Report of the Telecommunications Study Committee to the 2014 Kansas Legislature

Co-chairperson: Senator Pat Apple

Co-chairperson: Representative Joe Seiwert

Legislative Members: Senators Jay Emler, Marci Francisco, Tom Hawk, Forrest Knox, Jeff Longbine, Julia Lynn, Robert Olson, and Mike Petersen, Representatives Rob Bruchman, Will Carpenter, John Doll, Randy Garber, Ramon Gonzalez, Annie Kuether, Ronald Ryckman Sr., Scott Schwab, Jack Thimesch, and Brandon Whipple

Study Topic or Charge

- Study telecommunications issues including funding, uses, and sources of:
  - The Kansas Universal Service Fund (KUSF); and
  - The federal Universal Service Fund (FUSF);
- Review and make recommendations on the state's public policy on telecommunications; and
- Review possible need for funding sources of and uses of a Kansas Broadband Fund.

July 2014

Telecommunications Study Committee
December 16, 2014
Attachment 3

Telecommunications Study Committee

Annual Report

Conclusions and Recommendations

The Committee's final report, which is due December 31, 2014, will contain its conclusions and recommendations.

Proposed Legislation: None

Background

The Telecommunications Study Committee was created by 2013 HB 2201, a bill which also further deregulated telecommunications in Kansas, made changes to distributions from the Kansas Universal Service Fund (KUSF), and allowed the Board of Regents to charge fees for services provided by the Kan-Ed program.

The Committee's charge is to study telecommunications issues, the KUSF, the Federal Universal Service Fund (FUSF), the state's public policy on telecommunications, the possibility of establishing a Kansas Broadband Fund, and other issues determined by the Legislative Coordinating Council. In addition, the Committee is charged with determining the scope of an efficiency and effectiveness audit of the KUSF. The audit is to be administered by the Kansas Department of Revenue and submitted to the Committee by November 1, 2014.

The Committee is required to submit an annual report to the Senate Committee on Utilities and the House Committee on Utilities and Telecommunications and to submit a report and policy recommendations for telecommunications to those committees as well as to the Senate Committee on Ways and Means and the House Committee on Appropriations, prior to December 31, 2014. The Telecommunications Study Committee sunsets on June 30, 2015.

Committee Activities

The Committee met twice during the 2013 Legislative Interim on November 6 and December 12. The Committee reviewed its charge and received presentations on topics including the history of telecommunications legislation in Kansas from 1996 through 2013, an overview of the KUSF, state and federal Do-Not-Call legislation, the process for determining KUSF high-cost support, and changes to the FUSF. In addition, the Committee received testimony from industry groups on the effects of changes to the KUSF and the FUSF, and determined the scope of an audit of the KUSF.

Telecommunications Legislation in Kansas, 1996 - 2013

Staff from the Kansas Legislative Research Department reviewed major telecommunications bills enacted by the Legislature beginning with 1996, the year federal telecommunications law significantly restructured the industry.

The telecommunications policy framework set out in the Kansas Telecommunications Act of 1996 remains in effect today. The Act declares it to be the public policy of the State to:

- Ensure every Kansan has access to a first class telecommunications infrastructure that provides excellent services at an affordable price;

3-2

- Ensure consumers realize the benefits of competition through increased services and improved facilities and infrastructure at reduced rates;

- Promote consumer access to a full range of telecommunications services, including advanced services that are comparable in rural and urban areas throughout the state;

- Advance development of a statewide infrastructure capable of supporting applications such as public safety, telemedicine, services for persons with special needs, distance learning, public library services, access to internet providers, and others; and

- Protect consumers of telecommunications services from fraudulent business practices and practices that are inconsistent with the public interest, convenience and necessity.

Among its many provisions, the Act required local exchange carriers to change a number of their business practices to increase competition, file network infrastructure plans that included schedules for deploying universal service capabilities and the capability to comply with quality of service standards, and rebalance intrastate and interstate switched access charges. The bill also required the Kansas Corporation Commission (KCC) to establish the Kansas Lifeline Service Program (to help low-income Kansans afford residential local service) and the KUSF.

Major legislation passed in subsequent years included the following:

- 1998 House Sub. for SB 212 reduced the size of the KUSF.

- 2002 Sub. for SB 296 established the Kansas No-Call Act, while other legislation that year conformed Kansas law to federal law to provide a uniform method of sourcing tax revenues from wireless services (SB 372) and created a new and separate city franchise procedure for telecommunications local exchange service providers (SB 397). 2002 Sub. for HB 2754 further addressed access rate rebalancing by rural telephone companies; developed a procedure for determining affordable local telephone rates for residential and business service; and required rural telephone companies to calculate revenue requirements and KUSF support based on embedded costs.

