COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INQUIRY INTO LOCAL COMPETITION, UNIVERSAL SERVICE, AND THE NON- TRAFFIC SENSITIVE ACCESS RATE	)))	ADMINISTRATIVE CASE NO. 355

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O R D E R

PROCEDURAL BACKGROUND

On April 21, 1995, the Commission initiated this proceeding to determine the viability of local competition and, in that context, to explore ways to preserve and expand universal service goals. This proceeding was initiated also to address the feasibility of reduction or elimination of the non-traffic sensitive revenue requirement as the telecommunications industry moves toward market-based rates. All telecommunication carriers, the Office of the Attorney General ("AG"), and various others are parties to this docket. Replies to the Commission's initial inquiry were received from approximately 25 entities.

On July 22, 1995, the Commission entered a procedural schedule and stated that all replies and comments would be considered prefiled testimony. Additional comments or prefiled testimony were permitted to be filed by February 26, 1996. The Commission ran notices in newspapers of general circulation to inform Kentuckians of their opportunity to comment in writing or at the public hearing.

A public hearing was held March 25 to 29, 1996. Fourteen parties presented a total of 27 witnesses. Parties presenting witnesses were BellSouth Telecommunications, Inc. ("BellSouth"); Cincinnati Bell Telephone Company ("CBT"); GTE South Incorporated ("GTE"); ALLTEL Kentucky, Inc. ("ALLTEL"); TDS Telecom ("TDS"); AT&T Communications of the South Central States ("AT&T"); the Independent Telephone Group ("ITG");[1] MCI Telecommunications Corporation and MCI Metro Access Transmission Services, Inc. ("MCI"); Sprint Communications Company L.P. ("Sprint"); WorldCom, Inc. d/b/a LDDS WorldCom ("LDDS"); American Communication Service of Louisville, Inc. ("ACSI"); BellSouth Cellular Corporation ("BSCC"); Kentucky CATV Association, Inc. ("KCTA"); and the AG. Metro Human Needs Alliance cross-examined witnesses. Briefs were filed May 17, 1996.

In addition to witnesses presenting testimony, public comments were given at the hearing by several persons. Jerome Hicks of Marshall County argued for county-wide toll-free calling on behalf of the Kentucky Master Commissioners Association. John Stephenson of Fort Mitchell, Kentucky, associated with "public education and government access," requested that public rights-of-way and public access to communications be a high priority of this Commission. Gary Higdon of the Louisville

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1 The ITG is comprised of Ballard Rural Telephone Cooperative Corporation, Inc., Brandenburg Telephone Company, Inc., Duo County Telephone Cooperative Corporation, Inc., Foothills Rural Telephone Cooperative Corporation, Inc., Harold Telephone Company, Inc., Highland Telephone Cooperative, Inc., Logan Telephone Cooperative, Inc., Mountain Rural Telephone Cooperative, Inc., North Central Telephone Cooperative, Inc., Peoples Rural Telephone Cooperative, South Central Rural Telephone Cooperative, Thacker-Grigsby Telephone Company, Inc., and West Kentucky Rural Telephone Cooperative.

Apartment Association and Todd Strecker of Lexington On-Line asked that the Commission maintain access to communication facilities and advanced services. Laurel True of the Kentucky Association of Retired Persons spoke of the need for universal telephone service for low-income Kentuckians. Telemedicine issues were addressed by Dr. Peter Bosomworth, former Chancellor at the University of Kentucky Medical Center, and David Bolt, working in network development for St. Claire Medical Center in Morehead. Mr. Bolt also presented comments of Dr. Claire Louise Caudill on developing advanced technologies for rural health care. Dr. Bosomworth touted the benefits of distance insensitive pricing on the Kentucky Information Highway. Lastly, Joe Kelly, Chairman of the Kentucky Board of Education, spoke on behalf of the Kentucky Department of Education and the Kentucky Educational Technology Systems ("KETS"). He stated that voice, video, and data technology is being deployed to all public schools, including schools in low-income counties. Mr. Kelly argued for advanced, quality services at affordable rates and for universal service and resource sharing.

On February 8, 1996, the Telecommunications Act of 1996 ("the 1996 Act") became law.[2] The 1996 Act said that local competition in telecommunication markets is in the public interest. With that determination having been made by passage of the 1996 Act, the focus of this proceeding changed from determining the feasibility of local competition to implementing it. Since the passage of the 1996 Act, the Federal Communications Commission ("FCC") has issued several notices of proposed rulemaking to implement the 1996 Act. One involves unbundling of network elements,

[2] The 1996 Act is codified at 47 U.S.C. § 151 et. seq.

interconnection, and resale (CC Docket No. 96-98) and the other involves universal service (CC Docket No. 96-45). On August 8, 1996, the FCC adopted rules to implement local competition (hereinafter cited as the FCC Order).[3]

Decisions reached in this Order are based on the extensive record in this proceeding. Parties have had ample opportunity to express their views and respond to those of others. The Commission has reviewed the record and given due weight to all evidence. We have looked to the FCC Order for specific guidance, but all findings are rooted in statements and arguments made to this Commission.

We discuss the issues of interconnection and unbundling network elements first, then discuss resale discounts and universal service issues, rural company exemptions, and, finally, implementation of local competition.

INTERCONNECTION AND UNBUNDLING NETWORK ELEMENTS

The 1996 Act and the FCC Order place important emphasis on the role of negotiated agreements for the interconnection of telecommunications carriers' networks. Various obligations are assigned to all local exchange carriers ("LECs") and additional obligations are assigned to incumbent LECs ("ILECs"). All LECs are to allow resale of telecommunications services, provide number portability, provide dialing parity, allow access to rights-of-way, and establish reciprocal compensation for transport and termination of traffic. ILECs are to negotiate interconnection agreements, provide

3 Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 (CC Docket No. 96-98) and Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers (CC Docket No. 95-185) FCC 96-325, First Report and Order, released August 8, 1996.

interconnection, provide unbundled access to network elements, and provide resale without discrimination.[4] However, negotiated arrangements for interconnection are intended to take precedence over any generally established standards or any prescribed regulations. The Commission embraces this concept and finds that implementing specific rules for interconnection at the state level, at the outset, is not necessary and may only jeopardize the balance necessary for fully negotiated agreements.

