

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

PETITION OF AT&T COMMUNICATIONS OF THE )  
SOUTH CENTRAL STATES, INC. FOR REDUCED ) CASE NO.  
REGULATION OF INTRASTATE TELECOMMUNI- ) 92-297  
CATIONS SERVICES )

O R D E R

On July 16, 1992, AT&T of the South Central States, Inc. ("AT&T") filed a petition requesting reduced regulation of its intrastate telecommunications services pursuant to KRS 278.512. AT&T specifically requested that the Commission:

1. Dispense with rate of return regulation for all long-distance carriers ("IXCs") in Kentucky;
2. Dispense with all financial reporting requirements for AT&T and other IXCs or alternatively, allow AT&T to file annual reports similar to those filed by other IXCs;
3. Require only seven days notice to the Commission for rate adjustments;
4. Remove requirements for cost support for applications to adjust rates and offer new services;
5. Treat all its tariff filings as presumptively valid;
6. Remove the requirement that AT&T maintain its books and records in accordance with the Commission's prescribed Uniform System of Accounts; and
7. Eliminate any other existing regulatory treatment which places a greater obligation on AT&T than on the non-dominant carriers.

The Attorney General, by and through his Utility and Rate Intervention Division ("Attorney General"), Sprint Communications Company L.P. ("Sprint"), Advanced Telecommunications Corporation ("ATC"), and MCI Telecommunications Corporation ("MCI") were granted intervention. The Commission granted the Attorney General's request for a hearing and adopted a procedural schedule on September 3, 1992. Full discovery ensued.

On April 20, 1993, AT&T sought to amend its petition to request that its tariffs be granted presumptive validity and be allowed to become effective within seven business days rather than seven calendar days of filing. The Commission granted AT&T's motion on April 28, 1993.

MCI subsequently requested that AT&T further amend its petition to clarify that LEC tariffs would not be considered presumptively valid and AT&T agreed. A hearing was held on April 28, 1993, at which the following witnesses were offered by AT&T for cross-examination: Dr. David L. Kaserman, James K. Sharpe and L. G. Sather. Post-hearing briefs were filed by the Attorney General, AT&T, and ATC.

#### DISCUSSION

KRS 278.512 permits this Commission to exempt from regulation or reduce regulation of telecommunications services or products when it deems exemption or reduced regulation to be in the public interest. That statute identifies eight criteria to be considered by the Commission when determining whether relaxed regulation is in the public interest.

The Commission in Administrative Case No. 273<sup>1</sup> concluded that AT&T should be subject to full regulation. In making that decision in 1984, the Commission considered factors such as AT&T's market share, the infancy of equal access plans, the number of competitors, the lack of alternative transmission facilities, and the market advantages AT&T enjoyed as an established firm.

The Commission concluded that AT&T held significant market power in the Kentucky interLATA telecommunications market.<sup>2</sup> It identified several important advantages that AT&T possessed as a result of its historical position as the monopoly carrier including its virtually 100 percent market share in the Kentucky interLATA market, substantial goodwill, customer hesitancy to change carriers, the ubiquity of its interLATA toll offering, and its superior access and interconnection to the local exchange networks.<sup>3</sup> This market power caused the Commission to require AT&T to price and provide its services under full regulation applicable to monopoly conditions.<sup>4</sup>

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<sup>1</sup> Administrative Case No. 273, An Inquiry Into Inter- And IntraLATA Intrastate Competition in Toll and Related Services Markets in Kentucky, Order dated May 25, 1984.

<sup>2</sup> Id., page 26.

<sup>3</sup> Id., page 30.

<sup>4</sup> Id., page 39.

## INTERLATA COMPETITION

In its petition, AT&T provided current information applicable to the criteria which KRS 278.512(3) requires the Commission to consider and on the factors that the Commission considered in 1984.

