill Monday morning only, we will not work any bills on Monday.

KCC staff distributed memos in response to questions posed by the committee the previous day (Attachments 3 & 4).

Meeting adjourned 10:55 a.m.

Next meeting is Monday, March 15.

HOUSE UTILITIES COMMITTEE GUEST LIST

DATE: March 12, 1999

NAME	REPRESENTING
Nelson Krueger	LEL
Walker Hendrix	CURB
Rob Hodges	KTIA
Susan Mahoney	Senate Leadership Offices
Mike Reecht	AT+T
Paul Snider	SWBT
Charles Cheek	"
Shawn McKenzie	SWBT
Richard Lawson	Sprint
Mike Murray	Sprint
Susan Bechard	KIMF
Debbie Snow	CWA
John D. Pinegar	SITA
Shirley Allen	SWBT
Doug Lawrence	SWBT

HOUSE UTILITIES COMMITTEE GUEST LIST

DATE: March 12, 1999

NAME	REPRESENTING
Judy Moler	Ks. Ass'n of Counties
MIKE LURA	CURB
Chuck Layman	KDHE
JAN Sides	KDHE
Kim Gulley	League of KS Municipalities
Anne Wickliff	KCC
Jerry Lammers	KCC
Dave Dittemore	KCC
Diane Cafer	KCC
Tom Day	KCC
Dave Heinemann	KCC
Chris Wilson	
John Peterson	
Senator Karin Brownlee	
Jeanne Eudaley	

Before the House Utilities Committee

House Bill 2539

Testimony of Richard Lawson, State Executive

Sprint

Chairman Holmes and members of the committee, my name is Richard Lawson. I manage Sprint's legislative and regulatory activities in Kansas. My role today is to tell you why Sprint opposes House Bill 2539.

As you have noted, Chairman Holmes, House Bill 2539 is identical to Senate Bill 290 as it was *originally* introduced in the Senate earlier this legislative session. Sprint opposed the original version of SB 290 in testimony before the Senate Commerce Committee. It bears noting that Senate Bill 290 was subsequently amended in ways which made the proposal more acceptable to Sprint, but the legislative proposal before us today does not contain these amendments. As a result, my testimony today will focus on the same objections that I raised regarding the original Senate version.

In Sprint's view, now is not the time to make significant revisions to the Kansas Telecommunications Act of 1996 that was adopted by this legislature less than three years ago. Sprint continues to believe that the policies contained in the 1996 Act are fundamentally sound. Sprint believes the 1996 Act encourages competition, efficiency and innovation. Sprint is just as eager as you are for its customers to realize the full benefits of the 1996 Act. But I urge you not to act prematurely. The Kansas Corporation Commission continues to implement the Act. Patience is called for because the issues are complicated and due process takes time.

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DATE: 3-12-99

ATTACHMENT 1

Sprint opposes House Bill 2536 because it reverses fundamental policies contained in the 1996 Act. It dramatically changes the assumptions upon which we have made business decisions during the last two years. And, quite frankly, it is, in my our view, a step backwards in bringing the benefits of competition and less regulation to Kansas consumers.

There are three fundamental flaws in House Bill 2536 I want to discuss today.

First, House Bill 2536 sets aside the agreement made between this legislature with Kansas telephone service providers and their customers in 1996. The Act allowed Sprint to elect price regulation. Because of court challenges and continued debate in the legislature, Sprint did not ultimately elect price regulation until the fall of 1998. We thought at that time that basic policy and legal questions had been settled and that we could enter into this new form of regulation based on certain assurances from you and the courts. Here is what Sprint thought our price cap decision meant:

Price cap regulation assures consumers of reasonable and stable prices for high quality basic local service. That is because Sprint can not seek to increase local rates until the year 2000, except for unfunded mandates by the legislature or the Kansas Corporation Commission. After the year 2000, consumers are guaranteed that prices for local service will fall, remain the same or, at most, rise less than the annual rate of inflation.

These pricing restrictions protect consumers from such things as a down turn in the economy or other financial challenges that Sprint might face. In other words, Sprint assumes all the financial risks as a price cap company.

The trade off is that Sprint can return to its investors higher profits it might earn through being more efficient or generating more revenues through the introduction of new and innovative services. Under price cap regulation, Sprint is also afforded modest pricing flexibility for its more competitive services. Another important safeguard for consumers is continued regulation of quality of service. If Sprint attempted to earn more profits by cutting corners on service, the law says the price cap agreement would be terminated and Sprint's earnings would once again be subject to Commission regulation.

Sprint fully anticipated that as long as it upheld its end of this agreement, regulation would be more streamlined and certainly less contentious.

House Bell 2536 sets aside this agreement. The proposal would continue to severely restrict changes in local service prices. And while the bill says that the Commission can not take earnings into account in setting prices, it gives the Commission free reign to increase Sprint's costs or reduce its revenues and to use earnings as a reason for not allowing Sprint financial recovery.

Sprint elected price regulation in good faith based on the 1996 Act. For the legislature to retreat from these commitments at this stage of the game is just unfair.

The second flaw in House Bill 2536 is that it puts at risk Sprint's ability to recover more than $10 million in annual revenue that we lost when we were required by the 1996 Act to reduce our access charges. And in explaining this flaw, a little background might be in order.

I have heard it said that local telephone companies are reaping a windfall of new or undeserved revenue from the Kansas Universal Service Fund and that's why the fund needs to be reduced. This is just not the case.

Access charges are what local telephone companies charge long distance companies for use of their local telephone networks. Historically, access rates – and thus long distance rates – have been set well above the costs of providing access and long distance services. These above-cost revenues have historically been used to keep local rates well below the costs of providing local services. This regulatory approach has been used to ensure that reasonably priced local telephone service is universally available to anyone who wants it.