The 1996 Act authorizes the Commission to resolve any disputes through compulsory arbitration procedures. The Commission's decisions will be binding and may apply to all existing, as well as subsequent, agreements. This authority and the general guidelines of the 1996 Act empower the Commission to implement its policy on a case-by-case basis as petitions for arbitration are filed. The availability of resale services and unbundled elements is basic for alternative LECs ("ALECs") initially to provide local service. However, the Commission considers facilities-based competition essential to a truly competitive telecommunications market. Therefore, the Commission intends to encourage ALECs ultimately to invest in their own facilities rather than to rely solely on the ILECs' networks. In addition, the Commission will ensure that adequate incentives exist to promote investment by the ILECs for the continued quality of telecommunications services.

The Commission's review of negotiated interconnection agreements is somewhat limited in that an agreement may be rejected only if it discriminates against a telecommunications carrier not a party to the agreement or if the agreement is not

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[4] 47 U.S.C. § 251.

consistent with the public interest, convenience, and necessity.[5] In contrast, the review of disputed issues during arbitration is extended to include consideration of compliance with the interconnection requirements and pricing standards of the 1996 Act and subsequent FCC regulations.[6] This is evidence, again, of the 1996 Act's incentive for negotiated interconnection agreements in place of prescribed rules.

With regard to interconnection issues, the Commission finds that the framework created by the 1996 Act is sufficient for introducing competition in the local exchange and exchange access markets. The Commission intends fully to review areas of dispute through the arbitration process and will base its decisions on the information gathered through that process.

The Commission concludes that interconnection and unbundling workshops are not necessary at this time. However, the Commission intends to review interconnection related issues that may arise in the future, through complaints, upon motions of affected parties, or upon the Commission's own motion.

RESALE

The 1996 Act charged state commissions with the duty of determining the rates at which telecommunications services will be available for resale. Specifically, Section 252(d)(3) of the 1996 Act states:

> For the purposes of Section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any

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[5] Id. at § 252(e)(2).

[6] Id. at § 252(b).

marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

During this proceeding, the Commission has investigated the rates at which telecommunications services will be available for resale and has reviewed the FCC Order.

Duty to Offer for Resale

Section 251(c)(4)(A) imposes a duty on ILECs "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers."

AT&T believes that all current and future retail offerings of the ILEC should be available for resale, including promotional and trial offerings.[7] Included in AT&T's list are local exchange and vertical services, intrastate toll, private line, and centrex services, among others. AT&T also believes that operator services should be unbundled from the local service offering[8] and that the ILEC should provide basic white page and basic yellow page listings for reseller's customers at no cost to the reseller or the reseller's customers.[9]

The FCC concludes that an ILEC must establish a wholesale rate for each retail service that: (1) meets the statutory definition of a "telecommunications service"; and (2) is provided at retail to subscribers who are not "telecommunications carriers."[10] The

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7 Testimony of Mike Guedel for AT&T at 9 - 10.

8 Id. at 33.

9 Id. at 34 - 35.

10 FCC Order at paragraph 871.

FCC has not prescribed a minimum list of services to be resold, choosing instead to leave to the discretion of the state commissions, ILECs, and resellers to determine the services that an ILEC must provide at wholesale rates by examining an ILEC's retail tariff.[11] The FCC has, however, precluded the resale of exchange access services[12] and has concluded that ILECs are not required to make available service to independent public payphone providers at wholesale rates.[13] Finally, the FCC pointed out that the resale obligations do not impose on an ILEC the obligation to disaggregate a retail service into more discrete retail services.[14]

The Commission will not prescribe a minimum list of services subject to resale. Instead, we leave the determination of such services to the negotiation process set forth in Section 251 of the 1996 Act. Only at such time as parties cannot reach agreement through negotiations will the Commission consider the issue of resale services subject to the schedule set forth in Section 252(e)(4). The Commission will not require ILECs to unbundle services in their retail tariffs for resale. The FCC declined to impose on ILECs the obligation to disaggregate a retail service into more discrete retail services; therefore, AT&T's request to unbundle access to operator services from the local service is denied.[15] AT&T additionally requested several elements to be included in the ILECs'

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11 Id. at paragraph 872.

12 Id. at paragraph 873.

13 Id. at paragraph 877.

14 Id.

15 Id.

resale tariff. The Commission will consider each ILEC's resale tariff on an individual basis and follow the requirements of the FCC Order. ILECs will be required to provide white page listings for resellers, but the Commission will not require the inclusion of yellow page listings because these listings are the product of a contractual relationship between ILECs and directory publishing companies.

Wholesale Pricing

BellSouth presented in its testimony the results of an internal cost study showing costs it would avoid by making services available for resale in Kentucky. BellSouth determined the appropriate discount would be 9 percent for residential services and 8 percent for business services.[16] BellSouth was the only company to provide a cost study quantifying costs and supporting a wholesale discount.

MCI agrees with the language of the 1996 Act and has not suggested any percentage of discount. Nevertheless, it warned the Commission that the percentages presented by BellSouth should be scrutinized for understatements of avoided costs that would give an advantage to the incumbent carrier.[17]

AT&T also testified regarding a wholesale discount, urging that a discount ranging from 36 percent to 50 percent be applied to all services for resale.[18] AT&T bases these percentages on its analysis of other jurisdictions, upon which it has concluded that a

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16 Rebuttal Testimony of Frank R. Kolb, Jr. for BellSouth at 2.

17 MCI Brief at 28.

18 Testimony of Mike Guedel for AT&T at 23 - 26.

LEC could save 26 percent or more in providing services at the wholesale level.[19] AT&T further asserts that as a reseller it will face operational inefficiencies for which an additional discount of 10 percent should be applied. These figures, contends AT&T, produce a minimum discount of 36 percent.[20] AT&T further proposes a 50 percent discount justified on the basis that the ILEC will have tremendous market advantages and power and, without a significant discount, competitors will not risk entering the market.[21]

KCTA's position is that resale discounts should be established following the literal wording of the 1996 Act, based on the marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.[22] It feels that the Commission should not mandate a discount based on hypothetically "avoidable" costs.[23] The KCTA also states that an artificially high resale discount rate to jump start competition or as a means to force LECs to submit accurate and verifiable cost information is not consistent with the 1996 Act and could have the unintended effect of forestalling facilities-based

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19 Id. at 24.