KRS 278.512(3)(a) requires the Commission to consider the extent to which competing telecommunications services are available in the relevant market. In response, AT&T filed Exhibit 1, "Competitive Alternatives - Kentucky." The exhibit demonstrates that there has been a substantial expansion in the services offered by AT&T since the 1984 Order in Administrative Case No. 273<sup>5</sup> and "that for every AT&T service there are at least three other carriers, and sometimes, as many as eleven, offering similar alternatives."<sup>6</sup>

In 1984, AT&T was the sole provider of telecommunications services for over 90 percent of the Kentucky intrastate, interLATA telecommunications market.<sup>7</sup> Since that time, there has been a substantial increase in both the types of service and numbers of

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<sup>5</sup> These services include: MTS, the traditional long distance service; associated optional calling plans (Reach Out Kentucky, All PRO WATS Partners, Starterline and Area Code Plan); EasyReach 700 Service; Hi-capacity direct connect WATS (Megacom WATS, Megacom Plus and Megacom Optimum); Hi-capacity dedicated in-bound (800 Readyline, Personal 800 and 800 Masterline); and virtual private network (Software Defined Network and Distributed Network Service). These "families" of services, along with traditional WATS, 800 Service, and Private Line offerings, represent many of the telecommunications services AT&T's customers demand. Id., page 7.

<sup>6</sup> Id., page 26.

<sup>7</sup> Administrative Case No. 273, Order dated May 25, 1984, page 28.

providers. This is evidenced by the volume of tariff filings by AT&T's competitors.

Under Subsection (3)(b), the Commission must also consider the existing ability and willingness of competitive providers to make functionally equivalent or substitute services readily available. The number of firms competing in the Kentucky interLATA market has increased from 3 in 1984 to 46 in 1992 indicating that barriers to entry must be low or nonexistent. In addition, AT&T's estimated market share in Kentucky, based on access minutes, has fallen from 80.5 percent in 1988 to 65 percent in 1992. These data indicate that the new firms that have entered the intrastate interLATA market have succeeded in capturing a significant share of it. Also, significant barriers to expansion do not exist. As existing competitors have substantial excess capacity, they can serve many new customers with virtually no new investment. All these factors suggest that the competitors are able to provide equivalent services and, according to AT&T, that this market is effectively competitive.<sup>8</sup>

Mandatory equal access to local exchange networks provides other carriers with network connections comparable to those of AT&T. As of January, 1993, approximately 90 percent of Kentucky's subscriber access lines are being served by equal access end offices allowing customers to choose among a number of alternative

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<sup>8</sup> Testimony of Dr. David Kaserman, filed December 4, 1992, pages 36, 37.

carriers.<sup>9</sup> Equal access ballots sent to end-users indicate that most customers have had five or more long distance carriers from which to choose.<sup>10</sup>

In evaluating the market supply of the intrastate interLATA market in Administrative Case No. 273, the Commission concluded:

[T]he fact that it will take the IXCs time to expand their capacity to meet increased demand would make it possible for AT&T to exercise market power for at least the near term. . . . AT&T's position of monopoly on many routes will continue for some time, as it will be physically impossible for the IXCs to provide facilities-based service over anything but a small portion of the total interLATA routes in the near future. . . . There is no reason to expect the IXCs to be able to duplicate on a facilities basis in a short or even intermediate time period the interLATA toll network that has developed over considerable time under the existing monopoly structure of this industry in Kentucky. If full rate of return regulation of AT&T were lifted at this time, it would afford AT&T the opportunity to significantly raise prices and meet little or no competition on the bulk of its interLATA routes.<sup>11</sup>

Pursuant to KRS 278.020, the Commission must issue a Certificate of Public Convenience and Necessity prior to initial operation by a utility in Kentucky or for extensions of service outside the usual course of business. Over the past nine years, the Commission has reviewed the initial operations of all entrants in this market. The Commission also receives annual financial

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<sup>9</sup> Case No. 92-297, Petition of AT&T of the South Central States, Inc. for Reduced Regulation of Intrastate Telecommunications Services filed July 16, 1992, page 8.

<sup>10</sup> Id., page 8.

<sup>11</sup> Administrative Case No. 273, Order dated May 25, 1984, page 26.

reports from these companies which indicate the substantial capital investment of some and the relatively small size of operations of others. These sources verify changes in market structure and in the various participants' shares which have occurred since the Commission considered this issue in 1984.

