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Testimony of
Janet Buchanan, Chief of Telecommunications
Kansas Corporation Commission

Before the House Utilities Committee
Regarding SB 120
February 16, 2005

Chairperson Emler and Committee Members:

Thank you for allowing me to appear before you this morning on behalf of the Kansas Corporation Commission to express the Commission's views regarding SB 120. My name is Janet Buchanan. I am the Commission's Chief of Telecommunications.

Legislation similar to SB 120 has been introduced in each of the last four legislative sessions. As it has with past proposals, the Commission has several concerns with this bill. While the Commission supports the general movement toward reduced regulation of telecommunications markets as envisioned by the Kansas and Federal Telecommunications Acts, we believe the price deregulation provisions of this bill are still problematic. The Commission is also concerned with the provisions of this bill that pertain to depreciation rates, the price cap formula, and the calculation of KUSF support.

Depreciation Rates

At page 2, lines 2-4, the language of K.S.A. 66-2005(b) is amended to state:

Carriers that elect price cap regulation shall be exempt from: rate base, rate of return and earnings regulations; *and regulation of depreciation rates of assets for all regulatory purposes.*

While changes in the depreciation rates of a price cap company (SWBT and Sprint) do not have an impact on the rates for local service paid by their customers, this language would prohibit the Commission from examining the appropriate depreciation rate applicable for determination of KUSF support. It would also prohibit the Commission from examining depreciation rates to be used in determination of rates for unbundled network elements (UNEs) that Sprint and SWBT provide to competitors. It is important for the Commission to determine the reasonableness of depreciation rates in these contexts. The Commission could support this language if it did not limit its review of KUSF support and UNE rates.

Price Deregulation of Bundled Offerings

Beginning at page 5, line 23, the language of K.S.A. 66-2005(f) is amended to exclude services included in bundled offerings from the price cap baskets and price cap regulation. After August 1, 2005, any bundled offerings would be price deregulated. The amended language provides for the specific services contained in the bundles to be available to consumers on an individual basis under the traditional price cap applied to each service.

The Commission understands that price cap companies facing some level of competition would like to have greater flexibility in responding to customer desires. This provision would price deregulate bundled offerings even in those areas served by SWBT or Sprint for which there is minimal competition to discipline the price of the bundle. However, the proposed language still offers some protection for those consumers in such areas. If customers in those areas with little competition were dissatisfied with the price of the bundled offering, those customers could purchase the services individually at rates disciplined by the price cap mechanism. The level of protection offered to consumers in less competitive areas is then dictated by the price cap formula. It should be noted that changes to the price cap formula are proposed on page 6 of this bill. The Commission believes that at least one of the changes to the formula weaken the protections offered by price cap regulation in those areas served by SWBT and Sprint that have little or no competition. While, the reasonableness of the proposed changes will be discussed more fully later, it is pertinent to this discussion to indicate that the Commission finds the proposal of increases of up to 6% for Basket 3 or miscellaneous services to be unreasonable given either the performance of the telecommunications industry or the economy as a whole. This rate of increase is much greater than recent measures of inflation. By permitting the rates for services in Basket 3, such as caller ID, call waiting, etc., to increase by as much as 6%, it is possible that this may also lead to higher bundle prices in those areas with minimal competition. Thus, consumers in these areas may ultimately face increases for discretionary services.

We would also suggest that if this amendment is approved, it be made clear that when services in bundles are removed from Basket 1 or Basket 3, it should be done in a manner that does not have an impact on the existing rates of the services remaining in the respective baskets.

Price Deregulation of New Services

At page 5, line 28, the proposed legislation also excludes new services from rate regulation through price caps. It is unclear what is meant by “new services”. However, regardless of the definition, it appears that new services will not be offered individually under price cap as is intended for other services. Therefore, the rates for such services will be depend upon the degree of competition. Consumers will not have the opportunity to purchase new services individually under price cap regulated rates. Thus, the protections discussed above will not be extended to new services.