- 2006 SB 360 established thresholds for price deregulation in exchanges served by price-cap carriers (AT&T and CenturyLink). Prices were deregulated for bundled service statewide, individual components of bundles in urban areas, and business and residential services in rural areas if the standard for competition was met. Lifeline services, the initial residential line, and up to four business lines at one location remained subject to price-cap regulation.

- 2008 SB 49 required Voice over Internet Protocol (VoIP) service providers to contribute to the KUSF, and SB 570 required broadband service providers to report information about service availability to the KCC, and the KCC to report broadband availability to the Legislature annually. HB 2637 authorized local exchange carriers to adjust rates for the initial residential line and up to four business lines at one location without KCC approval, required price deregulated carriers to automatically enroll eligible customers in Lifeline services, and allowed a carrier to be relieved of its responsibilities as carrier-of-last-resort in limited circumstances.

- 2011 Sub. for SB 72 allowed further deregulation of a price-cap carrier that has deregulated a majority of its local exchange access lines (only AT&T met this criteria). Such carrier, to be known as an "electing carrier" is subject to price-cap regulation only for Lifeline services, must allow reasonable resale of its retail service, is eligible to receive KUSF funding, cannot charge more for a single residential or business line in its rural exchanges than in its urban exchanges, could choose to be relieved of its obligation to serve as carrier-of-last-resort in urban exchanges, must offer single residential local access lines in its exchanges, and must allow interconnection by a telecommunications carrier to transmit and route voice traffic.

- 2013 HB 2201 created the Telecommunications Study Committee and continued deregulation of the telecommunications industry. The legislation eliminated nearly all regulation of electing carriers and telecommunications carriers and changed distributions from the KUSF. Price-cap carriers (CenturyLink) were limited to the lesser of 90.0 percent of their 2011 KUSF level of support or $11.4 million. Distributions to rate-of-return carriers as a group was limited to $30 million annually, with the KCC authorized to modify carriers' KUSF support only based on changes in embedded costs, revenue requirements, investments, and expenses, until at least 2017. The identical support rule was discontinued for competitive eligible telecommunications carriers, whose KUSF high cost support was capped as of March 1, 2013, and will be reduced to zero beginning March 1, 2018.

Kansas Universal Service Fund

Staff from the Utilities Division of the KCC presented background information on the KUSF, including the programs funded, historical levels of support for programs and carriers, and audit processes carried out by the KCC. Presenters and respondents to questions included the Division Director, the Chief and the Assistant Chief of Telecommunications, and the Chief of Accounting and Financial Analysis.

Overview. The KUSF was created by the KCC in 1997, as directed by the 1996 Kansas Telecommunications Act. The purpose of the KUSF is to assure quality services are made available to all Kansans at affordable rates. Every telecommunications carrier, telecommunications public utility, wireless service provider, and VoIP provider offering intrastate telecommunications service must contribute to the KUSF, but companies can pass the assessment through to customers.

The assessment rate for 2013 (assessment years run from March 1 through February 28) is 6.42 percent on intrastate revenue. The rate has ranged from a high of 9.0 percent in the Fund's first year of existence to a low of 3.7 percent in 2002.

Since the Fund's inception a total of $1.1 billion has been awarded through five programs:

- High Cost Support, the largest program, accounts for 85.4 percent of total support provided since 1997. It provides affordable services in areas that are costly to serve, primarily because of low population density;

- Kan-Ed, funded primarily from KUSF for State FYs 2004 through 2013, was created to provide broadband Internet access and distance learning capabilities for schools, libraries, and hospitals. It accounted for 8.4 percent of total support provided, but KUSF support for Kan-Ed was eliminated as of June 30, 2013;

- Kansas Relay Service, Inc. (KRSI) provides intervention assistance between a hearing or speech impaired customer and a hearing person in order for them to communicate. KRSI has received 2.8 percent of the support;

- Lifeline provides a credit to eligible households to aid in payment of the bill for local telephone service. Historically, it has accounted for about 2.5 percent of support; and

- Telecommunications Access Program (TAP) helps pay for specialized equipment for persons with certified disabilities who need assistance in using the telephone. Over the years TAP accounted for 0.9 percent of the support.

Process for determining KUSF high-cost support. The KUSF initially was implemented on a revenue neutral basis — that is, it was set up to allow carriers to recover the revenue lost when intrastate access rates were reduced under the Kansas Telecommunications Act. The Act also required the KCC to periodically review the KUSF to determine if the cost to provide universal service justified modification of KUSF. For carriers that chose price-cap regulation (AT&T and CenturyLink), the KCC mirrored the federal approach that based support on the cost to provide service if the network were to be built given current technology, and a model was developed to calculate the forward-looking cost of providing service and support.