The number and size of competitive providers of services must be considered under KRS 278.512(3)(c). In 1989 when transmission capacity figures were examined in Administrative Case no. 323, Phase I,<sup>12</sup> AT&T's share was approximately 37 percent.<sup>13</sup> AT&T's competitors already have extensive transmission networks in place in Kentucky. Fiber optic technology is also available for rapid expansion of capacity. AT&T asserts that the capacity available to competing carriers is sufficiently large to preclude it from raising rates above competitive levels.<sup>14</sup>

Numerous resellers also provide alternative sources of transmission capacity in Kentucky. Because transmission capacity is a reproducible resource in abundant supply with minimal entry barriers, more can be added at a reasonable cost in a short period of time. No firm will be able to leverage a relatively strong position in the wholesale market into a monopoly in

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<sup>12</sup> Administrative Case No. 323, An Inquiry Into InterLATA Toll Competition, An Appropriate Compensation Scheme For Competition of IntraLATA Calls By Interexchange Carriers, And WATS Jurisdictionality.

<sup>13</sup> AT&T's Response to Commission Order dated November 2, 1992, Item No. 6.

<sup>14</sup> Testimony of Dr. David Kaserman, filed December 4, 1992, page 30.

telecommunications supply to consumers in the retail market.<sup>15</sup> Market share figures on transmission capacity confirm this conclusion.

In 1984, the Commission stated "there is no evidence in this record to indicate AT&T's share to be anything other than between 90-100 percent, with the most reasonable estimate being toward the upper end of this range."<sup>16</sup> The evidence presented in this proceeding, and state and national data from other sources confirm that the market has changed significantly since that time.

While the first three subsections of KRS 278.512(3) focus on the existing conditions of the market, Subsection (3)(d) requires the Commission to evaluate the overall impact of the proposed regulatory change on the continued availability of existing services at just and reasonable rates.

In Administrative Case No. 273, the Commission "emphasized that consumers must not only be willing, but must be able to switch suppliers, and competing carriers must not only be willing, but must be able to expand to meet increased demand." (Emphasis in original.)<sup>17</sup> At that time, the existence of three conditions was necessary to enable consumers to use alternative carriers. The IXC or reseller had to serve the customer's area, have touch tone capability in that area, and the customer had to have a touch tone

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<sup>15</sup> Id., pages 32, 33.

<sup>16</sup> Administrative Case No. 273 Order dated May 25, 1984, page 28.

<sup>17</sup> Id., page 14.



telephone or its equivalent. In 1984, these conditions were not met for a significant number of Kentuckians and it appeared that, even after implementation of the Modified Final Judgment's equal access provisions and expansion by the IXCs, many Kentuckians would have no alternative to AT&T for interLATA toll service.<sup>18</sup>

However, since competition was authorized in this market, AT&T has implemented price reductions, flexible pricing plans, and new services, while maintaining state-wide average rates. It has not abandoned service to any customers.<sup>19</sup> Overall market share figures based on access minutes indicate that consumers are aware of their choices and are willing to switch suppliers in response to even relatively small price differences. Estimates based on the most recent three months' data indicate that 17.4 percent of all Kentucky customers switched carriers in 1992.<sup>20</sup> The fact that a very small fraction of consumers accounts for a very large fraction of total use creates a situation in which the individual firms's demand is likely to be extremely sensitive to the price charged. In addition, the intrastate long distance market in Kentucky is

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<sup>18</sup> Id., pages 25 and 26.

<sup>19</sup> While Administrative Case No. 273 allows non-dominant carriers to discontinue service upon 30 days' notice to the Commission, AT&T remains subject to the requirements of KRS 278.020(4), Order dated May 25, 1984, page 36.

<sup>20</sup> Testimony of Dr. David Kaserman, filed December 4, 1992, page 38.

growing, facilitating entry and intensifying competitive pressures.<sup>21</sup>

In light of these changes, it appears that there is little likelihood that reduced regulation will inhibit the availability of existing services or cause their prices to become unjust or unreasonable.