Price Cap Formula

SB 120 amends the language requiring the Commission to develop a price cap formula and examine the formula every five years. At page 6, lines 20-25 the proposed language alters the

formula applied to services in Basket 1 and the proposed language at lines 32-36 alters the formula applied to services in Basket 3.

The Kansas Act established price cap regulation as an option for carriers to adopt. The Act states that Basket 1 would be comprised of residential and single-line business service while Basket 3 would contain multi-line business and discretionary services. Discretionary services are products such as call waiting, caller ID, call forwarding, etc. The Kansas Act required that the initial price cap be set at the rate levels existing when the local exchange carrier applied to elect price cap regulation and at K.S.A. 66-2005(g), required the Commission to determine a formula for adjusting the level of the cap. In developing the formula, the Commission was directed to “balance the public policy goals of encouraging efficiency and promoting investment in a quality, advanced telecommunications network in the state.” The Commission opened a generic proceeding to determine a price cap formula. All interested parties were invited to participate. Ultimately, the Commission determined that the price cap should be adjusted according to the following formula:

$$\text{Price Cap Index} = \text{Inflation} - \text{Productivity Offset} + \text{Extraordinary Event Adjustment}$$

Rates would be allowed to increase as costs of the local exchange carrier increase and would be decreased to reflect the effects of increases in productivity. The extraordinary event adjustment would permit adjustment to the price cap to reflect events that changed costs or cost recovery that were beyond the control of the local exchange carrier. After considering the positions of all parties, the Commission found that inflation would be determined by percent change in the Gross Domestic Product Price Index (GDP-PI)(chain-weighted). This index (or the similar Gross National Product Price Index) was utilized by most states and by the FCC at the time. The GDP-PI measures the price level, incorporating all final goods produced within the boundaries of the United States. However, it was generally recognized that the costs in the telecommunications market were rising more slowly than for the economy in general and that the productivity level of the telecommunications market differed from that of the economy in general. Therefore, the productivity offset was established to account for such differences. The Commission determined that the productivity offset should initially be set at 2.3%. K.S.A. 66-2005(g) requires the Commission to review the price cap formula every five years. The Commission reviewed the formula in 2002 and approved a Stipulation and Agreement presented by the parties. The parties agreed to retain the GDP-PI (chain weighted) as the measure for inflation. The parties agreed that the productivity offset for Basket 1 should be set at 3.15% and for Basket 3 it should be set at 1.4%. The price floor is set out in K.S.A. 66-2005(k) as the long-run incremental cost of a service.

The proposed language would replace this system for adjusting the price cap level each year. For Basket 1, the language would apply the change in the telephone service component of the consumer price index (CPI-TS). There are four individual indices relating to telecommunications services – local service, intrastate long distance service, interstate long distance service, and wireless service – and there is an index that combines these individual service categories with certain weights applied. It is not clear if CPI-TS is meant to represent the local service index or if it is the index that is a weighted combination of all telecommunications services. During the Commission’s last review of the price cap formula, Sprint’s own witness

recommended continued use of the GDP-PI. Dr. Brian Staihr stated that “[u]sing the GDPPI has met the needs of the price cap formula in Kansas, and Sprint can discern no compelling reasons at this point in time to make a change.”¹ However, Dr. Staihr did develop a productivity offset recommendation based on the CPI-TS. In his testimony, Dr. Staihr questioned the ability of the CPI for local services to reflect industry performance. He testified that the CPI for local service has “. . . reflected significant price increases in most recent years, quite possibly due to rate rebalancing that has occurred both here in Kansas and across the U.S. since the passage of the 1996 Telecom Act. As such, those price changes do not, on a stand-alone basis accurately reflect changes in LEC productivity.”² Rate rebalancing, increasing local rates to compensate for reductions in access rates, leads to rates for local services that are higher than would have otherwise been in place in the market absent regulatory actions. Dr. Staihr did indicate that if one examined the CPIs for interstate and intrastate long distance calling, the effect of rate rebalancing may be neutralized. The Commission is concerned that if the CPI-TS referred to in the legislation is index that examines only rates for local service, it will not be reflective of the industry’s performance in the future because the FCC has indicated that it will examine intercarrier compensation in the near future. If the FCC addresses intercarrier compensation then it is likely that rate rebalancing will occur again and a CPI based on local service rates will not reflect the productivity of the industry. However the Commission’s concerns may be alleviated if the CPI-TS contemplated in this bill also includes long distance and wireless rates because the impact of rate rebalancing may be reduced. The following is a comparison of the change in rates permitted under the formula that has been used and what changes would have been permitted had the CPI-TS (for all telecommunications services) had been in place.