The 1996 Act determined that long distance customers should not be the sole source of local service support. The Act required local telephone companies to reduce their intrastate access rates to more closely reflect the actual costs of providing access service. In turn, long distance companies were required to flow these reduced access costs to their customers through reductions in long distance rates.

Before the 1996 Act, Sprint recovered its costs of doing business in Kansas from primarily five sources:

1) About 31% of Sprint's costs were recovered from local telephone service revenue.

2) About 42% of Sprint's costs were recovered from access charges.

3) About 1% of Sprint's costs was recovered from long distance services.

4) About 6% of Sprint's costs were recovered from miscellaneous services.

5) About 20% of Sprint's costs were recovered from the Federal Universal Service Fund.

By reducing its intrastate access rates to interstate levels (which the 1996 Act required), Sprint lost more than $14 million in revenue that was needed to cover its costs of providing local service.

The 1996 Act told the Kansas Corporation Commission to allow Sprint to recover this lost revenue in one of three ways:

1) By increasing local rates.

2) By receiving revenues from a Kansas Universal Service Fund.

3) Or by a combination of local rate increases and revenues from the Kansas Universal Service Fund.

Subsequently, the Commission determined that the state universal service fund should be the primary source for recovery of these lost revenues. In this way, local service rates would not be raised. All telecommunications users – not just long distance users, as had historically been the case – would support the universal availability of low cost local service through the assessment of surcharges for the state fund.

As a result of the Commission's actions, Sprint ***now*** recovers about 26% of its costs from access, compared to 42% ***before*** the state universal service fund was created. Sprint ***now*** recovers about 16% of its costs from the state universal service fund, compared to 0% ***before*** the fund was. What has occurred is merely a shift between revenue sources, not the creation of an additional source of new revenues.

House Bill 2536 would deny Sprint recovery of most of its lost access revenues that resulted from the 1996 act. Granted, the legislative proposal says these lost revenues will be restored if Sprint can produce studies showing that these lost revenues are actually needed to cover costs. But this is like saying Sprint is guilty of receiving money it doesn't deserve until the company can prove its innocence. In addition, the legislative proposal sets no deadline for the Commission to make such a determination or the costing standards to be used. And while the Commission deliberates, regardless of the outcome, Sprint's cash flow is disrupted. Its investors will bear the costs of short-term borrowing because the company's cash needs can not be internally generated.

Sprint does not understand why such a harsh measure is needed. The Commission is already conducting proceedings to establish the costs of providing basic local service. In fact, a schedule for concluding the proceeding was published earlier this month. It appears from the schedule that the Commission will have ample time to make its findings before the end of the year.

The Commission staff has said that depriving price cap companies of state universal service fund revenues will encourage these companies to produce information needed by the staff for cost studies. I want to make clear that Sprint has participated fully in Commission cost proceedings that effect us. We have never been reluctant to file data that has been requested of us. We are just as eager as you and the Commission to fully implement the policies contained in the state and federal acts. Sprint needs no incentive to help create a cost-based state universal service fund.

The final concern I need to raise is that the severe reductions in KUSF revenues apply to only price cap companies. Sprint is one of only two price companies in this state. But on the basis of costs, we are much more like the non-price cap carriers. With the exception of Junction City, we serve rural, high-cost communities. And like most of the non-price cap companies in Kansas, we receive high cost support from the Federal Universal Service Fund. Simply put, House Bill 2539 discriminates against Sprint simply because of its election of price cap regulation, not because of its cost characteristics.

I have outlined for you what we believe are the major flaws in House Bill 2539. I would like to quickly conclude with what we think are the intended or unintended consequences if this proposal becomes law.

First, House Bill 2539 would destabilize rates for basic local service. The proposal would so change the rules under which Sprint elected price regulation, that we believe we would have the right to rescind that decision and return to traditional rate of return regulation. General rate cases would be our recourse to recovering lost revenues and higher costs.

Second, House Bill 2539 denies us the ability to recover in a timely and predictable manner our legitimate costs of doing business, which we believe could be interpreted as the un-Constitutional taking of investor property.

Third, House Bill 2539 would hold us guilty of inflating the Kansas Universal Service Fund until we could prove our innocence, which we believe could be interpreted as a violation of our rights to due process.

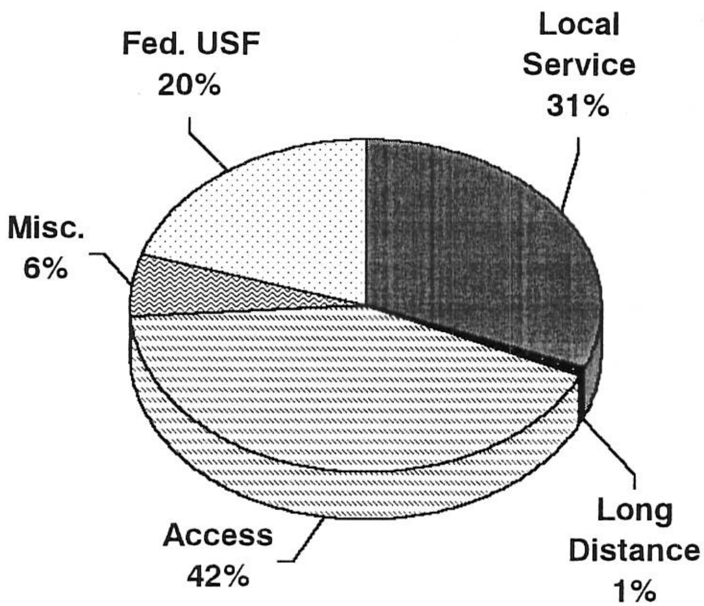
Fourth, House Bill 2539 would increase government regulation by returning us to the days when the Commission can challenge the appropriateness of our earnings at every turn. The result would undoubtedly be an increase in the number of costly and contentious proceedings before the Commission.