KRS 278.512(3)(e) requires the Commission to consider the existence of adequate safeguards to assure that rates for regulated services do not subsidize exempted services. AT&T identified the following safeguards against cross-subsidization:

1. Administrative Case No. 323, requires carriers to report intrastate minutes of use, allowing the Commission to monitor market share;
2. Carriers will still be required to file tariffs, allowing the Commission to monitor product availability.
3. Administrative Case No. 323 requires AT&T to offer all of its services at state-wide average rates;
4. KRS 278.512(5) allows the Commission to retain jurisdiction when persons or services are exempted from regulation and to reinstate full regulation if the public interest requires.<sup>22</sup>

At its most basic, cross subsidization allows an investor owned utility to use monies collected as rates to make investments in or lower prices for nonregulated services and earn additional profit for its shareholders. Use of the Uniform System of Accounts

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<sup>21</sup> Id. page 38.

<sup>22</sup> Case No. 92-297, Petition of AT&T of the South Central States, Inc. for Reduced Regulation of Intrastate Telecommunications Services.

and Commission review of a utility's costs are designed to guard against this potential abuse. In its most pernicious form, cross-subsidization can be used to support predatory pricing of unregulated services. AT&T argues that the basic regulatory protections are unnecessary because it does not possess sufficient market power to drive its rivals from the market. In addition, the significant sunk network costs of its facility-based competitors prevent the sort of rapid exit that is required for predatory pricing to succeed. Also, exiting firms would be forced to sell these assets at discounted prices, making the surviving firms that purchase them more effective competitors. Finally, the absence of significant entry barriers would prevent AT&T from raising rates to monopoly levels even if it could drive the other firms from the market.

These market factors will continue, in conjunction with the other regulatory safeguards outlined above, to prevent cross subsidization. Minutes of usage information is valuable in monitoring changes in the market place. Tariffs are another method of monitoring the marketplace and provide the Commission and the public detailed information on available services.

State-wide average rates are not affected by this case. The Commission considers state-wide average rates an essential policy for ensuring that the more competitive environment of the urban areas is extended to the rural areas of the state. Of most importance, the right of the Commission to reinstate full regulation if the public interest requires, allows the Commission

to use all these monitoring resources to determine if full regulation is necessary in the future and to reinstate it if the circumstances should again change.

Subsections (3)(f) and (g) require the Commission to consider the impact of proposed regulatory change upon universal availability of basic telecommunications services and upon the need of telecommunications companies to respond to competition, and upon the ability of a regulated utility to compete with unregulated providers of similar services or products, respectively. AT&T asserts that granting this Petition will allow it to respond to market demands more promptly and efficiently, and permit it to meet customer needs more effectively.

In Administrative Case No. 323, the Commission found that effective intraLATA competition exists and that it will be viable, sustainable, and in the public interest.<sup>23</sup> In addition it determined that intraLATA competition would not erode universal service. AT&T concludes that granting the modifications it seeks will result in a more competitive marketplace and enhance efforts to attain universal service rather than inhibit them. The Commission continues to agree that an increasingly competitive telecommunications market will further the goal of universal service, not hinder it.

In considering AT&T's ability to respond to competition, it is important to note that AT&T seeks to be regulated in the same

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<sup>23</sup> Administrative Case No. 323, Phase I, Order dated May 6, 1991, page 17.

manner as the non-dominant carriers in the intrastate telecommunications market. It is certainly not unreasonable for AT&T to argue that any regulatory burden which it, but not its competitors, must bear inhibits its ability to compete.<sup>24</sup>

In addition to addressing the specific criteria of KRS 278.512(3), AT&T provided a summary of the empirical results of reduced regulation of AT&T in other states. Some 30 states have reduced their regulation of AT&T. Since many of these policies have been in place for several years, there is considerable empirical evidence concerning their effects on this industry. Most careful study has been given to the prices paid for MTS service, and to a lesser extent, to WATS pricing and the effects of reduced regulation on the number of competitors. Based on this evidence, AT&T asserts that consumers have unequivocally benefitted from reduced regulation and that industry performance has consistently improved.<sup>25</sup>

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<sup>24</sup> The last of the specific criteria the Commission must consider, Subsection (3)(h) is not applicable to this case.

