KANSAS
CORPORATION COMMISSION

Testimony of
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Kansas Corporation Commission

Before the Senate Utilities Committee
Regarding SB 350
January 24, 2006

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 350. My name is Janet Buchanan. I am the Commission's Chief of Telecommunications.

In 1996, both Congress and the Kansas Legislature determined that it was appropriate to encourage the development of competitive markets for telecommunications services. The Federal Telecommunications Act of 1996 and the Kansas Telecommunications Act of 1996 contain provisions to facilitate the transition to a telecommunications industry disciplined by competition rather than agency regulation. Deciding whether this goal has been met; and thus, deciding that it is appropriate to grant price deregulation is a matter of public policy. Kansas law has specified that the existence of competition was a question of fact to be determined by the Commission in an evidentiary type proceeding with notice and an opportunity to participate provided to interested parties.

SB 350 would modify current statutory language which provides parameters for determining whether conditions in the Kansas telecommunications market support a grant of price deregulation to an incumbent local exchange carrier that has elected price-cap regulation. The current language at K.S.A. 66-2005(q) states:

> The commission may price deregulate within an exchange, or at its discretion on a state wide basis, any individual service or service category upon a finding by the commission that there is a telecommunications carrier or alternative provider providing a comparable product or service, considering both function and price, in that exchange area.

The statute provides the Commission with considerable discretion. As I will summarize, the Commission has believed that it is in the public interest to exercise that discretion by evaluating the detailed circumstances of the competitive landscape surrounding each service at issue. However, the Commission is a creature of the legislature and the legislature may determine that competition should be evaluated on a less detailed basis. If the legislature determines that such a policy change is necessary or appropriate, I also provide the Commission's comments on the bill and suggestions for addressing concerns.

Background

The Kansas Telecommunications Act of 1996 provided incumbent carriers with an option of electing to be regulated under price-cap regulation rather than rate-of-return regulation. An incumbent carrier that has elected price-cap regulation may petition the Commission for price deregulation of services pursuant to K.S.A. 66-2005(q). The two companies that have elected price-cap regulation are Southwestern Bell Telephone Company ("SWBT"), United Telephone Company of Kansas, United Telephone Company of Eastern Kansas, United Telephone of Southcentral Kansas and Sprint Missouri Inc., d/b/a United Telephone of Company of Southeastern Kansas (collectively "Sprint/United"). Since 1996, the Commission has considered several requests made by SWBT for price deregulation of certain services. In its application for price cap regulation (Docket No. 98-SWBT-380-MIS) filed on December 17, 1997, SWBT included a request for price deregulation of several services. However, SWBT later stated that it was not seeking price deregulation of services and could not provide testimony to support price deregulation at that time but would file an application at a later date. The Commission issued an order regarding price deregulation of service on March 8, 1999. While SWBT had, in essence, withdrawn its request for price deregulation, the Commission offered its initial interpretation of the statute. The Commission stated that it must make a finding that there is a competitive carrier providing a comparable product or service and that in determining comparability it must consider both function and price. The Commission also stated that its evaluation of an application for price deregulation was not limited to these considerations. The Commission determined:

> [t]he statute provides that, even upon finding a telecommunications carrier or alternative provider is providing a comparable product or service considering both price and function, the Commission retains discretion in granting or denying a request to price deregulate. Thus, the Commission has the authority to determine whether price deregulation is in the public interest. (paragraph 14)

SWBT filed, as it had indicated, two applications for price deregulation of the services it believed were candidates for price deregulation. In an order issued December 18, 2000 in Docket No. 01-SWBT-444-TAR, the Commission determined that price deregulation was appropriate for the Plexar family of services (a service for business customers), auto redial, and speed calling for all exchanges served by SWBT. In an order issued June 12, 2001, in Docket No. 01-SWBT-932-MIS, the Commission determined that price deregulation was appropriate for directory services (local directory service, directory assistance for call completion, auto connect, national directory assistance) and local operator services for all exchanges served by SWBT. In

both of these instances, the Commission found that the availability of customer premises equipment or competing directory services was sufficient to protect consumers in a price deregulated environment.