And fifth, House Bill 2539 would tell business in general that state policy, upon which investment decisions are made, is every changing.

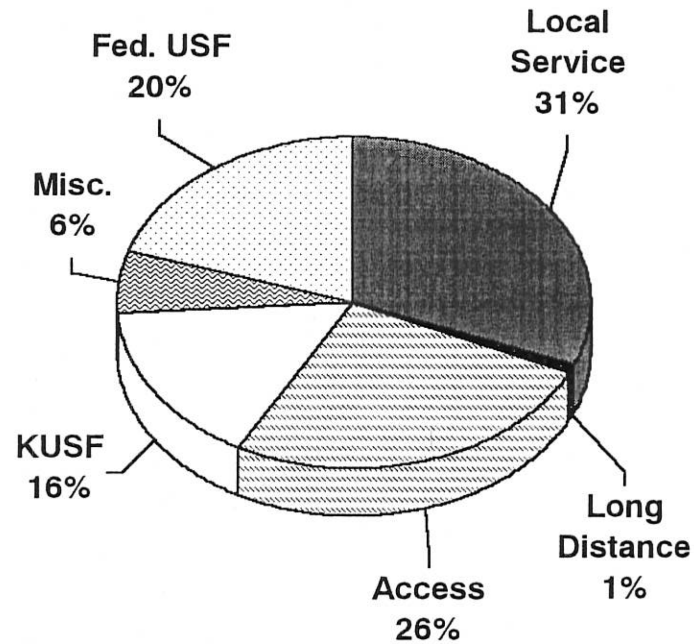
Again, I ask you not to adopt House Bill 2539.

Sources of Revenue
To Cover *Total* Costs

Before
Kansas Universal Service Fund



After
Kansas Universal Service Fund



Testimony of Shawn McKenzie, President
Southwestern Bell Telephone Company--Kansas
Regarding HB2539
Utilities Committee
Kansas House of Representatives
Thursday, March 11, 1999

Over the last ten years, the telecommunications industry, the Legislature, the governor's office, the KCC and others have labored mightily to usher in a new approach to telecommunications policy. And, for the most part, that hard work has paid off. In particular, I would point to the actions the legislature took over the last five years to advance regulatory reform, culminating in the enactment and implementation of HB 2728--the keystone of the progress we've made.

The main goals of TeleKansas I, II and the '96 Act were to promote the statewide availability of basic and enhanced telecom services, and establish the conditions for a speedy transition to competition and to lower long distance rates. And I think it's fair to say that these main goals have been met: long-distance rates are lower, companies have invested (SWBT's annual capital investment in the state of Kansas has increased by approximately 33% since the '96 ACT) in infrastructure upgrades and competition is growing. All this has been accomplished with no increase in Southwestern Bell's basic local rates since 1984. (See Attachment A for more detail on these accomplishments.)

It is fair to say that HB2539 would alter that progress and, at least for Southwestern Bell, return it to more regulatory oversight than has existed for a decade. Southwestern Bell opposes this radical change in course and HB2539.

I too am concerned about the current size of the KUSF. Unfortunately, the KUSF has come to be a target for everyone to attack. Some try to make it into an urban vs. rural issue. Others suggest that it is providing an unwarranted source of revenue to rich incumbent phone companies. But both suggestions are wrong and ignore history. For SWBT both rural and urban residential service is provided below statewide average cost. (See docket 190.492-U referred to in HB2539.) Also, some have suggested that because Southwestern Bell does not receive funds

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ATTACHMENT 2

from the Federal Universal Service Fund, that we do not serve "high cost" rural areas. I'm sure the members of this committee--especially those from rural areas--recognize the fallacy of this argument but, for the record: Even using the HB2539 reference to "high cost areas" (page 13 line 31 *et. seq.*) Southwestern Bell serves more "high cost" areas than any other local exchange carrier in Kansas--over 200,000 rural lines by that definition. The next largest local exchange carrier serves approximately 118,000.

There's about $100 million in the KUSF now. This is the direct result of the telecom act requirement to reduce access rates. Of that amount, SWBT required access and toll reductions account for about $65 million, because the KCC has now completed early the initial three-year access rate reductions under the Telecom Act. Prior to the Act, SWBT was charging approximately $.17 per minute for toll calls. As a result of the Act SWBT is now charging approximately $.09 per minute for toll calls. In addition to SWBT's lowering of its toll rates, all long distance companies were forced to reduce their toll rates as a result of the lower access charges SWBT was charging them. The KUSF balance is now sufficient to compensate SWBT for the universal service rate subsidy support revenue lost through these access and toll rate changes. Before 1996, access and toll charges were a principal source of the implicit local rate subsidy necessary to provide universal local service throughout the state. Now the local rate subsidy is explicit and comes from the KUSF. (The KUSF also supports KRSI [service for hearing impaired], TAP [equipment for the disabled] and Lifeline [phone service for the poor]). The amount carriers contribute to the KUSF is determined and assessed at an equal percentage of their intrastate retail revenues.