<sup>25</sup> Testimony of Dr. David Kaserman, filed December 4, 1992, page 49. "For example, the Mathios and Rogers papers concludes: 'The results of this analysis suggest that AT&T's daytime, evening, nighttime and weekend rates are significantly lower in states that allow pricing flexibility than in states that use rate-of-return regulation.' Indeed, the study indicates that the price of a five minute daytime intrastate toll call was, on average, 7.2 percent lower in states that allow pricing flexibility. Similarly, the Sedgley study confirms the finding that prices are significantly lower in states that have adopted reduced regulation. And, the Kaestner and Kahn paper concludes: 'The price of AT&T was found to be lower in states with pricing flexibility than in states where AT&T is operating under rate of return regulation. This is evidence in support

In conclusion, AT&T stated that none of the states that have relaxed regulation of it have found it necessary later to reinstate traditional regulatory controls.<sup>26</sup> As a result of all the evidence presented, AT&T states that a policy of substantially relaxed regulation or even outright deregulation is warranted at this time<sup>27</sup> and a continuation of traditional rate-of-return regulation is indefensible in the presence of effective competition.<sup>28</sup>

After reviewing the change in AT&T's market position since 1984, the Commission concludes that there has been a significant increase in the number of providers and the variety of services offered. The willingness of providers to offer substitute services is demonstrated by the substantial decrease in AT&T's market share of both transmission capacity and access minutes as new competitors have installed transmission capacity and successfully marketed their services. This change helps allay many of the Commission's concerns about the ability of competing carriers to enter the market and meet increased demand. Implementation of equal access plans for approximately 90 percent of the access lines in the state has also reduced the Commission's concerns about the technical ability of consumers to choose alternate carriers. For these

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of this type of regulation. However, the price of AT&T service was lowest in states with complete deregulation."

<sup>26</sup> Id., page 53.

<sup>27</sup> Id., page 28.

<sup>28</sup> Id., page 61.

reasons, the Commission finds that AT&T does not have sufficient market power to price and provide its services under monopoly conditions. Thus, in light of the changes in the market since 1984 and after considering the statutory criteria, it appears that reduced regulation of AT&T would be consistent with the public interest.

#### INTRALATA COMPETITION

In Administrative Case No. 323, the Commission recognized that, based on existing market share in the intraLATA toll market, AT&T could not be considered a dominant carrier. Rather, based on the ease with which AT&T could expand its operations and marketing into the LATA because of many of its competitive advantages in the interLATA market, the Commission determined that it should be subject to the same regulatory treatment in both markets to ensure consistent regulation.<sup>29</sup>

In response to a data request,<sup>30</sup> AT&T requested that the Commission treat its petition as a petition for reduced regulation in the Kentucky intrastate toll market as well. AT&T states that the testimony and evidence gathered in the interLATA segment applies with equal weight to the intraLATA market. It asserts that separation of these markets would unnecessarily complicate pricing and marketing its services in Kentucky. This request is consistent with the primary thrust of the Commission's Order in Administrative

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<sup>29</sup> Id., pages 45, 46.

<sup>30</sup> AT&T's Response to Commission's Order dated January 15, 1993, Item No. 8.

Case No. 323. Further, looking at this issue on a state-wide basis will ease the regulatory burden on all interested parties.

The Commission agrees that AT&T's role in the marketplace should be determined on a state-wide basis. To do otherwise would create inefficiencies for consumers and needlessly increase regulation. It is anticipated that AT&T will experience competition in the intraLATA market similar to that it is already experiencing in the interLATA market. The Commission will therefore treat AT&T's request for reduced regulation in the interLATA market segment as a petition for reduced regulation in the entire Kentucky intrastate toll market.

#### REGULATORY REQUIREMENTS

AT&T seeks to be regulated in the same manner as other IXCs.<sup>31</sup> It argues that changing from rate-of-return regulation to a less burdensome form of regulation will allow greater reliance on competition and generate lower prices. Unlike its competitors, AT&T is required to maintain separate accounts exclusively for regulatory purposes. AT&T believes this requirement is an outmoded vestige of rate-of-return regulation and provides no benefit to the Commission in analyzing interexchange market competition.