The KCC also mirrored the federal approach for the carriers that chose rate-of-return regulation (the rural independent companies) and based support on historical costs, which has been revised to include embedded costs, revenue requirements, investments, and expenses.

To implement the required periodic review, the KCC initiated KUSF audits based on the amount of KUSF support provided, working from largest to smallest amount of support. The first audit (AT&T) was conducted in 1998 and the last initial audit of a rate-of-return carrier was completed in 2013. In all, 16 of 36 rate-of-return carriers have undergone second audits. Based on a district court ruling, any change to KUSF support must be based on a KUSF audit. For example, a carrier with a large increase in access lines to remote locations would be required to request an audit to determine whether it was entitled to additional KUSF support.

Audits, conducted by KCC audit staff and consultants, consist of an in-house review of carrier data as well as an on-site review of carrier records and facilities. Staff recommendations are presented via the docket process to the Commissioners who make the final determination of KUSF support.

Detailed information was provided to the Committee regarding the types of expenditures reviewed during an audit and the process for determining a carrier's revenue requirement. Schedules from a recent audit demonstrated the information reviewed and the types of adjustments and allocations made during an audit.

Do-Not-Call Legislation

Staff from the Kansas Legislative Research Department provided a briefing on telemarketing laws in response to questions raised by Committee members.

Federal laws were passed in the early 1990s to help protect consumers from unsolicited telephone marketing calls to their homes, including automated and prerecorded messages, and to restrict telemarketing calls a reasonable consumer would consider coercive or abusive of the consumer's right to privacy. These laws, enforced by the Federal Trade Commission, included requirements on the identifying information a telemarketer had to provide a consumer; a prohibition on placing calls before 8 a.m. or after 9 p.m.; and a requirement for the telemarketer to comply with any do-not-call request made during the call. In 2003, the National Do-Not-Call Registry was established.

The Kansas No-Call Act was established in 2002. It incorporates the protections of the federal laws and places additional restrictions on telemarketers. It clarifies the limited circumstances under which a telemarketer may contact a person whose phone number is on the No-Call List (For example, if expressly requested by the consumer, if the consumer and the telemarketer have a business relationship, or if the call is of a charitable nature.). Violations of the Kansas No-Call Act are enforced by the Kansas Attorney General and are subject to a civil penalty. The Kansas No-Call List is part of the National Do-Not-Call Registry, which is managed by the Federal Trade Commission.

Federal Universal Service Fund

The Chief of Telecommunications, KCC, provided an overview of the FUSF and the Federal Communications Commission (FCC) Reforms. Historically, the provisions in federal law to develop a fund to maintain and enhance universal service referred to telephone service. However, in 2009, Congress directed the FCC to develop a National Broadband Plan to ensure ubiquitous access to broadband service, which has led to significant changes in the way federal universal service funds will be deployed in the future.

In 2012, the FUSF disbursed $8.7 billion nationwide among its four component programs. Telecommunications providers must contribute to the FUSF through an assessment on their interstate and international revenues, and providers typically pass the cost of FUSF contributions to their customers. The programs are described below, along with the percent of funding each received in 2012:

- The High Cost Program allows carriers to recover part of the cost of providing service in areas too sparsely populated or too remote to otherwise have affordable telecommunications service (47.6 percent);
- The Lifeline Program provides a discount on the cost of service for qualifying low-income households (25.1 percent);
- The Schools and Libraries Program, commonly referred to as E-rate, offsets the cost of telecommunications in eligible schools and libraries (25.5 percent); and
- The Rural Health Care Program helps pay the cost of telecommunications service necessary for the provision of health care in rural areas (1.8 percent).

Kansas receives a large share of the total amount of FUSF support awarded. In 2012, Kansas was the 14th largest recipient of support from all FUSF programs, receiving $218.4 million in all, and the 4th largest recipient of High Cost Support, receiving $189.6 million for that program alone.

In November 2011, the FCC issued its Reform Order for the FUSF. The Order created the Connect America Fund (CAF) to support broadband and take the place of the legacy High-Cost Program, created a Mobility Fund to support 3G or better wireless coverage, reformed Intercarrier Compensation, and expanded the Lifeline Program to allow subsidies to be provided for broadband. The Order identified support for broadband-capable networks as an express universal service principle and set five performance goals for reform of the FUSF, as follows:

- Preserve and advance availability of voice service;
- Ensure universal availability of modern networks capable of providing voice and broadband service to homes, businesses, and community anchor institutions;
- Ensure universal availability of modern networks capable of providing advanced mobile and broadband service;
- Ensure rates for broadband services and rates for voice services are reasonably comparable in all regions of the nation; and
- Minimize the universal service contribution.