20 Id. at 26.

21 Id. at 24.

22 KCTA Brief at 24.

23 Id.

competition.[24] The KCTA believes that most resale issues, especially pricing issues, must be resolved through further Commission proceedings.[25]

CBT advocates that the optimal resale discount for resold services should be based on the existing downstream market price and the net costs that will be avoided, which includes the net of the wholesale costs added and the retail costs avoided.[26] CBT opposes applying large discounts to retail rates to determine wholesale rates because it believes that in the long run the market will not benefit. In fact, CBT contends that large discounts would deter others from deploying new facilities.[27]

The AG advocates a 25 percent wholesale discount based on data previously presented to the California Public Utilities Commission which suggests that avoided costs approximate 25 percent of the retail rate.[28] The AG, however, acknowledges that the 1996 Act requires wholesale rates to be discounted from retail rates and the maximum rate to be the retail rate less avoided retail related costs.[29]

The FCC Order has established national rules to determine the statutory pricing standard within which state commissions shall determine (1) the marketing, billing, collection, and other costs that will be avoided by the ILECs when they provide services

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24 Id. at 25.

25 Id.

26 Testimony of Dr. Richard D. Emmerson for CBT at 93.

27 CBT Brief at 9-10.

28 Testimony of Dr. Marvin H. Kahn for the AG at 21.

29 Id.

at wholesale; and (2) the portion of the retail prices for those services that are attributable to the avoided costs. The first and preferred method is to identify and calculate avoided costs based on avoided cost studies. The second method allows states to select, on an interim basis, a discount rate from within a default range of discount rates adopted by the FCC.[30]

The statutory pricing standard for wholesale rates requires state commissions to identify what marketing, billing, collection, and other costs will be avoided by ILECs when they provide services at wholesale and calculate the portion of the retail prices for those services attributable to the avoided costs.[31] The FCC requires states to select a wholesale rate between 17 percent and 25 percent below the retail rates if an avoided cost study that satisfies the criteria set forth below does not exist, if a state commission has not completed its review of such avoided cost study, or if a rate established by a state commission does not comply with the criteria.[32]

There has been considerable debate in this proceeding, as well as at the FCC, on whether section 252(d)(3) of the 1996 Act embodies an "avoided" cost standard or an "avoidable" cost standard. The FCC found that "the portion [of the retail rate]. . . attributable to cost that will be avoided" includes all of the costs that the ILEC incurs in maintaining a retail, as opposed to a wholesale, business.[33] Under this "reasonably

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30 FCC Order at paragraph 908.

31 Id.

32 Id. at paragraph 910.

33 Id. at paragraph 911.

avoidable" standard, an avoided cost study must include indirect, or shared, costs as well as direct costs.[34] A portion of contribution, profits, or mark-up may also be considered "attributable to costs that will be avoided" when services are sold wholesale.[35]

An avoided cost study may not calculate avoided costs based on non-cost factor or policy arguments, nor may it make disallowances for reasons not provided in 47 U.S.C. § 252 (d)(3).[36] Therefore, AT&T's proposed 10 percent penalty discount for inferior interfaces is rejected. The avoided cost study methodology must be consistent with the manner in which retail rates have been set.[37] Different rates for service groups or a single rate for all services will be allowed.[38] The Commission recommends a single discount rate for all services in the interim, but, as may be justified by future cost studies, multiple discount rates will be allowed.

Based on the guidelines established in the FCC Order and the record herein, the Commission disregards the wholesale discount rates proposed in this proceeding. Although BellSouth submitted evidence regarding the discount rate, the Commission finds that BellSouth's methodology is too simplistic, has insufficient detail, and does not comply with the FCC's criteria. AT&T's proposed rate was not supported by any

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[34] Id. at paragraph 912.

[35] Id. at paragraph 913.

[36] Id. at paragraph 914.

[37] Id. at paragraph 915.

[38] Id. at paragraph 916.

evidence and is not in compliance with the 1996 Act. Similarly, the AG did not base his estimate on any specific cost studies. Therefore, the Commission chooses a wholesale discount rate from the default range.[39] At this time, based on the absence of any studies that comply with the FCC guidelines, the wholesale discount rate for both business and residential service will be the same. For all LECs, other than GTE and BellSouth, the discount rate shall be 17 percent, the low end of the proxy range. GTE shall use 18.81 percent and BellSouth shall use 19.20 percent as their respective wholesale rates.[40] These rates were calculated by the FCC using the modified MCI model. They are interim rates and may not be implemented if appropriate and timely Kentucky-specific avoided cost studies are furnished.

The Commission is required by the FCC to initiate separate proceedings for each LEC to determine the wholesale discount within a reasonable time.[41] We will, therefore, require that avoided cost studies be filed by each LEC as soon as available, but not later than 12 months from the date of this Order, unless otherwise ordered by the Commission. Companies exempted pursuant to Section 251(f)(1) should file avoided cost studies within 3 years from the date of this Order, unless otherwise directed by the Commission.

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[39] Id. at paragraph 910.

[40] Id. at paragraph 930.

[41] Id. at paragraph 934.

Conditions and Limitations on Resale

Generally speaking, the potential ALECs supported MCI's position that all of the services provided by ILECs, including discount plans, promotions, and other service options, must be provided at wholesale rates.[42]

The FCC Order recognizes, as does this Commission, that ILECs possess market power and that resale restrictions are presumptively unreasonable. ILECs may, however, rebut this assumption if the restrictions are narrowly defined.[43] The FCC has discussed specific restrictions, including those discussed in the following subsections, for which the presumption of unreasonableness may or may not apply.