AT&T is also required to file tariffs for new services and changes to existing services on 30 days notice.<sup>32</sup> They are not effective until approved by the Commission, and may be suspended to

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<sup>31</sup> Testimony of L. G. Sather filed December 4, 1992, page 5.

<sup>32</sup> KRS 278.180.



review cost support for up to 10 months. However, AT&T's competitor's tariffs are considered presumptively valid when filed and cost support is not required. They generally go into effect after a 30 day notice period subject to any suspension. With these differing requirements, it is possible for a competitor to construct a tariff to counteract an announced AT&T filing and have its service introduced before AT&T's tariff becomes effective. This in AT&T's opinion places it at a competitive disadvantage.

AT&T identified the consumer benefits likely to occur as a result of uniform intrastate regulation of interexchange carriers in the following statement:

The elimination of rate base rate-of-return regulation together with its costly bookkeeping provisions and the elimination of cost support requirements will reduce the cost of providing services to AT&T's customers in Kentucky. This will be reflected in the prices AT&T charges for its services. Allowing AT&T's price changes and new service offerings to go into effect in a shorter time period and on a presumptively valid basis will ensure that AT&T is able to bring new services and price changes to the market more rapidly.<sup>33</sup>

In Administrative Case No. 273, the Commission stated that "all companies certified as non-dominant carriers for the provision of competitive intrastate telecommunications services shall be subject to an abbreviated form of regulation relative to that applied to dominant carriers," because, lacking market power, they

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<sup>33</sup> Testimony of L. G. Sather, filed December 4, 1992, page 21.

will not be in a position to violate the fair, just and reasonable requirement of KRS 278.030.<sup>34</sup>

In Administrative Case No. 273, the Commission noted that this is an evolutionary process.<sup>35</sup> As discussed at length in this Order, many changes have occurred since 1984 and they support reduced regulation of AT&T. However, the evolution is not yet complete. Certain minimum information and the time required to process it are still necessary for the Commission to perform its statutory duties and protect the public interest.

#### FINDINGS AND ORDERS

Based on the evidence of record in this case and being otherwise sufficiently advised, the Commission finds that:

1. AT&T now lacks sufficient market power to price and provide its services under monopoly conditions;
2. AT&T should be relieved from rate of return regulation;
3. AT&T should be required to file with the Commission the "Annual Report for Resellers/Operator Services, Kentucky Operations Only" as required of other IXCs;
4. AT&T should continue to provide 30 days notice to the Commission for rate adjustments in accordance with KRS 278.180;
5. AT&T should not be required to provide cost support for applications to adjust rates and offer new services; and

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<sup>34</sup> Administrative Case No. 273 Order, dated May 25, 1984, page 33.

<sup>35</sup> Id., page 31.

6. AT&T's tariff filings should be considered presumptively valid subject to any suspension that may be ordered.

7. AT&T should continue to maintain its books and records in accordance with the Uniform System of Accounts.

Therefore, the Commission HEREBY ORDERS that:

1. AT&T shall not be subject to rate of return regulation.

2. AT&T shall file the "Annual Report for Reseller/Operator Services, Kentucky Operations Only."

3. AT&T shall provide 30 days notice to the Commission prior to any adjustments in rates and services.

4. AT&T shall not be required to file cost support data in applications to adjust rates and offer services.

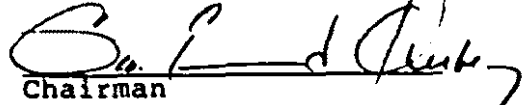
5. AT&T's tariffs shall be considered presumptively valid; provided, however, the Commission will continue to suspend any tariff filing when it determines that further investigation is warranted.

6. AT&T shall continue to maintain its books and records in accordance with the Uniform System of Accounts.

7. AT&T shall remain subject to all other requirements and obligations imposed upon it in the Order of May 25, 1984 in Administrative Case No. 273 not specifically reduced in this Order.

Done at Frankfort, Kentucky, this 23rd day of July, 1993.

PUBLIC SERVICE COMMISSION

  
Chairman

  
Vice Chairman

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Commissioner

ATTEST:

  
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Executive Director