The initial budget for the first six years of FUSF reform was set at $4.5 billion. Price-cap carriers and rate-of-return carriers are treated differently under the Order.

For price-cap carriers (in Kansas, AT&T and CenturyLink), existing high-cost FUSF support was frozen at 2011 levels. An additional $300 million in CAF Phase I funding was made available, but to qualify for that support a carrier had to provide broadband with actual speeds of 4 megabits per second (Mbps) download and 1 Mbps upload and deploy broadband to at least one currently unserved location for each $775 in additional high-cost support received. Nationwide in 2012, carriers initially accepted only $115 million of the $300 million available — AT&T declined the $47.9 million offered, and CenturyLink accepted $35 million, none of which was spent in Kansas.

In the second round of Phase 1 funding for price-cap carriers, a minimum of $300 million was made available. Criteria was modified, and nationwide, the FCC approved $289 million in support. AT&T was approved for $95 million, none designated for Kansas; CenturyLink was approved for nearly $40 million, of which $81,474 will be spent in Kansas; and FairPoint Communications Missouri, Inc. was approved for $2.9 million, of which $91,612 will be spent in Kansas.

In Phase 2, in each state, each incumbent price-cap carrier will be asked to make a state-level commitment to provide affordable broadband to all high-cost locations in its service territory. If the incumbent declines to make the commitment, CAF support will be distributed through competitive bidding.

For rate-of-return carriers, the FCC adopted new rules including, elimination of FUSF support in areas completely overlapped by an unsubsidized competitor; capping total FUSF support at $250 per line per month; and elimination of, or new limits on, reimbursement of various other costs previously eligible for support. Rate-of-return carriers receiving legacy high-cost support or CAF support to offset lost intercarrier compensation must offer broadband service with actual speeds of at least 4 Mbps download and 1 Mbps upload upon a customer's reasonable request.

Industry Comments on Changes to the KUSF and the FUSF

Representatives of different types of carriers were asked to address how changes in the KUSF and FUSF affect their business model as a telecommunications provider, and what the future holds.

The Legislative Director for AT&T Kansas noted that AT&T's support from the KUSF has been significantly reduced over the years as its number of residential retail lines decreased by 81.0 percent from 2000 to 2013. Currently, the company receives about $5.5 million in KUSF support, but that support will be eliminated as of January 1, 2014, concurrent with the elimination of AT&T's remaining retail regulations and legacy obligations to serve. Because its wireless and landline customers pay into the KUSF, AT&T has a vested interest in seeing that the Fund is effectively and efficiently managed.

A Government Affairs representative for CenturyLink said the company receives KUSF support only where the cost to provide voice service exceeds 125.0 percent of the benchmark cost of $36.45, which constitutes about 45.0 percent of the company's rural, high cost customers. CenturyLink receives no KUSF support for fiber, broadband, or incremental investment (the high cost associated with bringing service to the last few households).

The General Manager and CEO for Pioneer Communications spoke on behalf of the rural independent providers, noting that in order to access KUSF and FUSF support, a rural independent carrier must first spend money and invest in its network, then "prove" the investment to regulatory entities before cost recovery from universal service funding programs is allowed. Access to KUSF and FUSF support has allowed companies to build and maintain a robust rural network that provides service at affordable rates. Both the KUSF and FUSF need to be modernized and adapted to a broadband world. The independent carriers continue to experience high demand for wired broadband access, with high speeds and no limit on the amount of data that can be accessed during a billing period. However, the reforms put into place by the FCC in 2011 have caused a significant amount of regulatory uncertainty, have frustrated access to capital for network deployment, and have resulted in a significant slowdown of broadband deployment. The FCC reforms, combined with the effect of HB 2201, will slow investment by rural independent carriers dramatically. They will receive requests for more bandwidth that neither they nor any other carrier, including wireless, will be able to provide. Without access to broadband, businesses and young people are less attracted to rural areas, and the quality of life in rural areas suffers. Without a reliable KUSF, consumers in the most rural areas of the state will not be able to afford the cost of service.

The Senior Counsel and Director of State Government Affairs for Sprint said changes made in 2013 to limit the amount paid from the KUSF are positive, but Kansas wireless customers still pay too much for funds that go primarily to landline companies. Even with reforms fully implemented, the KUSF will give out more than $40 million annually in high cost funds to

CenturyLink and the rural carriers. Sprint views the federal CAF, which is narrowly targeting its funds to companies to roll out broadband to unserved and underserved areas, as a good use of universal service funds. The KUSF should have goals consistent with the CAF, where efficiency is expected as access recovery amounts are reduced annually, and funding is conditioned on building out broadband in currently unserved areas. Sprint posed a series of questions for consideration by the Study Committee and KUSF recipients.