After the 1996 Kansas Act was passed, SW Bell, Sprint/United and the KCC staff recommended to the KCC that the best way to remove the implicit local rate subsidies was by rebalancing the access rate reductions to local rates over three years. In order to bring rates into line with the cost of actually providing the service, rates for local service would have increased as decreases in toll and access charges mandated by the Legislature were implemented. The proposal we submitted (which followed the TSPC approach recommended to the Legislature) would have increased local rates by a total of $4.50/mo. incrementally added over three years. If this approach had been followed, the KUSF balance would have been about $25 million. (This is even lower than the $33 million KUSF projected under HB2539.) But the KCC—the Commissioners themselves—decided that the KUSF alone would be used to handle the subsidy issue. As a result of this KCC decision, the size of the KUSF has become larger in comparison with universal service funds of other states, and, correspondingly, Kansas's local rates are lower in comparison.

Now some seem to be suggesting that the proper way to solve "the problem" of the size of the fund is to simply remove "revenue neutrality" from the act. The HB2539 proposal would simply eliminate the historic local rate subsidy revenue Southwestern Bell lost as a result of legislatively mandated reductions in access and toll charges, and require the company to "prove" that it was entitled to recover it.

HB2539 appears to be based on a false premise. It appears that some seem to believe that the reason the KUSF is at a $100 million balance today is only because the KCC was forced to blindly apply the "revenue neutral" provision of the 1996 Telecom Act. But in fact the commission made findings of fact and reviewed financial data and cost data as part of the initial KUSF undertakings in Docket 190.492-U. Indeed this suggestion that there was "no cost support" for the KCC decisions has been raised before. CURB and others argued in the Phase II proceedings that there was no cost basis for the "revenue neutral" access reductions mandated by the 1996 Act. The KCC, KCC staff and SWBT countered those arguments with facts: with cost studies and financial data. Based upon this data, the KCC concluded that SWBT local service rates were as much as $7 below the cost of service and that the statewide cost of service for SWBT was $34.50 per line per month. And the KUSF subsidy was therefore approved as reasonable. On appeal to the Supreme Court, and in the face of challenges from CURB, the KCC argued that there was ample, substantial and competent cost support that justified the current KUSF payments to SWBT and that it met all federal requirements. And the Kansas Supreme Court unanimously upheld all aspects of the KCC proceedings last March. So there is a "cost justification" for the current KUSF support for SWBT.

Some proponents of HB2539 disagree that the KCC did a careful evaluation of costs in 1996 which they then defended before the Kansas Supreme Court in 1997. So perhaps it's best to let the record speak for itself. Here's what the KCC argued in its brief dated April 21, 1997 in The Citizens' Utility Ratepayer Board vs. The State Corporation Commission of the State of Kansas:

> Page 19: "The KCC took measures to assure local service rates included only their fair share of costs. Although not required by the State Act, the KCC Staff reviewed SWBT and United costs studies and determined that a maximum increase to local service rates of $7.00 per month could be justified based on the cost studies. (R.Vol.14 at 98). Thus, if the KCC had found that access reductions should be rebalanced to local service rates, it could have rebalanced any amount up to $7.00 without exceeding the cost of the service. The maximum justifiable increase was determined based on the local rate that would be necessary to cover the cost of local service, without any subsidy. That maximum increase amount when added to the current price for local service 'represents the amount necessary to cover the cost of offering local service.' (R. Vol.14 at 99).
>
> P.21: "Contrary to CURB's assertion, KCC staff has, however, reviewed costs studies for SWBT and United and determined on the basis of those cost studies that local service is priced below cost (R.Vol. 14 at 98-99). There is substantial competent evidence in the record to support such a determination, but it only becomes relevant if the KCC finds that rates must be increased. The KCC did not increase local rates. The cost data showed that local service was not priced above costs and thus was not providing a subsidy to other services. (R. Vol. 21 at 101)."

Given this history, I am at a loss to understand why HB2539 now proposes a completely different standard for support --$36.88 per line/per year. The $36.88 figure was specifically developed from independent phone company data, based upon only their costs and the corresponding FCC support they receive in Kansas. And it may well be correct for those companies, but it is not based on SWBT data. The KCC confirmed that the $36.88 was the remaining--not the total--amount of support needed after all the federal support was obtained for these independent companies. SWBT receives no such FCC support and, as the KCC found in the very same order that SWBT's costs are $34.50 per line, per month. I am not at all sure why HB2539 imputes to SWBT an independent phone company cost basis. Indeed, KCC staff stated in their Senate testimony that $36.88 is "not a perfect number" because it is neither company nor state specific. But the $34.50 per line per month number is a perfect number, by that definition, because it is Kansas specific and SWBT specific.

Witnesses also argued in the Senate committee that it was appropriate that SB290 would require SWBT to prove a "need" for a KUSF distribution. I emphasize their use of the word "need" because it is a euphemism for an earnings review. But please understand that $36.88 is not "need" based--it is a straight forward cost based number, exactly like SWBT's $34.50 per line per month cost basis.

I believe that HB2539 is unrealistic and unfair. The changes contemplated by HB2539 would undermine the intricate design of compromises and concessions that allowed the Legislature and the industry to move forward toward regulatory reform. The telecommunications policies that now govern our business were, like all public policy, built on a foundation of negotiations and give-and-take.

The concepts of revenue neutrality, price-cap regulation, and freedom from earnings audits were established in the law because our company and others were willing to agree to such things as significant new investments and reductions in access fees. We have kept the commitments that we made in the process of formulating that policy and it would be manifestly unfair now to set about reversing only one side of those agreements.

