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Opponent Testimony
On Senate Bill 346

Submitted by Christine Aarnes, Chief of Telecommunications, Utilities Division
On Behalf of
The Staff of the Kansas Corporation Commission

Chair Olsen, Vice Chair Petersen, Ranking Minority Member Francisco, and members of the committee, thank you for the opportunity to appear before your committee today on behalf of the staff of the Kansas Corporation Commission (Commission). My name is Christine Aarnes and I am the Chief of Telecommunications.

The Commission has the responsibility of ensuring that all local exchange carriers preserve and enhance universal service and provide quality telecommunications services, while also safeguarding the rights of consumers. The Commission staff does not believe SB 346 would further those goals, which is why we are opposing SB 346.

In summary, if the proposed bill is enacted:

- The <u>minimum</u> annual financial impact on the Kansas Universal Service Fund (KUSF) would be $17.1 million, which would increase the KUSF assessment rate by 38%, from 6.53% to 9.04%;
- Local exchange carriers could be allowed to over earn, at the expense of Kansas consumers; and
- Voice over Internet Protocol (VoIP) providers could be subject to additional regulations, which may not be the intent of the legislation.

Commission staff appreciates the opportunity to share staff's analysis of the proposed changes and potential impacts to the KUSF, Kansas telecommunications providers, and consumers. My testimony will address various elements of the bill and provide recommendations for the Committee's consideration.

Background

In 1996, the Kansas Legislature determined that it was appropriate to create a state universal service fund subsidy to maintain and enhance universal service. The KUSF was created by the Commission and implemented March 1, 1997. As of March 1, 2016, the KUSF funding obligation will be $47.6 million, including high-cost support in the amount of $4.5 million for the competitive eligible telecommunications carriers, $10.9 million[1] for CenturyLink, and $29.2 million for the rate of return carriers.

Pursuant to K.S.A. 66-2008(a), every telecommunications carrier, telecommunications public utility, wireless telecommunications service provider and interconnected VoIP provider that provides intrastate retail telecommunications services must contribute to the KUSF. On March 1, 2016, the current assessment rate of 6.47% on intrastate retail revenues will increase slightly to 6.53%. K.S.A. 66-2008(a) authorizes, but does not require, a company to collect an amount equal to, or less than, the assessment it owes to the KUSF from its end-user customers, which the majority of companies do.

The Federal Communications Commission's (FCC) universal service funding mechanisms also provide support for carriers' intrastate costs, which is known as Federal High Cost Loop (FHCL) support.[2] The FHCL amount the carrier receives is used as an offset to the company's KUSF support because it is revenue the company receives to recover its intrastate costs.

In November 2011, the FCC comprehensively reformed and modernized its universal service funding mechanisms to ensure that robust, affordable voice and broadband services are available to Americans throughout the nation. The FCC adopted what it referred to as fiscally responsible, accountable, incentive-based policies to transition the outdated systems to the new Connect America Fund.[3] Although the FCC expanded the services it supported (voice and broadband), it determined that a higher budget was not warranted, given the substantial reforms it adopted to modernize its legacy funding mechanisms to address long-standing inefficiencies and wasteful spending.[4]

The FCC stated that its package of universal service reforms was targeted at eliminating inefficiencies and closing gaps in its system, not at making indiscriminate industry-wide reductions. Many of the rules addressed had not been comprehensively examined for more than a decade and directed funding in ways that no longer made sense in the current marketplace. The FCC stated that by providing an opportunity for a stable 11.25% interstate return for rate-of-return companies, regardless of the necessity or prudence of any given investment, its prior system imposed no practical limits on the type or extent of network upgrades or investment. The FCC asserted that its prior funding system provided universal service support to both a well-run company operating as efficiently as possible and a company with high costs due to imprudent investment decisions, unwarranted corporate overhead, or an inefficient operating structure.[5]

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[1] $10.9 million is an estimated amount, which is subject to change following the Commission's review of the appropriate offset for Connect America Fund II monies.

[2] FHCL provides support to local exchange carriers (LECs) that have loop costs above the national average. FHCL also includes Safety Net Additive (SNA) and Safety Valve Support (SVS). SNA provides support to LECs "with over 14 percent growth in telecommunications plant in service on a per-line basis" and SVS provides "additional support for 'meaningful new investments' in exchanges acquired by rural carriers."