In September of 2001, SWBT filed an application in Docket No. 02-SWBT-245-MIS for price deregulation of several large business customer services in the Topeka, Wichita, Kansas City, Manhattan and Abilene exchanges and for two services on a statewide basis. In an order issued November 19, 2001, the Commission again noted that the authority granted to it is discretionary. The Commission concluded that neither the data provided by SWBT nor the additional information gathered by Staff was sufficient to grant the application. However, the Commission provided some guidance regarding evidence it would find necessary for its future reviews. The Commission expressed concern regarding whether competitors had "established a firm enough foothold . . . to ensure continued competition in the months and years ahead." (paragraph 16.) The Commission stated that it must consider the extent of competition and whether it is reasonably sustainable. Thus, the Commission indicated that the competitor's mode of providing service is a relevant consideration as well as SWBT's performance as a wholesale provider in its review of the competitive environment. Additionally the Commission stated it would examine evidence regarding what products are actually provided and how long they have been offered.

On November 9, 2001, SWBT filed an application for price deregulation in Docket No. 02-SWBT-358-MIS. In this application, SWBT requested price deregulation of most of its business services on a statewide basis. In an order dated December 31, 2001, the Commission found that the data provided by SWBT and the additional information provided by Staff were insufficient to grant SWBT's application.

Following the denial of these two applications, SWBT met with Staff to discuss what evidence the company should provide for the Commission's review of the public interest in price deregulation applications. Ultimately, it was determined that Staff would request that the Commission open a generic proceeding to develop the criteria the Commission would consider for substantiating that price deregulation is appropriate. To that end, the Commission opened Docket No. 02-GIMT-555-GIT on January 18, 2002. The Commission received comments regarding issues to be addressed and then set a procedural schedule setting a timeline for the filing of direct and rebuttal testimony and for a technical hearing. The Commission issued an order on September 30, 2003, providing general guidance on its review of applications for price deregulation. SWBT appealed the order.

In its order in Docket No. 02-GIMT-555-GIT, the Commission determined that it is appropriate to require the applicant to provide advance notice. Because the statute provides for, at most, 51 days to review the application and issue an order, the Commission believed that the provision of notice would allow Staff and other parties to gather the necessary resources to analyze the application once filed. The notice must describe the product or service for which price deregulation is sought, define the market area by exchange where price deregulation will be sought, and list all carriers the applicant believes are providing competitive services in the market. The notice is to be provided to the Commission, the Citizens' Utility Ratepayer Board ("CURB") and any carrier identified in the notice as a competitor. Notice must be given at least 10 days in advance of filing but no more than 30 days in advance of the filing of the application.

Additionally, the Commission determined that an application for price deregulation must include the following:

- a detailed description of the product or service for which price deregulation is proposed;
- an exchange-by-exchange description of the areas in which price deregulation is sought;
- identification and description of each telecommunications carrier or entity the applicant claims is providing a comparable product or service;
- price floor information;
- a description of the applicant's compliance with notice provisions;
- analysis of competition in the relevant markets;
- a description of the nature of competition including whether the market is growing or declining, the strength of competitors, substitutability, and the number of competitors; and,
- a discussion of entry and exit conditions in the relevant markets.

On April 11, 2005, SWBT filed an application for price deregulation in Docket No. 05-SWBT-907-PDR. In that application, SWBT requested price deregulation of the residential access line and call management services as well as nearly all business services and call management services provided in the Kansas City, Topeka and Wichita exchanges. Because of discrepancies in data provided in response to data requests, SWBT filed notice that the company intended to withdraw its application. SWBT refiled its application on May 6, 2005, in Docket No. 05-SWBT-997-PDR. Witnesses for SWBT, Staff, CURB, and other intervenors (Cox Kansas Telecom, L.L.C, d/b/a Cox Communications, Worldnet LLC, AARP, Everest Midwest Licensee, L.L.C., Prairie Stream Communications, Inc., and Birch Telecom of Kansas, Inc.) filed testimony addressing the issues set forth by the Commission in the generic proceeding. The Commission held a technical hearing on June 14 and 15, 2005.