Promotions and Discounts. Promotions are temporarily discounted standard service offerings.[44] BellSouth believes that it should not be required to resell promotional, trial, and special package offerings, as these do not represent retail rates.[45] MCI does not agree that the promotional, trial, and special package offerings may be withheld from resale.[46] The FCC found that the language of the 1996 Act provided no basis for creating a general exemption from the wholesale requirement for all promotional or discount service offerings of ILECs. The FCC also stated, however, that promotional prices offered for a period of 90 or fewer days need not be offered at a

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42 MCI Brief at 26.

43 FCC Order at paragraph 939.

44 Id. at paragraph 948.

45 Rebuttal Testimony of Robert C. Scheye for BellSouth at 21.

46 MCI Brief at 27.

discount to resellers and that ILECs may not evade the wholesale obligation by consecutively offering a series of 90-day promotions.[47] The FCC has left to state commissions the authority to make specific rules concerning restrictions on discounts and promotions to be applied to resellers in marketing their services to end-users. The state commissions are directed to develop such rules as necessary for use in the arbitration process under 47 U.S.C. § 252. Finally, the FCC has found that restrictions on the resale of volume discount plans should be considered presumptively unreasonable.[48]

Below-Cost and Residential Service. Both CBT and GTE stated that ILECs should not be required to resell services priced below cost. GTE recommended that the Commission adopt general guidelines to ensure that no ILEC is required to resell services below cost.[49] Likewise, CBT stated that the resale price of services currently priced below cost should recover their full costs.[50] The AG pointed out in his testimony that resale of services that are already priced below cost is not prohibited by the 1996 Act and does not affect the contribution received by the ILEC.[51]

The FCC has opined that 47 U.S.C. § 251(c)(4) does subject below-cost services to the wholesale rate obligation. The FCC points out that a service's being priced below

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47 FCC Order at paragraph 950.

48 Id. at paragraph 953.

49 GTE Brief at 12-13.

50 CBT Brief at 8-9.

51 Testimony of Dr. Marvin H. Kahn for the AG at 22.

cost does not justify denying the customers of the service the benefits of resale competition. The FCC further concludes that the resale of below-cost services will not affect the ILECs' net income because any change in revenues should be accompanied by a proportionate change in expenditures.[52]

Cross-Class Selling. Most parties agreed that the resale of residential services to nonresidential end-users should not be allowed. MCI believes that the only restriction on resale should be on offering resale to a different class of customers, i.e., residential service should not be resold to business.[53] AT&T also concurred with this position.[54]

The FCC Order supports this position.[55] That Order also allows the state commissions to make similar prohibitions against the resale of Lifeline and other means-tested service offerings to end-users not eligible to subscribe to such services offerings.[56] Based upon the authority conferred on the Commission by the FCC Order, the Commission will prohibit the resale of all means-tested service. Cross-class selling restrictions on all other services, including shared tenant services, are presumed unreasonable. The FCC will allow LECs to rebut this assumption by proving to the state commission that a specific class restriction is reasonable and nondiscriminatory.[57]

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[52] FCC Order at paragraph 956.

[53] MCI Brief at 27.

[54] Testimony of Mike Guedel for AT&T at 10-11.

[55] FCC Order at paragraph 962.

[56] Id.

[57] Id. at paragraph 964.

ILEC Withdrawal of Services. The FCC has declined to issue general rules on the withdrawal of service by an ILEC, but instead has left this power to state commissions. This commission will ensure that procedural mechanisms exist for processing complaints regarding ILEC withdrawals of service.[58] The FCC has, however, stated that it is important to ensure that "grandfathered" customers are not denied the benefits of competition. It also has directed that "grandfathering" must extend to reseller end-users.[59]

Providing Service. MCI states that the Commission must ensure that ILECs offer resellers the same quality service they provide themselves and their own retail customers.[60] To do this, ILECs must have systems and procedures that permit the ordering and use of wholesale facilities under the same timetables available to the ILEC. These systems must include pre-service ordering capabilities, on-line automated order processing, exchanging of billing and customer account data, on-line monitoring, and service quality reports.

The FCC concurs with MCI's position and states that practices to the contrary violate the 1996 Act's prohibition of discriminatory restrictions, limitations, or prohibitions on resale.[61] The FCC further requires that where operator, call completion, or directory

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[58] Id. at paragraph 968.

[59] Id.

[60] MCI Brief at 28.

[61] FCC Order at paragraph 970.

assistance is a part of the service or service package, ILECs must comply with reseller branding requests.

The FCC has left to state commissions the responsibility to determine reasonable and nondiscriminatory charges for customer change-overs and the level of fees or wholesale pricing offsets that may be reasonably assessed to recover any costs associated with these activities. The Commission will determine these charges and prices on a case-by-case basis as LECs request approval.

Resale Obligations of LECs

The 1996 Act imposes a duty on all LECs to offer certain services for resale. Specifically, Section 251(b)(1) of the 1996 Act requires LECs "not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of [their] telecommunications services."

The Commission concurs with the FCC decision and its application of this section of the 1996 Act. Section 251(b)(1) of the 1996 Act requires resale of all telecommunications services offered by the carrier, while section 251(c)(4) only applies to telecommunications services that the carrier provides at retail to subscribers who are not telecommunications carriers. Section 251(b)(1) of the 1996 Act omits a wholesale pricing requirement and, therefore, wholesale pricing requirements are not imposed on non-incumbent LECs.[62] Additionally, the FCC found that the rules concerning resale

[62] Id. at paragraph 976.

restrictions under Section 251(b)(1) of the 1996 Act should be the same as those under Section 251(c)(4).[63]

Application of Access Charges

We also concur with the FCC's assessment that the 1996 Act requires that ILECs continue to receive access charge revenues when local services are resold under Section 251(c)(4). Interexchange carriers ("IXCs") must still pay access charges to ILECs for originating and terminating intrastate traffic, even when the end-user is served by a telecommunications carrier that resells ILEC retail services. The FCC decided to allow the ILEC to bill the reseller for the interstate subscriber line charge and preferred interexchange carrier ("PIC") charges. From this, we conclude that the ILEC must also recover the Telecommunications Relay Service ("TRS") and Telecommunications Device for the Deaf distribution program ("TDD") surcharge from the reseller for each line served, and that these rates are not subject to wholesale pricing.