Scope Statement for the KUSF Audit

The Study Committee was charged with determining the scope of an efficiency and effectiveness audit of the KUSF. HB 2201 required the audit to be administeredby the Kansas Department of Revenue, consistent with the scope determined by the Study Committee. The bill identified metrics that may be included in the audit, and the Committee agreed to a draft scope at its first meeting. The Committee then invited written comments on the draft from all interested parties and the draft was further discussed at the Committee's second meeting before being modified and adopted. The audit scope adopted by the Committee follows.

Audit Scope

In addition to such other measures as the auditors deem appropriate for determining the overall efficiency and effectiveness of the Fund, the audit should address broad oversight and structural questions, as well as detailed analysis of actual revenue, spending and operations of KUSF recipients (per recipient and per program). A detailed review of the Kan-Ed program is not necessary; a January 2012 audit by Legislative Post Audit that evaluated the effects of eliminating Kan-Ed addressed operations and effectiveness of the program, and a January 2013 needs assessment contracted by the Kansas Department of Commerce entitled "Building the Broadband Future" also contained an assessment of Kan-Ed outcomes.

Metrics for the oversight and structure assessments include:

- The adequacy of applicable Kansas statutes and governmental review processes to ensure the amounts of KUSF moneys disbursed to recipients are not excessive, including the possible need to redefine the types of expenditures eligible for reimbursement under the KUSF, and that appropriate incentives to produce efficiencies are created;

- Identification of the quantifiable benefits of the KUSF programs. (What has the program achieved, and what impact has it had on local rates?);

- Comparison of the KUSF programs to state-level universal service programs in other states (Are other states accomplishing the same thing in a different way? Are any other states in the process of changing their USF program? Do other states have the same mix of independent telephone companies that Kansas has?); and

- Comparison of FUSF distributions to states, including analysis of the basis for Kansas' share. (Why is Kansas one of the largest recipients of FUSF, and given that Kansas receives substantial federal assistance, why is there a need for additional aid in the form of KUSF?)

For the detailed analysis of revenues, expenditures and operations, specific metrics to be included in the report, to the extent they do not involve proprietary information and are not, in the auditor's opinion, unduly burdensome to collect, include the following:

- Historical information on which companies have received KUSF and in what amounts, including calculation of annual per line, per linear mile support (taking population density and/or geography into consideration in interpreting the results), or other metrics;

- Total amount of rural utilities service debt and other debt with a nexus to the KUSF, by recipient or related entity;

- Capital expenditures on each technology modality (*eg.* fiber, copper, wireless), including the supporting rationale;

- Affiliate transactions and transfers with a nexus to the KUSF;

- Expenditure assessment to ensure the KUSF is only being used to subsidize services authorized by Kansas statutes;

- The number of telephone competitors in each exchange, and whether the exchange is supported by the KUSF;

- Economic assessment per exchange, *i.e.*, how do the revenues paid into the KUSF and into the FUSF from each exchange compare with benefits each exchange receives from the KUSF and from the FUSF;

- Detailed review of the companies with high KUSF support per line, to identify the factors that contribute to this level of support;

- Documentation of the change in the number of landlines over time, with fax and data lines separated from voice lines; and

- "Stress test" on the KUSF as the number of landlines decreases by 10.0 percent, 25.0 percent, and 50.0 percent. (How does the KUSF distribution process respond to these types of decreases – do payments decrease correspondingly?)

Note: To the extent a KUSF recipient is part of a regional or national company, the analysis of spending and operations should focus on Kansas operations.

In addition, the report should include descriptive information that helps place the audit findings in context, such as:

- Historical background including when the KUSF was created and for what purpose, statutory changes that have taken place and why, and how the total size of the KUSF and the assessment rates have changed over time; and

- "Process" information describing the factors that determine how much KUSF support a company receives (including an explanation of how the cost of delivering two-way voice communication is separated out from costs of other services a company might provide, such as broadband or TV), the role of the third-party administrator vs the role of the KCC, the process for requesting and receiving support, and an explanation of the KUSF accounting processes for rate-of-return carriers, including depreciation of assets.

Finally, the audit report should include proposals for legislative consideration and action for adequate oversight of the KUSF.

Conclusion and Recommendations

The Committee's final report, which is due December 31, 2014, will contain its conclusions and recommendations.