[3] *USF/ICC Reform Order*, WC Docket No. 10-90, Rel. November 18, 2011, ¶ 1.

[4] Id. at ¶ 125.

[5] Id. at ¶ 287.

The FCC was taking the overdue steps necessary to address the misaligned incentives in its prior funding system by correcting program design flaws, extending successful safeguards, ensuring basic fiscal responsibility, and closing loopholes to ensure its rules reward only prudent and efficient investment in modern networks. The FCC's reforms will help ensure rate-of-return carriers retain the incentive and ability to invest and operate modern networks capable of delivering broadband as well as voice services, while eliminating unnecessary spending that unnecessarily limits funding that is available to consumers in high-cost, unserved communities.[6]

Because the FCC's approach is focused on rooting out inefficiencies, the FCC stated that the reforms would not affect all carriers in the same manner or in the same magnitude. After significant analysis, including review of numerous cost studies submitted by individual small companies and cost consultants, the FCC was confident that these incremental reforms would not endanger existing service to consumers. Further, the FCC stated that it strongly believed that carriers that invest and operate in a prudent manner would be minimally affected by its reforms.[7]

To the extent that any individual company can demonstrate that it needs temporary and/or partial relief from one or more of the FCC's reforms in order for its customers to continue receiving voice service in areas where there is no terrestrial alternative, the FCC will review a request for additional support. The FCC, however, stated that it did not anticipate routinely granting requests for additional support, and any company that seeks additional funding would be subject to a thorough total company earnings review.[8]

Proposed Legislation – SB 346

Rate of Return Carrier KUSF Support

The most troubling section of the bill is the proposed change to K.S.A. 66-2008(e)(1). The proposed language changes the current requirement that KUSF support for rate of return carriers shall "**be based on**" such carrier's embedded costs, revenue requirements, investments and expenses to instead require that rate of return carrier KUSF support shall "**ensure recovery of**" such carrier's intrastate embedded costs, revenue requirements, investments and expenses. This language revision, although seemingly minor, is not.

K.S.A. 66-2008(e)(2) and (e)(3) were modified by the 2013 Kansas Legislature to impose an annual $30 million cap on rate of return carrier KUSF support and to prevent KUSF support from offsetting any loss of federal universal service support. Presumably, the 2013 Legislature adopted these measures over concerns that the amount of KUSF support rate of return carriers receive could increase due to the universal service reforms implemented by the FCC. The proposed language in SB 346 effectively negates these provisions by ensuring rate of return carriers' KUSF support recovers such carrier's intrastate embedded costs, revenue requirements, investments and expenses.

[6] Id. at ¶ 288.
[7] Id. at ¶ 289.
[8] Id. at ¶ 202.

The proposed language could also be interpreted to mean that a rate of return carrier is ensured it will recover all of its recorded intrastate embedded costs, revenue requirements, investments, and expenses, which would essentially provide unlimited funding – at the expense of all Kansas telecommunications providers and consumers. The Commission has historically disallowed claimed expenses for items such as lobbying, advertising, sponsorships, political contributions, family travel, alcohol, and entertainment because these expenses are not necessary for the provision of safe and reliable service. The proposed language could be interpreted to allow for recovery of such currently-disallowed expenses from the KUSF. The proposed language transfers the very inefficiencies the FCC wanted to eliminate to the KUSF. Specifically, providing an opportunity for a stable return for rate of return companies, regardless of the necessity or prudence of any given investment, and imposing no practical limits on the type or extent of network upgrades or investment may lead to inefficient and wasteful spending. Similar to the FCC's prior funding system, it would provide support to both a well-run company operating as efficiently as possible and a company with high costs due to imprudent investment decisions, unwarranted corporate overhead, or an inefficient operating structure.

The financial impact of this particular provision is difficult to quantify because it is unknown how much KUSF funding a rate of return carrier would seek to recover from the KUSF; however, it could be substantial. For example, in the most recent KUSF audit proceeding, the company requested $1.43 million in KUSF support in addition to its then-current $3.67 million in annual KUSF support. Following staff's review of the company's records and the filing of testimony, the Commission ultimately awarded the company $14,688 in additional annual KUSF support, substantially less than the company's initial request.