HB2539 is not a simple "tweaking" of the legislative framework that this committee labored so hard to construct three years ago. It is, as I noted earlier, a radical change in direction --180-degrees--in the course we've been taking. Both the Kansas Act and the Federal act were intended to reduce regulation. As the KCC argued before the Kansas Supreme Court in the brief I quoted earlier, "The Federal Act is intended to decrease regulation, not increase it and the type of earnings review believed necessary by CURB is the epitome of regulation." (p. 21) And now, less than 24 months later, the KCC staff is arguing that this legislation--that would enable the KCC to pursue the "epitome of regulation"--is an appropriate step to take in an era of competition. This is bad for my company, yes, but more importantly it is bad for the telecommunications industry and bad for Kansas.

In addition to these problems with the premise upon which this bill appears to be based, there is an even more fundamental problem. In an era when deregulation is being embraced across the country, a trend that the 1996 Legislature helped to lead, HB2539 would return us to a highly regulated environment. It takes at least $57.2 million from my company, $10.5 from another, and tells us that to get the money back we must submit ourselves to an unlimited inquiry into our books and business practices. There are no limits on the power of the commission to investigate, including no time limit by which they would have to rule on our petition to return our revenue.

In Senate testimony, it was explained that such drastic measures are necessary in order to induce Southwestern Bell to produce the information needed for the KCC to complete its "cost of local service" docket. Again, I need to set the record straight. Yes, we have had disagreements with the KCC staff about what information to produce in that proceeding. We believe that some of the information is irrelevant, much of it is proprietary and some of it is highly confidential, and have asked a KCC administrative law judge (ALJ) to rule on our concerns regarding some of the information requests. However, all of the information requested by the staff has been in the ALJ's possession for nearly a month, and we are still awaiting a ruling on our concerns about relevance and confidentiality. Let me also point out that the first date by which we were to produce any information was in November, and no further discovery requests were made until December.

I should add that in addition to these proceedings in the "cost of local service" docket, there is another relevant ongoing docket, commonly referred to as the "generic cost docket". The purpose of this proceeding is to select the appropriate type of "cost study" to be used by the KCC to determine the cost of local service and the size of the KUSF. Why this "generic" docket was not completed before the "cost of local service" proceeding was undertaken is a fair question. It seems illogical to do a certain kind of "cost study" and them subsequently decide whether you picked the right kind. Indeed, it is our understanding that the KCC intends to complete the "generic" docket before determining the "cost of local service". But however all of that falls out, the point I want to make is this. The length of time being taken to make these determinations is a result of the complexity of the proceedings and the difficulty the KCC is having in addressing them, not evidentiary disputes with Southwestern Bell.

The immediate reduction in our KUSF draw provided for in HB 2539 is only the first bite of the apple. The bill also requires further yearly access reductions to bring intrastate rates into parity with interstate rates, and puts us in the same regulatory morass each time to recover the lost revenue. It essentially singles out two companies and returns them to rate-of return regulation. For example:

- HB2539 gives the KCC the power to conduct rate base, rate of return and earnings regulation on carriers that have elected to be price cap companies. (Page 7, lines 17, 18, and 19).
- It gives the KCC the power to annually investigate and adjust rates (page 9, lines 37-41) using the broadest possible grant of investigative authority (Page 11, lines 41-43).

A return to such pervasive and burdensome regulation would surely stifle competition. Investors will not put their capital in a state where the regulatory climate is so uncertain. Furthermore, by requiring a highly regulatory approach to recovering revenues for high-cost service, HB2539 removes any incentive whatsoever to invest in the residential and rural markets by putting regulatory barriers in the way of those willing to risk their capital in competing in such markets.

For my company, the new regulatory burdens proposed in this legislation would be imposed at a time when Southwestern Bell is facing increased competition from unregulated competitors. Southwestern Bell has lost approximately 80,000 customers in Kansas to its competition. That's better than a 100 percent increase in one year's time. Over 70 companies have been approved by the KCC to compete against us in Kansas. And this relates to competition for local service, where the competitive environment is in its infancy. When you look at the big picture--total intrastate telephone retail revenues, Southwestern Bell has about 50 percent of the market.

And there's more evidence that competition is thriving. Nearly every phone book has a page near the front listing competitors that consumers can choose to replace Southwestern Bell. The papers are full of ads and stories about new competitors--both facilities based, such as KMC Telecom in Topeka and resellers like Feist. And, I would note, all of these competitors like AT&T or wireless carriers are not similarly regulated by the KCC. Also, competition is not just an urban phenomenon--established competitors are moving in to smaller communities. Finally, these examples are to say nothing about the competition from cable providers, the Internet and wireless providers that is on the horizon and being written about every day.

And please remember, even absent new regulation as proposed in HB2539, Southwestern Bell continues to shoulder a pervasive regulatory burden not shared by many of our competitors:

- We are the carrier of last resort--we must provide service to all who request it.
- Prices continue to be regulated, under price caps.
- We cannot provide interLATA long distance.
- The investigations the KCC has undertaken pursuant to current law impose significant costs in both time and money. For example, in the cost of local service docket we have produced nearly 18,000 pages of evidence and are continuing to provide more information as it is requested.
- We must provide broad-based access to the internet at $15 per month.
- We must provide schools and libraries broad band service at cost.
- We must justify that all of our rates are above cost.
- We must resell our services at a 21 percent discount.
- We must open our local markets to competition.