On June 27, 2005, the Commission issued its order granting in part and denying in part SWBT's application.[1] As a starting point, the Commission evaluated the market share of the competitive carriers and SWBT for each service in each exchange. If the Commission found that the competitive carriers had significant market share, then it considered additional factors regarding sustainability such as the number of competitors and whether the competitors were financially viable. The Commission found it was appropriate to place emphasis on the presence of facilities-

[1] Commissioner Michael C. Moffet attached a Statement of Dissent to the order. Commissioner Moffet stated his belief that if an incumbent demonstrates that there is a competitive alternative for its services, then "the incumbent and, hence, the entire market should be allowed to function more freely." He also pointed to the statutory provision permitting the Commission to resume price regulation of the incumbent (K.S.A. 66-2005(r)) serves as an incentive for the incumbent provider to behave in a manner that does not thwart the development of competitive markets. However, Commissioner Moffet tempered his position by stating that he believed residential and single-line business services should remain under price-cap regulation because of the importance afforded to accessibility to basic local service. Commissioner Moffet said that competition may provide sufficient protection for these services in the future, but the Commission must first address the barriers placed by the legacy of rate regulation to the development of competition for these services.

based competitors given the FCC's decision eliminating switching as a UNE and the uncertainty regarding the ability of carriers that had used SWBT's switching to remain a competitor in the future.

The Commission evaluated price deregulation of the basic residential access line with consideration for those consumers who subscribe to stand-alone residential service (only the basic access line). While the majority of residential customers in these exchanges do subscribe to more services than the stand-alone access line, the Commission acknowledged evidence showing that between 23 and 25% of SWBT's residential subscribers in the Kansas City, Topeka and Wichita exchanges do not purchase additional call management services. The Commission also received evidence stating that this stand-alone service is vital to a large proportion of the elderly, disabled and impoverished communities in Kansas. Thus, the Commission believed it must pay special attention, given the vulnerable position of these customers, to whether there was sufficient competition to control pricing of stand-alone residential service.

The Commission found that there was insufficient competition to protect consumers of the stand-alone residential access line in these exchanges. In support of its decision, the Commission cited the market share information provided by Staff which indicated that SWBT served 73.6% of the market for stand-alone residential service in Kansas City, 84.2% of the market in Topeka, and 77.1% of the market in Wichita.[2] Additionally, the Commission stated that it was pessimistic regarding the state of competition for stand-alone residential service. In reaching this conclusion the Commission referred to evidence of the poor financial status of some of the competitors, the impact of the FCC's ruling regarding the availability of switching as a UNE, and the service limitations associated with VoIP service. The Commission noted that there were facilities-based competitors in the Kansas City and Wichita exchanges, but noted that these were cable providers with limited footprints.

The Commission also found that there was insufficient competition to discipline SWBT's pricing of single-line business service. Again, in reaching this conclusion the Commission cited the market share information provided by Staff which indicated that SWBT served 76.4% of the market in Kansas City, 64.9% of the market in Topeka, and 66% of the market in Wichita. The Commission noted that there were several facilities-based providers of single-line business service but for various reasons, the Commission believed that five of the nine competitors would be unlikely to aide in disciplining SWBT's pricing behavior for single-line business service. For instance, the Commission noted that AT&T would be merging with SWBT, thus, eliminating a competitor; MCI would be merging with Verizon, raising doubts about its continued presence as a competitive carrier; Birch was no longer accepting new customers; McLeod was experiencing financial difficulties; and, Everest's future was uncertain as Aquila was attempting to sell the company. The Commission did not believe the market shares of the remaining competitors were large enough to discipline the market.

The Commission determined that there was sufficient and sustainable competition in the Wichita exchange to justify price deregulation for multi-line business service. The Commission found

[2] The Commission had access to the market share of each individual carrier for each service offering in the exchanges and utilized that information in making its determinations. While much of that information was deemed confidential, the Commission was able to cite to SWBT's market share in its order.

that competitors served 47.7% of the multi-line business customers in Wichita. However, in the Kansas City and Topeka exchanges, the Commission did not find sufficient competition to grant price deregulation, finding that competitors served only 30.0% and 34.5% of the multi-line business customers respectively. In both of these exchanges, the Commission found that AT&T was the largest competitor and it would soon be merging with SWBT. In the Topeka exchange, the Commission noted that Birch also had a significant market share but the company was not offering the service to new customers and thus could not be relied on to help discipline the market in the future.