UNIVERSAL SERVICE FUND

This Commission has an established record of supporting universal service goals.[64] Much work has been done in Kentucky to keep residential rates affordable and to increase subscribership. Technological advances are fueling the development of sophisticated services available over communications networks. The Commission will

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63 Id. at paragraph 977.

64 Administrative Case No. 323, An Inquiry into IntraLATA Toll Competition, An Appropriate Compensation Scheme for Completion of IntraLATA Calls by Interexchange Carriers, and WATS Jurisdictionality, May 1, 1991 and December 29, 1994 Orders.

continue to pursue policies promoting subscribership and will continue to work diligently to ensure that the benefits of resale and facilities-based competition are extended to all Kentuckians.

The findings and assumptions discussed in this section are preliminary and interim until the FCC issues its order on universal service expected in May 1997. The Commission, through its staff, will conduct workshops on all issues related to universal service funding as quickly as possible. Furthermore, all persons are invited to file comments on this section within 30 days. These comments will be reviewed in the universal service workshops and will form the basis for workshop discussions.

The Commission believes that during the transition to full market competition, its traditional role will, to some extent, continue. Once significant market competition takes hold, the Commission's regulatory role in those areas will change. However, some parts of the state may never have full local competition. In those cases, the Commission's traditional role will largely continue. The Commission will also encourage high standards for wholesale and retail service and fair business practices, such as the prevention of the unauthorized switching of local carriers, commonly called "slamming." A competitive market is generally self-policing but the Commission will continue to give serious consideration to all customer complaints, including those of end-users or carriers, especially during the crucial transition to full-market competition.

The 1996 Act requires that implicit subsidies supporting universal service be removed from rates.[65] Henceforth, universal service is to be explicitly subsidized. An

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[65] 47 U.S.C. § 254(b)(5).

intrastate Universal Service Fund ("USF") will be established to comply with the minimum federal standards. The USF will be used to support one single residential access line per Kentucky subscriber and to promote facilities-based competition. The USF will provide direct universal service support and low-income assistance and administrative costs. All telecommunications service providers regulated by this Commission will contribute toward universal service, except for customer-owned, coin-operated telephones ("COCOT"). The assessment will be based upon a percentage of gross intrastate revenues net of payments to other carriers. The USF administrator will be required to file annual reports subject to Commission review. Although any glaring problems will be investigated immediately, a more general formal investigation will be conducted in four years fully to review all issues surrounding the USF.

The Commission also finds that there should be a flash-cut transition in universal service funding. In other words, after considering workshop recommendations concerning USF implementation issues, the Commission will remove non-traffic sensitive ("NTS") rate elements from access charges and from intrastate toll rates.[66] Since ILECs currently receive NTS revenue on a monthly basis, the USF will begin receiving payments from and making payments to telecommunications carriers on a monthly basis. The transition to a USF should cause as little disruption as possible.

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66 See generally FCC Order at Section VII. Though the FCC Order allows states to maintain implicit universal service funding through access charges and toll rates, Kentucky will move ahead with its universal service fund.

Low-Income Assistance

No party objected to some form of low-income assistance as being appropriate for universal service funding. Low-income households may fail to subscribe to telephone service because of inability to afford the basic local exchange rates or inability to afford toll charges. Attempts to increase subscribership among this group of customers should recognize that policy decisions that address the problems of the former may not address those of the latter. A household that is able to afford the monthly basic local service charge may still do without a telephone when faced with the possibility of high long-distance bills.

Two well-established federal programs, Link-Up and Lifeline, assist low-income households in obtaining and maintaining telephone service. Kentucky currently participates in the Link-Up program. Link-Up assists verifiable low-income households in obtaining telephone service by covering a portion of the installation fees. The Commission elected years ago to forego participating in the Lifeline program, which covers the federal subscriber line charge of $3.50. States are responsible for one-half of the expenses of the Lifeline program. The Commission finds that Kentucky should begin participating in the Lifeline program and that its portion of the expense should be funded through the USF. This will provide additional aid for households that cannot afford local service.

Low-income verification is needed for Link-Up participation, and similar verification procedures should be required for Lifeline. The ILEC or ALEC will be responsible for implementing both programs for its low-income customers. The Commission realizes that some additional cost, unrelated to penetration rate, will be incurred when low-income households which already have a telephone take advantage of the Lifeline program. The additional cost to the USF is, however, unavoidable for reasons of fairness. Any reduction in toll rates resulting from decisions herein may also benefit those low-income households which have difficulty affording toll charges but choose to leave their telephones unblocked.

For those households that cannot afford excessive long-distance bills, the Commission finds that ILECs should provide, on a one-time basis, free of charge, complete toll blocking and a reversal of the toll block. Any customer who so chooses will have local call capability without incurring unforeseen long-distance bills. The cost of subsequent requests for toll blocking or unblocking will be the responsibility of the customer. However, the toll block will be portable if the customer changes location. The USF will cover the cost of the first block and unblock requests.

Carrier Of Last Resort Obligations

Under the traditional regulatory paradigm, the term "carrier of last resort" ("COLR") refers to the statutory obligation of ILECs to at all times be ready, willing, and able to serve every customer in their designated service territories who may request service. There are quality of service standards, safety standards, and other guidelines which must be met to operate in Kentucky. ILECs argue that certain investments have been incurred with regulatory approval to fulfill their service obligations. As such, the depreciation lives of many investments have been lengthened to help keep depreciation expense and local exchange rates low.[67] This has led to an accumulated depreciation reserve deficiency defined as the difference between actual and net book asset values. It is possible that the prior accounting treatment of ILEC investments would have been different under competitive market conditions. ILECs argue that a competitive market in the future will make it impossible for them to sustain recovery of these unrecovered depreciation expenses through implicit support and that fairness dictates they be allowed recovery of this portion of their revenue requirement.[68] BellSouth proposes that accumulated depreciation reserve deficiency recovery should be a short-term component of a USF to be phased out as expenses are recovered.[69] The IXCs and other intervenors generally argue that the ILECs' accumulated depreciation reserve deficiency is not a legitimate item to be recovered through the USF.[70] MCI questions whether the deficiency even exists.[71] Referring to BellSouth's previous $2.7 billion charges for accounting changes and equipment writedowns, KCTA seems to suggest that to the extent a deficiency exists, it should be written off.[72]

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67 Arguments made by BellSouth are indicative of ILEC positions. See generally Direct Testimony of Martin for BellSouth at 12, Direct Testimony of Perl for BellSouth at 10, and BellSouth Brief at 45-7.