Finally, I believe the bill has consequences that may have been unintended by its authors. Certainly there are provisions that have received little critical examination. For example:

- Changes in the universal service definition would remove the current requirement that carriers eligible for KUSF support provide equal access to long distance services (Page 2 line 39). This would make wireless carriers eligible to draw on the fund, thereby creating upward pressure on the fund. (Ironically, with this change no carrier is being forced to provide equal access except SWBT. Those who compete with us need not provide it. Why would this inequity be appropriate?)
- In the changes to KSA 66-2002, the bill would remove quality of service standards that the '96 Legislature put in HB2728 to emphasize to the KCC it should consider the quality of telephone service in establishing rates. (Page 6, lines 41-43)
- The bill changes the mechanics of the price cap formula. (Page 9, lines 29,37-40)
- It changes the method of handling exogenous costs. (Page 14, lines 32-35)

In summary, I think the concerns with HB2539 that I have pointed out demonstrate that this bill is not just a simple adjustment to the size of the KUSF designed to lower the assessment. It would do that, but it would do much, much more. It works a fundamental change in the state's telecommunications policy.

At the outset of this testimony, I alluded to the many benefits Kansans have experienced as a result of the changes in telecommunications policy that this committee, the Legislature and the industry have forged. Those successes were not built overnight. The road we've been travelling down began 10 years ago with TeleKansas I, which evolved into TeleKansas II. That progress was enhanced by the work of the Telecommunications Strategic Planning Committee that led to HB2728. And that bill was heard, debated and evaluated for months, passed with overwhelming support in the Legislature and then was tested and upheld in the Courts. This proposal would overturn all of that work and do so after only cursory deliberation.

The policies we have put into place together are based on a fundamental belief--that the marketplace is the best place for allocating services, setting prices and protecting consumers. And I believe that we in Kansas are proving that less regulation leads to competition, and that competition gives people a choice and serves as an incentive for better service, more products, more innovation and, in the long run, lower prices. Surely, now is not the time to turn back the clock on that promise.

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Attachment A

As a result of our move together to reduce regulation of the telephone industry, Kansans have received:

- **Quick reductions in long distance charges.** Since going to alternative regulation, Intra-LATA toll rates have been reduced by nearly 50 percent. In just the last two years ('97 and '98) Southwestern Bell has decreased toll and access charges by over $73 million

- **Wider availability of enhanced service due to infrastructure investment.** Southwestern Bell has, over the last several years, invested more than $200 million over and above our normal capital expenditures. (See page 2 of this attachment for a year by year breakdown in our capital expenditures). We've completed fiber optic connections between our central offices and replaced analog switches with digital switches. These and other enhancements have eliminated party lines and made optional services like caller ID widely available. We've also invested to enable two-way interactive video for schools and universities and to offer broadband services to virtually all of our customers with discounts for schools, libraries, hospitals and state and local governments

- **More choice through entry of competitors into the market.** Southwestern Bell has lost nearly 80,000 customers to competitors (a number that has increased 100 percent in the last year). And competition has not been limited to the largest markets. We're losing customers in small towns and big cities. The KCC has approved 77 companies to offer local service in competition with us and we've signed interconnection agreements with 68. Customers in most cities need only to look in the front of their phone books to realize phone competition is alive and growing every day in Kansas. In terms of competition, Kansas is further along than most states in the nation, certainly ahead of our neighbors.

Southwestern Bell Telephone Company--Kansas

Capital Expenditures

1984-1998

1984	$115,627,003
1985	$122,811,682
1986	$146,139,118
1987	$130,921,218
1988	$107,910,974
1989	$127,969,022
1990	$128,761,682
1991	$138,611,915
1992	$173,566,769
1993	$131,097,576
1994	$143,792,345
1995	$149,799,784
1996	$150,812,211
1997	$198,939,933
1998	$199,342,188

Source: SWBT Annual Report to KCC, Plant in Service Schedule
1998 from SWBT financial records

2-11

MEMO

To: House Utilities Committee
From: KCC Staff
Date: March 11, 1999
Re: HB 2539 Background Information

1. Where did the $ 36.88 figure come from?

The KCC has had a case open since April of 1994 to investigate the status of competition in Kansas and move Kansas toward a competitive telecommunications environment. The Commission issued an order on December 27, 1996, that established the current KUSF mechanism in compliance with the Kansas Telecom Act. The state act mandates that local exchange carriers reduce their access rates and be reimbursed for the lost revenues from rate rebalancing and/or the KUSF. The Commission took into account the fact that there could be new competitive companies providing basic universal service in high cost areas who would be entitled to receive KUSF support also (called ALECs, or alternative local exchange carriers). Funds could not be distributed to these companies in the same, revenue neutral fashion since the law calls for companies to be made revenue neutral as of September 30, 1996 [K.S.A. 66-2008(a)] and there were no ALECs providing universal service on that date. The Commission found in its December, 1996 order that the appropriate amount of KUSF support for a high cost area where there was no revenue neutrality consideration would be $ 36.88 per year for each access line in a high cost area. Paragraph 124 of that order reads:

> Based on the evidence on the record the Commission finds that those companies that provide service in high cost rural areas shall receive support. Rural areas shall be defined as exchanges with 10,000 or fewer access lines. ALECs are eligible to receive support to the extent they provide service in high cost rural areas. . . The support shall be paid at a rate of up to $ 36.88 per residential loop. *In the Matter of a General Investigation Into Competition Within the Telecommunications Industry*

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ATTACHMENT 3

in the State of Kansas, Docket No. 190,492-U, 94-GIMT-478-GIT, Order issued December 27, 1996, at ¶ 124

2. How did you get $ 36.88?

The $ 36.88 figure was derived by examining the costs used for calculating federal universal service support levels, and deducting federal universal service support amounts to determine the cost of the local loop that remains unrecovered. The specifics of how this figure was calculated have been set out in a diagram and explanatory note attached to this memo.