Following similar logic, the Commission price deregulated the following services included in SWBT's application:

- Flat Rate Trunk business service in all three exchanges;
- Smart Trunk business service in all three exchanges;
- Digital Loop business service with the Super Trunk option in all three exchanges;
- Plexar business service in the Wichita exchange; and,
- Digital Loop business service in the Wichita exchange.

The Commission did not price deregulate call management features unless the underlying access line service had been price deregulated. For instance, since multi-line business service was price deregulated in the Wichita exchange, any call management features associated with a multi-line business customer would also be price deregulated in the Wichita exchange. Since the call management services must be purchased from the same carrier providing the underlying basic access line, the Commission reasoned that without sufficient and sustainable competition to grant price deregulation of a particular access line service, the call management service would not be price deregulated.

Because the Commission found that there was evidence in the record demonstrating the most competition in the exchanges is for bundled services, the Commission granted SWBT pricing flexibility with respect to bundles if there was at least one facilities-based provider currently offering service in the exchange. Because the Commission did not make a finding of sufficient competition, the Commission placed conditions on the flexibility granted to SWBT. The Commission required that the individual services contained in the bundle must be made available separately at rates regulated through the price cap mechanism. The price cap on the individual services would then act as a pricing constraint for the bundle.

The Commission also determined that in those instances where price deregulation was granted, SWBT was still obligated to price its services in a manner that was not "unjust or unreasonably discriminatory or unduly preferential." (K.S.A. 66-1,187) Concern had been raised by some parties that because cable carriers, the primary source of facilities-based competition, do not cover the entire exchange for which price deregulation was requested, SWBT could engage in pricing differentiation within an exchange. Therefore the Commission determined that, for purposes of price deregulation granted in this docket, it would consider prices to be unreasonably discriminatory or unduly preferential if there are differing rates within an exchange for which the difference can only be explained by differences in the presence of a competitive alternative.

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Bundles

Beginning on page 7, line 41, the legislation would price deregulate bundles of services, statewide, while the services which comprise the bundle remain available for purchase individually at prices subject to price caps. This condition would remain in effect until an exchange qualified for price deregulation of basic access lines.

This language is similar to that ordered by the Commission in Docket No. 05-SWBT-997-PDR. However, the Commission granted this type of pricing freedom for bundles only after making a finding that there was a robust facilities-based competitor providing service. This was done because of a concern that carriers providing service through a Commercial Agreement (an agreement through which the incumbent carrier provides switching services to a competitor at "market-based rates") have small margins and must bundle services to achieve those small margins. Thus, allowing price deregulation of bundles when there is no facilities-based competition in the market may permit the incumbent carrier to engage in a price squeeze resulting in the loss of competitors. That price squeeze is possible only because the incumbent serves as both wholesaler (in a market with few other options) and retailer. The goal of the Kansas Telecommunications Act to encourage competition is then frustrated because the Commission can no longer address either the wholesale or the retail side of the market.

If the Committee believes this to be a valid concern, the Committee may wish to include language which would permit the price deregulation of bundles only in those exchanges for which there is a facilities-based competitor for at least a period of 2 years. This would provide those competitors who are attempting to transition away from reliance on the incumbent provider's network to develop a customer base that will support a move to facilities-based provisioning of service.

Exchanges with 75,000 or more Access Lines

Beginning on page 8, line 8, the legislation would price deregulate all services in exchanges with 75,000 or more exchange access lines. At this time, the Kansas City, Topeka, and Wichita exchanges would qualify for price deregulation of all services under this provision. This portion of the legislation does not require a showing that there are competitors; however, evidence from SWBT's application updated for recent changes (AT&T's merger with SWBT, Birch's impending departure, etc.) indicates that there are several competitors remaining in those exchanges. This competition is limited in the services that it provides (for instance, many competitors do not offer stand-alone access line service) and may not provide service throughout the entire exchange. Therefore, it is likely that some consumers will not have the benefit of either a competitive market or agency regulation to discipline prices.