The proposed bill also modifies K.S.A. 66-2008(e)(2), which currently states that KUSF support shall not be used to offset any loss of federal support and instead states that KUSF support shall not "be used to offset any reduction of federal universal service fund support for recovery of such carrier's interstate costs and investments." First, as discussed above, the revision to K.S.A. 66-2008(e)(1) effectively negates the current prohibition of KUSF support making up for losses in federal funding, and this revision takes it one step further to ensure that a rate of return carrier's KUSF support is not reduced in any way.

Because the FCC's reforms are focused on rooting out inefficiencies and wasteful spending, the FCC stated that the reforms would not affect all carriers in the same manner or in the same magnitude and this has held true for Kansas carriers. Since the enactment of HB 2201 in 2013, Kansas rate of return carrier annual FHCL support has declined collectively by $9.6 million. Fifteen Kansas rate of return carriers receive more annual FHCL support than they received prior to the enactment of HB 2201 ($7.5 million) and twenty carriers' FHCL funding has been reduced ($17.1 million). If the proposed bill is passed and all of the carriers whose federal support has decreased request KUSF support to make up for reduced federal support, the fiscal impact would be an annual increase of

$17.1 million. This alone would increase the KUSF assessment rate from 6.53% to 9.04%, and the assessment rate will continue to increase in future years due to continued declining intrastate assessable revenues.

Lastly, with regard to K.S.A. 66-2008(e)(2), there appears to be a typo in the proposed bill as it states KUSF support shall not be used offset any reduction of FHCL support for recovery of such carrier's "interstate" costs and investments. The Commission staff assumes "intrastate" was intended to be used instead of "interstate" because local exchange carriers do not recover interstate costs from the KUSF.

Local Rate Increases

In order to ensure that carriers in rural areas are not unfairly burdening consumers across the nation by using excess federal universal service support to subsidize artificially low end-user rates, the FCC determined that it would reduce FHCL support for carriers that maintain artificially low end-user voice rates. Specifically, effective July 1, 2012, the FCC began reducing, on a dollar-for-dollar basis, FHCL support to the extent that a carrier's local rates were below a specified urban local rate floor. If a carrier's local rate plus state regulated fees, such as the KUSF assessment, are below the rate floor benchmark, the carrier's FHCL support is reduced. The rate floor benchmark was $10 effective July 1, 2012; $14 effective July 1, 2013; and, $16 effective July 1, 2015. To date, none of the Kansas carriers' federal support has been reduced as a result of this rule.

Pursuant to the proposed bill, the Commission is to approve an application by a rural telephone company to increase its local rate to ensure a local exchange carrier's local rate is not below the FCC rate floor, and the carrier's KUSF support shall not be reduced to offset the increased revenue the carrier will receive from its local ratepayers. In some cases, it may be appropriate not to reduce a carrier's KUSF support if its local rate is increased; however, in other cases, it may allow a carrier to over earn – at the expense of its ratepayers and all other Kansas consumers. It would be unjust for all Kansas providers and their subscribers that contribute to the KUSF to continue to subsidize a carrier and allow such carrier to over earn. It would be more appropriate to approach this on a case-by-case basis based on each carrier's individual circumstances.

The placement of the language revision in K.S.A. 66-2005(d) is also confusing. Currently, K.S.A. 66-2005(d) describes the biennial process whereby rural telephone companies increase their local residential and single-line business rates to the statewide rural telephone company average rates and the carrier's KUSF is reduced by the amount of increased annual revenue the carrier will receive due to the local rate increases from its customers. It is unclear if the KUSF would be reduced in this instance – or whether the carrier could simply claim it is increasing its local residential rate to ensure it is not below the FCC rate floor and keep the increased local ratepayer revenue and its KUSF subsidy.

It is also unclear: (1) whether the company would be able to make a separate application requesting a local rate increase to ensure it is above the FCC rate floor or if the request could only be made in conjunction with the biennial local rate adjustment process; (2)

whether there would be any limit on the amount of a local rate increase the carrier could request; (3) what timeframe would be provided for the Commission to review such applications; (4) whether this provision creates a conflict with K.S.A. 66-2007(b), which allows for local rate increases up to $1.50 per year; and (5) whether the calculation of the statewide rural telephone company average rates would include the increased rates or not.