3. Where did the $ 34.50 figure come from?

In April of 1996, in the Competition Docket, SWBT submitted cost studies based on a 1995 test year. Staff did not audit the cost information because the State Act, which required revenue neutrality, was put in place before Phase II was completed. After the Commission issued its order in December, 1996 setting up the fund a number of parties filed motions for reconsideration. On February 4, 1997, the Commission issued an Order on Reconsideration.

One of the arguments raised by CURB and other parties was that the size of the KUSF was not based on the costs of providing local service. CURB argued that basic local rates were not being subsidized by other rates. In discussing this issue the Commission referred to the cost study evidence submitted by SWBT in April. SWBT had reported that its total local exchange cost amounted to $ 506 million. The Commission stated that if the $ 506 million were divided by its total number of access lines, SWBT would need to recover $ 34.50 per month to cover its local exchange costs. SWBT would recover that amount from rates, access charges and other revenue sources as well as any KUSF subsidy ordered. The Commission did not find that SWBT needed that amount of money from the KUSF. *See* Docket No. 190, 492-U, 94-GIMT-478-GIT, Order on Reconsideration, February 3, 1997, pages 9-10, ¶ 20.

4. How would HB 2539 change the size of the KUSF?

HB 2539 would reduce the size of the KUSF by a total of $ 67.7 million, at least in the short run. The proposed bill would allow a company that could show that its costs to provide local service merited greater KUSF support than $ 36.88 per high cost access line per year to get additional support.

	Impact on SWBT	**Impact on Sprint**
Current KUSF disbursements	$65.0 million	$14.2 million
KUSF disbursements at $36.88/access line	$ 7.9 million	$ 3.7 million
Reduction in KUSF	$57.2 million	$10.5 million

Total Reduction in KUSF: $67.7 million
Total Fund Amount: $33 million ($29 million in high cost support, $4 million for KRSI, Lifeline, and TAP programs)

Resulting Assessment Rate: 3.13%
Surcharge per line, SWBT customers:$ 0.88

5. Also attached to this memo is a document titled Access Reduction KUSF Recovery Information for SWBT/Sprint demonstrating the changes in access rates under the state act and KUSF recovery for those lost revenues.

DERIVATION OF $36.88/LOOP HIGH COST SUPPORT REQUIREMENT

For federal universal service fund purposes, the cost of the local loop is based on companies' reported costs which include embedded costs. When a company's loop costs are at the national average, the federal universal service fund supports 25% of the cost of the local loop, as 25% is considered to be the percentage of loop usage that is dedicated to interstate services, such as interstate long distance calls. The other 75% is considered to be used for providing intrastate services, and supported by intrastate rates.

All costs above 150% of the national average, i.e. between $250.00 and $375.00 per loop, are recovered through federal universal service.

Of the costs above 115% of the national average, i.e. $287.50 per loop, but below 150% of the national average, 65% are recovered through federal universal service.

None of the costs between 100% of the national average, i.e. $250 per loop, and 115% are recovered from federal universal service.

<u>The $36.88 high cost support amount was calculated as follows:</u>

1. Determine the unrecovered amount between the 115% and 150% levels:

150% of national average ($375/loop) - 115 % ($287.50/loop) = $ 87.50

Of that $87.50, all but 10% is recovered from federal sources:
- 25% is allocated to the federal jurisdiction and recovered through interstate access, EUCL, and PICC charges;
- 65% is recovered through the federal universal service fund.

$87.50 - $21.87 (25%) - $56.88 (65%) = $8.75

$8.75 remains to be recovered from the state fund.

2. Determine the unrecovered amount between the 115% and 100% levels:

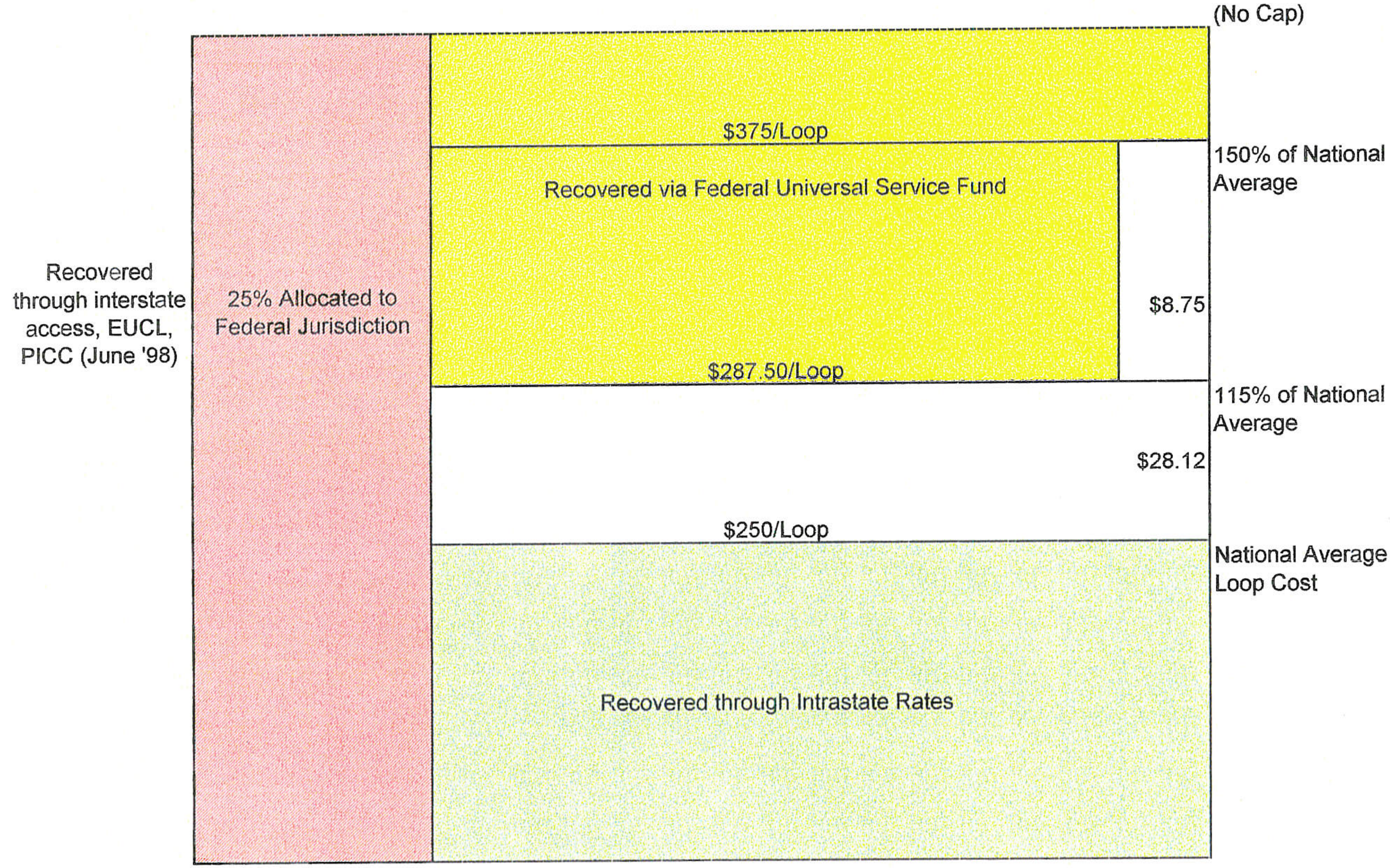
Note: None of the costs between 100% and 115% are recovered through federal universal service.