68 See BellSouth Brief at 46 and Direct Testimony of Perl for BellSouth at 14 and Transcript of Evidence ("T.E."), Vol. V, at 92-4.

69 Direct Testimony of Martin for BellSouth at 12.

70 See AT&T Brief at 12-13 and T.E., Vol. II of V, at 78-9.

71 MCI Brief at 45-6.

72 KCTA reply comments dated March 11, 1996, at 1-2. Also see Reply Testimony of Montgomery for ACSI at 7-8.

The ILECs' argument is correct to the extent that depreciation rates approved by the Commission would not be representative of rates found in a truly competitive market. Increasing competition may increase the risk of not fully recovering an accumulated depreciation reserve deficiency. However, a complete inability to recover these expenses is not a foregone conclusion. The record does not support the argument that competition, especially facilities-based competition, will occur with such speed that accumulated depreciation expense recovery will be impossible. Nor does the record show that associated plant will cease to be used to generate revenues.[73] There is every reason to believe that ILECs will act aggressively to retain their customer base. Consequently, the Commission finds that ILEC arguments to guarantee recovery of any depreciation reserve deficiency through a universal service fund should be rejected. There are alternatives to traditional rate of return regulation, such as incentive regulation, which may facilitate successful participation in increasingly competitive markets.

All current ILECs will remain carriers of last resort. If an ILEC wants to abandon or sell territory, it must file a petition with the Commission. There will be a formal investigation concerning the conditions surrounding the request to appoint another COLR, if necessary, and to set new USF payments. ILECs may not use petitions to abandon or sell territory to circumvent regulatory responsibilities.

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[73] At the federal level, many parties made similar arguments concerning recovery of embedded costs, i.e. COLR obligations and universal service social policy objectives, through interconnection and unbundled network rate elements. The FCC rejected these arguments. See FCC Order at paragraphs 655-9, 663-9, 687-8, and 708.

Non-Traffic Sensitive Revenue Requirement

Until passage of the 1996 Act, universal service was largely supported through implicit subsidies embedded in various service rates. Section 254 of the 1996 Act mandates that all implicit universal service subsidies shall be removed from rates and explicitly provided to ILECs.[74] In Kentucky, the non-traffic sensitive revenue requirement ("NTSRR") portion of the ILECs' revenue requirement determined through residual pricing rules has been recovered through access and toll rates rather than through increased local exchange rates. Such a system is tantamount to universal service funding. This known and measurable revenue stream is the direct result of past Commission actions.[75] Generally, ILECs argue that local service rates are below cost. GTE argues that, with the advent of local exchange competition, a rate structure which includes implicit subsidies cannot be sustained.[76] BellSouth agrees that rate rebalancing should occur, but since it may not be politically feasible, a USF is needed to remove implicit subsidies from rates.[77] IXCs and other intervenors question ILECs' contentions that basic local service is being provided below cost.[78] They also question the necessity

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[74] See 47 U.S.C. § 254(b)(5).

[75] Administrative Case No. 323 and Administrative Case No. 273, An Inquiry Into Inter- and IntraLATA Intrastate Competition in Toll and Related Services Markets in Kentucky.

[76] GTE Brief at 6.

[77] BellSouth Brief at 37, Direct Testimony of Martin for BellSouth at 6-7. Also see CBT Brief at 7-8.

[78] AT&T Brief at 6-11, MCI Brief at 43-8 and T.E., Vol. III of V, at 8-11 and 70-1.

of a local service subsidy, arguing that the revenue realized from all services purchased by residential customers more than covers the associated costs.[79]

The Commission finds that removing NTS rate from access and toll rates goes a long way toward initially satisfying federal mandates. However, this case is not a formal rate proceeding and has not been conducted as such. The Commission finds that there is no basis for denying ILECs full recovery of their respective NTSRRs at this time. Aside from stimulation of toll minutes and the increased revenues, this action should be substantially revenue neutral. Therefore, ILECs will continue to receive their respective NTSRRs through the USF. All customers should see the immediate benefits of lower access charges through reduced toll rates. Consequently, all ILECs shall file tariffs which reflect the removal of NTS rate elements from access charges. Toll providers operating in Kentucky should not realize windfall gains and, accordingly, shall file new tariffs reflecting the amount of access charge reductions as offset by corresponding USF contributions.

Although ILECs argue that their current rate structure needs rebalancing, removing NTS rate elements from access charges and toll rates is the full extent to which the Commission will rebalance rates at this time. With the exception of BellSouth's, the ILECs' rates are currently established under traditional rate of return

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79 See, for example, Direct Testimony of Gillan for LDDS at 40-5, Reply Testimony of Montgomery for ACSI at 3-4, AT&T Brief at 6-9, AG Brief at 7 and T.E., Vol. II of V at 122 and Vol. IV of V, at 130-4. BellSouth readily acknowledges that the entirety of its revenues covers its costs but that is irrelevant regarding the question of local exchange rates being offered below cost. Rebuttal Testimony of Martin for BellSouth at 3.

regulation, so rebalancing must be done in that arena.[80] Despite the NTSRR being transferred to the USF and no longer existing as an implicit subsidy, an ILEC's USF revenue is a potential issue in an earnings investigation to the extent that ILECs realize any additional revenue from increased toll calling, and it should be used to facilitate further rate rebalancing to offset the need for local rate increases.

The Commission finds that the total size of the USF should be equal to the sum of all ILECs' NTSRR, plus the Lifeline amount previously discussed, plus fund administrative costs. In the past, ILECs' NTSRR grew proportionately with access lines.[81] Such will not be the case with the USF at this time.

Administrative Costs

The Commission also recognizes the USF should include reasonable costs of administering the fund. These costs will be determined in a workshop and are further discussed herein.