If it is the Legislature's desire to allow rural telephone companies to increase their local rates to avoid facing a reduction in their federal funding, the language should be revised and clarified to ensure the directives are clear. Commission staff also recommends language be added to ensure a carrier is not allowed to over earn at the expense of Kansas consumers.

VoIP Regulation

The 2013 Kansas Legislature passed HB 2326 which created K.S.A. 66-2017. Pursuant to K.S.A. 66-2017, VoIP and Internet Protocol (IP)-enabled service are exempt from the jurisdiction, regulation, or supervision of the state or any political subdivision, with a few exceptions. K.S.A. 66-2017 specifies the requirements VoIP services are and are not subject to.

The language in the proposed bill states that no provision of this section shall be construed to modify the regulation of any rural telephone company. Staff is uncertain what this language is intended to accomplish. It is possible that the language was added to codify that rural telephone companies would remain subject to state and Commission regulations regardless of whether the company converts from circuit-switched technology to IP-based technology.

The language could, however, also be construed to imply that VoIP carriers are not exempt from the Rural Entry Guidelines because it relates to the regulation of a rural telephone company. The Rural Entry Guidelines, which were established almost 20 years ago, exempt rural telephone companies from certain obligations of an incumbent local exchange carrier, which are prerequisites for competition.[9] The Rural Entry Guidelines also require the applicant to meet the eligible telecommunications carrier requirements and obtain a Certificate of Public Convenience and Necessity from the Commission.

Currently, wireless and VoIP providers are able to provide service to customers anywhere in the state they wish to serve but, under such an interpretation, VoIP providers would no longer be able to do so unless each carrier goes through the Rural Entry process and the Commission approves each request for each rural telephone company service area.

[9] Pursuant to the Rural Entry Guidelines, rural telephone companies are exempt from certain obligations, such as the duty to negotiate interconnection, unbundled access, resale, notice of changes, and collocation, unless a rural telephone company has received a bona fide request for interconnection, services, or network elements and the Commission determines that such request is not unduly economically burdensome, is technically feasible and preserves and enhances universal service.

Unless the Committee intends for VoIP providers to be subject to the Rural Entry Guidelines, it should be clarified that this provision does not affect VoIP providers and the Rural Entry Guidelines or any other rural telephone company regulation. Staff, has no concerns with codifying the continued Commission jurisdiction over rural telephone companies, but suggests the language be revised to clarify that this is the intent.

Broadband

Pursuant to the proposed bill, the definition of "broadband" in K.S.A. 66-1,187(a) is amended from "1.5 megabits per second" to "10 megabits per second download and one megabit per second upload". The proposal also declares it is the sixth public policy of the state to "promote local investment and the development and expansion of economic opportunities, through the statewide availability and ongoing enhancement of reliable and affordable broadband data and communication services."

It is unclear why the definition was revised and why the additional public policy of the state was added, but it could be construed to imply that the KUSF shall provide support for investment, maintenance, and enhancement of broadband at speeds of 10 Mbps/1 Mbps. Currently, the KUSF implicitly provides funding for infrastructure that provides broadband at this speed because the same network is utilized to provide voice services, but broadband is not explicitly funded. If it is the Committee's desire to explicitly support broadband at the aforementioned speeds from the KUSF, Commission staff recommends the Committee add a provision to ensure that broadband revenues are included in KUSF audit proceedings as broadband would be an explicitly supported service. Explicitly supporting broadband will have a financial impact on the KUSF, but it would be difficult to quantify because it is unknown what additional costs would be incurred.

If the legislature does not intend for the KUSF to explicitly subsidize the investment, maintenance, and enhancement of broadband at the aforementioned speeds, Commission staff recommends the policy statement either be eliminated or revised to state "it is the public policy of the state to "promote local investment and the development and expansion of economic opportunities, through the statewide availability and ongoing enhancement of **privately funded** reliable and affordable broadband data and communication services."

Conclusion

The Commission staff has concerns about the potential financial impact SB 346 could have on the KUSF, Kansas telecommunications carriers and consumers, and the possible unintended consequences the proposed bill could create. Therefore, Commission staff is opposed to SB 346.

Thank you for your consideration of these comments and the opportunity to appear before your committee.