Basket 1

Year	<u>% Change Permitted</u>		<u>% Change Using</u>
	<u>SWBT</u>	<u>Sprint</u>	<u>CPI-TS</u>
2004	-1.42%	-1.53%	-2.54%
2003	-1.55%	-1.81%	-1.40%
2002	-0.93%	-0.43%	0.40%
2001	-0.04%	0.02%	0.81%
2000	-0.46%	-0.70%	-1.60%
1999	-1.02%	-0.24% **	-0.60%

** This represents the prorated change permitted for the 2 months affected by the plan

Basket 3

Year	<u>% Change Permitted</u>		<u>% Change Using</u>
	<u>SWBT</u>	<u>Sprint</u>	<u>CPI-TS</u>
2004	0.33%	0.22%	-2.54%

¹ *In the Matter of a General Investigation Into the Price Cap Formula in Compliance with K.S.A. 2000 Supp. 66-2005(f)*, Docket Number 02-GIMT-272-MIS, Direct Testimony of Brian K. Staihr on Behalf of Sprint, filed April 1, 2002, page 5.

² *Id.*, page 10.

2003	0.20%	-0.06%	-1.40%
2002	-0.93%	-0.43%	0.40%
2001	-0.04%	0.02%	0.81%
2000	-0.46%	-0.70%	-1.60%
1999	-1.02%	-0.24% **	-0.60%

** This represents the prorated change permitted for the 2 months affected by the plan

Overall, the formula currently in place and the CPI-TS (for all telecommunications services) would have resulted in similar changes in the price cap. In discussions with Sprint, representatives for the company have indicated that the intent of bill is to apply the CPI-TS that is a combination of all telecommunications services. The language of the bill should be modified to indicate this intent.

For Basket 3 services, the bill proposes that the total basket be adjusted at the discretion of the price cap carrier by an amount that does not exceed 6%. In reviewing the history of price cap adjustments for the two price cap companies we have found that for Sprint the greatest change in the GDP-PI (chain weighted) was 2.32% in 2001; for SWBT, the greatest change in GDP-PI (chain weighted) was 2.26% in 2001. Even before applying the productivity offset, this is somewhat less than the proposed 6%. It is unclear whether this 6% increase includes any adjustment for exogenous events. If it is the intent of this language to include exogenous adjustments within the allowable increase, then it would be appropriate to permit changes greater than the change in inflation; however, 6% is likely to be more accommodating than necessary.

While the Commission understands that carriers under price cap regulation might desire the certainty provided by a fixed method of determining the price cap, it may be prudent to include language to permit the Commission to continue to have jurisdiction to review these measures for reasonableness and propose adjustments as the industry changes if prices appear to be increasing unreasonably.

Price Deregulation

At page 8, beginning on line 1, the bill proposes new language to determine when price deregulation is appropriate. The new language provides for price deregulation when the carrier demonstrates that there is a single carrier providing two-way voice service that can be originated and terminated in the relevant exchange, regardless of technology.

Current Kansas law provides a process for price deregulation of services when the Commission finds that competitive activity can protect consumers by disciplining the pricing of those services. The Commission has permitted price deregulation of services under this statutory process. The Commission has also established a process for achieving greater pricing flexibility, which Sprint has recently taken advantage of for its Garner exchange, which still provides for consumer protection when it is uncertain whether the presence of one competitor is sufficient to discipline the prices of a dominant carrier. This legislation seeks to restrict the discretion of the Commission in determining whether market conditions exist to permit price deregulation through the review of factual evidence. The Commission is concerned that this bill eliminates any discretion of the Commission to determine whether a substitutable service is available to consumers and whether the presence of one competitor is sufficient to discipline prices. It also

eliminates the discretion of the Commission to evaluate if the market has matured sufficiently to assuage concerns regarding “destructive competition.” Destructive competition is competition that leads to lower prices for consumers in the short-term but that eliminates competitors from the market and creates the potential for price increases in the long-term.