Universal Service And Basic Local Exchange Service

Most parties argue that the elements of basic local exchange service to be supported by a USF should include only those elements necessary to receive dial tone.[82] In this way the cost of the USF would be kept as small as possible. The Commission agrees with this philosophy and finds that the definition of basic local exchange service

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80 BellSouth can rebalance its rate structure at any time within limits established in its price-cap plan.

81 See Administrative Case No. 323.

82 See, for example, MCI Brief at 48-9, AT&T Brief at 10-11, Direct Testimony of Jamison for Sprint at 16-7.

for residential customers should consist of dial tone, access to touch tone, access to locally provided emergency service (911 and E911), operator services, interexchange services, directory assistance, and a white-page directory and listing. Adding additional services to the basic local exchange definition would add to the size and cost of the USF. Unless federal law mandates otherwise, the Commission will address the need for adding services to the definition as it may arise.

Some parties recommended that TRS/TDD and other services be included in a USF-supported basic local exchange definition.[83] TRS/TDD are currently funded by an assessment on ILEC customers, and the Commission sees no reason to change this funding mechanism. However, the LECs argue that they will be at a competitive disadvantage because of the actual funding mechanism. LECs pass TRS/TDD costs to their residential and business customers. The Commission finds that fairness dictates that the TRS/TDD assessment be tied to customers' access lines. In other words, when an ALEC takes a residential or business customer away from an ILEC, the TRS/TDD assessment will go to the ALEC along with the customer.

Touch tone is inherent in switch software and the ILEC incurs some expense to give a customer pulse service. While the Commission finds it is appropriate to include touch tone service in the basic local service definition, it recognizes that there are some residential customers who do not subscribe to the service. To the extent that customers are already subscribing to and paying for touch tone service, that payment will be rolled

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[83] See, for example, Metro Human Needs Alliance of Louisville, Kentucky, Brief at 8 and Direct Testimony of Martin for BellSouth at 2-3, and AG Brief at 6.

into basic local exchange service rates. There will be no rate increase for these customers. Existing customers who do not yet subscribe to touch tone service will be "grandfathered" and the service will continue to be optional while they remain at their current addresses. For new customers, touch tone will be mandatory.

Most parties agree that basic local exchange rates should reflect their costs, but disagree over what those costs legitimately are. Some parties propose using costing workshops to arrive at the appropriate methodology and cost of basic local exchange service.[84] However, other parties caution that workshops are not always efficient.[85] Some parties advocate using proxy models to estimate the cost of local exchange service.[86] However, the use of proxy models is not wholly accepted either.[87]

BellSouth proposed using actual cost data as reflected in Automated Reporting Management Information System ("ARMIS") cost data filed with the FCC as the most accurate way of determining the actual cost of universal service.[88] This

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84 See, for example, CBT Brief at 7.

85 See ACSI Brief at 14 and AG Brief at 13, and T.E., Vol. IV of V, at 78-9.

86 See, for example, Direct Testimony of Jamison for Sprint at 15-22, MCI Brief at 42-3 and T.E., Vol. II of V, at 217 and Vol. IV of V at 110-2.

87 See, for example, BellSouth Brief at 92-3. Also, even though the FCC indirectly used the Benchmark cost and Hatfield 2.2 proxy models to set interim rates, it acknowledges that further study is needed. See generally FCC Order, Section VII.C.3 and paragraph 794.

88 BellSouth Brief at 40.

recommendation, however, has been criticized as an attempt by BellSouth to recover its embedded costs.[89]

BellSouth, GTE and CBT filed incremental cost studies which detail the cost of providing the local loop.[90] BellSouth's study employed a long-run incremental cost approach and included forward-looking joint and common costs.[91] GTE employed two different costing methodologies: a benchmark cost model ("BCM") for residential service and a long-run incremental cost model, which included forward looking joint and common costs.[92] GTE admits that the "BCM does not define the actual cost of any telephone company, nor the embedded cost that a company might experience . . . . Rather, [it] provides a benchmark measurement of the relative costs of serving customers residing in given areas [census block groups]."[93] CBT's incremental study appears to include historic joint and common costs.[94] These studies did not utilize a Total Service Long Run Incremental Cost ("TSLRIC") methodology, which is advocated by most parties other than the ILECs.[95] Another issue is whether joint and common costs should be included

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89 See, for example, MCI Brief at 44 and CATV Brief at 29.

90 BellSouth filed its study in response to AG information request, Item No. 4, dated September 20, 1995. GTE and CBT responded to Commission's Order dated April 3, 1996.

91 Id.

92 Id.

93 Id. GTE's response filed June 3, 1996.

94 Id.

95 See, for example, AT&T Brief at 23-5, AG Brief at 8, Direct Testimony of Jamison for Sprint at 18, KCTA Brief at 16 and LDDS WorldCom Brief at 5.

in the cost studies. ILECs argue that it is appropriate to recover these costs in unbundled network element rates.[96] This position is also supported by Sprint, MCI and the AG.[97]

In the context of the FCC Order, the local loop and other unbundled network elements are to be priced using a TSLRIC methodology which focuses on each specific element[98] and includes a reasonable allocation of joint and common costs. Unless federal law mandates otherwise, the Commission finds that it is appropriate to include a reasonable share of joint and common costs in calculating the cost of basic local exchange service.

It is clear from the FCC Order that ILEC embedded or historic cost recovery will not be allowed through unbundled network element rates. The FCC has deferred to its universal service proceedings the questions of if and how embedded costs will be recovered. For example, the extent to which proxy models will be allowed for determining the cost of local exchange service remains unclear. Equally unclear is whether large ILECs may use such models. If acceptable, proxy models may be the best method for small ILECs to determine local service costs, while large ILECs may be required to use TSLRIC models. Also unclear is whether a subscriber line charge or some other method will be used to recover embedded costs, if recovery of these costs

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96 See, for example, T.E., Vol. II of V, at 18, and Direct Testimony of Perl for BellSouth at 18.

97 See Direct Testimony of Jamison for Sprint at 18-9, MCI Brief at 42-3, and T.E., Vol. II of V, at 41-2, stating that such recovery is appropriate.

98 This pricing methodology is referred to by the FCC as Total Element Long-Run Incremental Costs or TELRIC.

is allowed at all. Therefore, the Commission will take no action on universal service cost issues aside from that taken herein until the FCC provides further guidance.