These concerns have been addressed in other states where price deregulation has been granted through a legislative mandate rather than through a fact finding process. In Michigan, stand-alone residential service remains under price cap. In Missouri, the new law states that carriers may offer service in a geographic area smaller than the exchange unless the Missouri Public Service Commission finds such an offering to be contrary to the public interest. The new Texas

law contains language requiring the incumbent carrier to make services available at uniform rates consistent with any flexibility the company had prior to August 31, 2005. In the past, SWBT and Sprint have had the ability to charge several different rates in large exchanges given the differences in cost of serving customers. However, both companies have reduced or eliminated those rate disparities in recent years.

Additionally, there is no provision for resuming price regulation for exchanges with 75,000 or more access lines. It may be prudent to include language that would permit the Commission to resume price cap regulation under certain conditions. This will be discussed below.

Exchanges with fewer than 75,000 Access Lines

Beginning at page 8, line 11, the proposed legislation includes provisions for price deregulation of business and residential services in exchanges with fewer than 75,000 access lines. The provisions for residential services differs from the business service provisions in that to qualify as a competitor in the provision of residential services the carrier must be facilities-based. Again, there is no requirement that the competitive carriers offer stand-alone service or that they provide service throughout the exchange. If this is a concern, the Committee may wish to adopt language discussed above to leave at least the residential access line under price-cap regulation and require uniform pricing throughout the exchange.

Resuming Price-Cap Regulation

Beginning at page 9, line 33, the legislation permits the Commission to resume price-cap regulation of an incumbent carrier's services if the conditions for price deregulation are no longer satisfied. For exchanges with fewer than 75,000 access lines, this would occur if there were no longer two competitors in the exchange. For exchanges, with 75,000 or more access lines, there are no conditions for price deregulation other than the requisite number of access lines. It may be of concern that while in the short-term it may be sufficient to rely on only two competitors to discipline the pricing behavior of the incumbent, it may not be sufficient in the longer-term. For instance, the three market participants may initially compete vigorously but later move prices in tandem with the pricing of the dominant provider of the service. It also may be of concern that the language in K.S.A. 66-2005(b) which permits the Commission to move a price-cap company to rate-of-return regulation if quality of service standards are not met would seem to no longer be applicable to a company in those exchanges where it has received price deregulation.

It may be prudent to adopt language similar to that included in the Missouri law. The Missouri Public Service Commission is required to review whether the conditions for deregulation still exist every two years or whenever the incumbent carrier files a tariff containing a rate increase for a price deregulated exchange. Additionally, the Missouri Public Service Commission must provide a report to the Missouri General Assembly regarding the state-wide average rate for basic local service (excluding wireless rates) in 2008 and 2011 (two and five years after passage of the law). If the average rate is greater than the average rate for 2006 multiplied by (1 + % increase in CPI) then the Commission is required to recommend changes in the statute. This procedure permits the General Assembly to evaluate the success of price deregulation and consider re-regulation if it appears consumers are not receiving benefits of competition through

lower prices. Texas has also addressed the concern that it may be insufficent to protect consumers to consider re-regulation only upon a finding that two competitors are no longer present in the market. The Texas law forms a Legislative Oversight Committee to conduct hearings, at least annually, with the assistance of the Texas Public Utility Commission, to gather information regarding the introduction of competition. Among other things, the Oversight Committee is to evaluate any problems caused by price deregulation in the telecommunications markets and recommend legislative action to address those problems. This Committee may find processes similar to that developed in Missouri or Texas helpful in evaluating whether the price deregulation granted based on the presence of two competitors has led to the expected benefits.

Additionally, it may be prudent to adopt language making clear that incumbents having received price deregulation for some or all exchanges are still subject to K.S.A. 66-2005(b). While we generally presume that quality of service issues will be addressed by the presence of competition in a market; that is not always true. The Committee may wish to preserve the incentive contained in K.S.A. 66-2005(b) for incumbents to provide service consistent with the standards established by the Commission.

Thank you for your consideration of these comments. I am available for questions at the appropriate time.