Sprint has indicated to us that its intent is to apply this new language only in those areas where it faces competition from a cable provider or other facilities-based land line company. However, the proposed language is broad and would permit price deregulation, for example, in the presence of one wireless provider. Even if the intent of the bill is to permit price deregulation if a cable or other facilities-based land line provider is present in an exchange, the Commission has several concerns. The bill strikes the language requiring that the service provided by the competitor be comparable in function and price to the service of the incumbent. Thus, price deregulation can occur without regard to whether the services of the competitor can be a substitute for those of the incumbent. For example, a competitor may provide basic single line business services but not multi-line business services but the bill language would still permit the price deregulation of multi-line business services even though there is not a substitute for such service. Additionally, there is no requirement that competition be present in the entire service area for which price deregulation is sought. Many cable providers do not have service territories that follow the exchange boundaries of Sprint or SWBT. If the presence of a cable provider is used to demonstrate that there is at least one competitor in the exchange, it is possible that there are some customers not served by the cable provider or other land-line competitor. These customers will not have a substitute for the service of Sprint or SWBT and there will be no competition to discipline the price charged to those consumers. One may also question whether sufficient competition exists if the competitor offers only bundled services. Some customers desire only to purchase the basic local service with no discretionary services added on. In some cases, the cable provider utilizes Voice Over Internet Protocol to provide voice services and this requires the customer to also subscribe to broadband services. If price deregulation is permitted to occur in this instance, these customers may have to purchase bundles they do not desire or, since no substitute exists, Sprint or SWBT may increase the rate applied to basic local service.

The bill asserts that carriers providing only “prepaid telecommunications service” will not be considered entities providing two-way voice service. However, “prepaid telecommunications service” is not defined. While the Commission is aware that it is intended to exclude carriers who provide service only to the credit challenged market, technically, all customers prepay for local telecommunications services. The term should be better defined to avoid any future confusion.

KUSF

At page 10, the bill amends K.S.A. 66-2008(c) to state that the Commission should review costs specific to the carrier, including costs associated with the carrier of last resort designation, when reviewing KUSF support. K.S.A. 66-2008(e) requires the Commission to examine embedded costs for rate of return regulated carriers. For price-cap carriers, the Commission has employed a model for determining the costs of an efficient provider to serve customers.

Sprint has stated that its intent is to require the Commission to utilize Sprint specific inputs into the model used for determining its KUSF support. The Commission understands that Sprint

believes its service territory and customers are sufficiently different from SWBT's to warrant a company specific model. Under the current statutes, Sprint can request that the Commission recognize its distinguishing characteristics that impact its cost of providing service. Therefore, the Commission believes the proposed language is unnecessary to achieve Sprint's goal or could be modified to more accurately reflect Sprint's intent.

Also in this section of the bill at lines 22-23, language is included to require the Commission to examine "costs arising from fulfilling carrier of last resort obligations" in the determination of high cost KUSF support. This issue is being addressed before the Court of Appeals. Oral arguments were heard last week. While carrier of last resort costs are separately addressed in K.S.A. 66-2009, there is no indication anywhere in the current statutory framework regarding how such costs should be determined. If carriers are simply required to be ready to serve customers while it is quite possible that the obligation to actually serve may never materialize, this could greatly increase costs for carriers (no matter how such cost is determined) and thus, the size of the fund. For price cap companies whose KUSF support is based on a model, inclusion of such carrier of last resort cost may be particularly speculative without an audit. Additionally, funding for carrier of last resort costs may be in conflict with the requirement that distributions from the KUSF be made in a competitively neutral manner unless that support is also portable to competitive carriers.

Thank you for the opportunity to appear today to express the Commission's concerns regarding SB 120. I am willing to answer questions at the appropriate time.