115% (287.50) - 100% ($250) = $37.50

Of the $37.50, 25% ($9.38) is allocated to the federal jurisdiction and recovered through interstate access, EUCL (end user common line) and PICC (presubscribed interexchange carrier charge) charges, leaving $28.12.

3. Add the two unrecovered portions: $8.75 + $28.12 = $36.87 (actual figures round to $36.88)

Derivation of $36.88/Loop High Cost Support Requirement



Cost of Local Loop (Based on Embedded Costs)

3-5

Kansas Corporation Commission
Access Reduction KUSF Recovery Information for SWBT and Sprint

Southwestern Bell

SWBT's per line draw from KUSF last year-total lines*	$ 50.03			
SWBT's per line draw from KUSF per high cost access line	$ 302.53			
	1-Jan-97	1-Mar-97	1-Jun-98	Decrease
SWBT's Composite Access Rates:	0.059656	0.040113	0.024706	0.034950
Total Amount of Access Revenue SWBT lost in first year of Access Reductions (Includes imputed Toll Reductions)	$ 40,025,600			
Amount Recovered from KUSF	$ 40,025,600			
Cumulative Total Amount Access Revenue SWBT lost in Second Year ofAccess Reductions	$ 73,596,788			
Reduction Recovery Components:				
Recovered from KUSF	$ 65,042,907			
Rebalancing (Coin & D.A.) & Payphone Dereg.	8,553,881			
	$ 73,596,788			
*Number of Access Lines in SWBT's Rural Areas @$36.88	$ 7,929,200			

Sprint/United of Kansas

Sprint's last year's draw from KUSF-total lines	$ 104.14			
Sprint's last year's draw per high cost access lines	$ 139.61			
	1-Jan-97	1-Mar-97	1-Jun-98	Decrease
Sprint's Composite Access Rates:	0.081418	0.062601	0.046323	0.035095
Total amount of Access Revenue Sprint lost in first year of Access Reductions	$ 7,790,640			
Amount Recovered from KUSF	$ 7,790,640			
Total Amount of Access Revenue Sprint lost in second year of Access Reductions	$ 14,932,737			
Reduction Recovery Components:				
Recovered from KUSF	$ 14,235,297			
Rebalancing (Coin & D.A.) & Payphone Dereg.	697,440			
	$ 14,932,737			
Number of Access Lines in Sprint's Rural Areas @ $36.88	$ 3,761,612			

Notes:
*SWBT has classified its actual access line counts as proprietary.
These amounts are based on public access line counts.

3-6

MEMO

To: House Utilities Committee
From: KCC Staff
Date: March 12, 1999
Re: Response to Inquiry

Q. Please differentiate between a cost study review and an earnings audit.

A. An earnings audit is one type of cost study. In other words, an earnings audit is a subset of the phrase "cost study". Another type of cost study would be a forward looking cost study as is required by the FCC in establishing wholesale unbundled network elements.

Staff is currently attempting to perform an embedded cost study for SWBT, which is virtually identical to an earnings review. The important distinction between the embedded cost study and a traditional rate case, or earnings review, is that the KCC is prohibited by the State Act from reducing SWBT's rates. Staff is pursuing the embedded cost study approach at this time, rather than a forward looking methodology , due to concerns that SWBT would advance a legal challenge, arguing that the use of a forward looking study to establish an appropriate KUSF draw represents a "takings"and would be unconstitutional.

Q. How much have access rates been reduced since the 1996 Act?

A. See below.

Company	1996 Access Rate	6/1/98 Access Rate	Decrease
SWBT	6.0 ¢	2.5 ¢	58%
Sprint-United	8.1 ¢	4.6 ¢	43%
ILECs*	10 ¢	7 ¢	30%

*ILECs refers to all local exchange carriers other than SWBT or Sprint-United.

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ATTACHMENT 4