The Commission finds that the current ILEC basic local exchange rate plus touch tone charges should constitute the interim price for basic local service. This combined rate will serve as the basis for local exchange service resale rates. The current penetration rates of Kentucky ILECs suggest that current rates are affordable for most Kentuckians. However, the Commission will monitor the effectiveness of the low-income initiatives and make any necessary adjustments.

Who Pays Into Fund

The majority of all regulated telecommunications carriers should pay into the USF, including all ILECs, ALECs, competitive access providers ("CAPS"), IXCs, toll services resellers and wireless providers. To prevent some double counting, the assessment should be based upon a percentage of gross intrastate revenues derived from services sold to end-users, i.e., net of payments to other carriers. Requiring most carriers to pay into the USF will keep individual carriers' assessments as small as possible. However, the assessment would be unduly burdensome for COCOT providers.

The cellular industry argues that it should not contribute to the USF because it already pays toward achieving universal service goals through implicit rate elements embedded in access charges paid to connect to ILEC networks.[99] However, implicit subsidies are to be taken out of access charges, rendering this argument moot. Another argument put forth by the cellular industry is that its service is not a substitute for

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[99] BSCC Brief at 7-8.

wireline service.[100] To a certain degree this is true. However, cellular providers are in the process of upgrading their networks with digital technology which will allow them to compete more effectively with landline and personal communications services ("PCS") carriers. Also, cellular carriers are expanding the concept of what constitutes a local calling area beyond the expanded calling area service concept.[101] There is no reason to believe that present local calling areas will remain unchanged with the advent of local competition.[102] BellSouth uses this argument, in part, as the basis for its proposal to use its switched access rate structure for interconnection agreements, so that its switches could distinguish and track ALEC calls that do not conform to its predefined calling areas.[103] As seen in the Louisville and Lexington example, the cellular industry is a leader of this new trend. Digital technology, new marketing alliances and strategies, and the bundling of service options in the near future may be expected to allow the cellular industry to compete with landline carriers for greater shares of the local market. Wireless service is an integral and growing part of the telecommunications landscape.[104] At least one party envisions a scenario in which wireless could be less expensive than,

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[100] Id. at 2-7.

[101] Both Cellular One and BellSouth Mobility advertise that they offer local calling between Louisville and Lexington, Kentucky. The calling scope of these services goes well beyond the calling scope of BellSouth's tariffed area calling service arrangements.

[102] Customer choice of calling areas could be a hallmark of local competition. See T.E., Vol. IV of V, at 100-1.

[103] See Direct Testimony of Scheye for BellSouth at 10-13.

[104] See, for example, Direct Testimony of Martin for BellSouth at 18.

and eventually replace, wireline service.[105] Accordingly, the Commission reaffirms its previous finding that all wireless providers should contribute to the USF based on a percentage of gross revenues net of payments to other carriers.

The ILECs generally argue that USF payments to themselves should not be counted as revenue for the purposes of USF assessments. It does not make sense, they say, to assess subsidy payments to provide subsidy payments. Furthermore, such a course of action would lower the actual amount of money received by the ILECs for universal service. However, considering the manner in which the USF has been structured at this time, this argument is without merit. ILECs are to receive a revenue stream from the USF that is equivalent to current NTS revenue obtained through access and toll rates. The ILECs will receive the same revenue stream from the USF that they have been receiving from NTS sources; only the name and source of funds will have changed. ILECs are required to impute NTS rate elements in their toll rates, thus essentially paying into the current USF funding mechanism. Paying into the USF should be essentially no different, since the money is still earmarked to support universal service. Exempting USF revenue from USF assessment calculations would represent a subsidy for which ILECs have not made an adequate case. The Commission finds that ILECs should count USF payments as revenue to be counted toward calculating USF assessments.

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105 T.E., Vol. II of V, at 205.

Who Collects And How

This section addresses universal service goals through general policy guidelines. There are many detailed issues to be worked out in workshops, some of which will be discussed below.

The Commission's universal service goal is to promote, through wireline and wireless technology, connection to the telecommunications network. Maintaining affordable residential rates and bringing the benefits of competition to all ratepayers is in keeping with universal service goals. Therefore, only designated "eligible telecommunications carriers" will receive USF payments.[106] Initially all ILECs will be designated as eligible telecommunications carriers. Subsequently, facilities-based competitors who serve under certain criteria may petition the Commission to be designated as eligible telecommunications carriers and receive USF payments. The criteria for eligibility should include COLR obligations, a prohibition against "cherry picking," and measures to encourage residential line and rural area competition. COLR obligations mean that once a carrier has been designated as an eligible telecommunications carrier and has begun receiving USF payments, it may not abandon territory without prior Commission approval. "Cherry picking" is prohibited in that an ALEC may not provide service to only a select portion of customers within an area as defined by the Commission, such as one served by a central office.[107] A condition of

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106 For the purpose stated herein, "eligible telecommunications carriers" means the same as it does in 47 U.S.C. §102.

107 Several parties argue that a "no cherry picking" provision is unnecessary in competitive markets. See, for example, T.E., Vol. II of V, at 203 and 207-9 and AT&T Brief at 22.

certification for ALECs is that service to all customers within a defined geographic area must be made available through resale, facilities-based competition, or a combination of both.

Once an ALEC becomes designated as an eligible telecommunications carrier serving a designated territory, the ILEC may petition the Commission to abandon that part of its territory that is identically served by the ALEC. An ILEC must petition the Commission prior to any sale of any part of its territory to another entity. Moreover, existing exchanges may not be split or partitioned by the ILECs. Any transfers of territory must occur on at least an exchange-by-exchange basis.

While the Commission believes that benefits flow to customers from resale competition, it also wants to encourage facilities-based competition. The Commission is especially concerned that facilities-based competition may initially occur only in the more densely populated urban areas. The less densely populated rural areas may or may not experience the benefits of sufficient facilities-based competition. The Commission finds that USF payments to eligible telecommunications carriers should be based upon the number of single (first line only) residential lines served within a designated area and should be portable. Using the number of rural, as opposed to all, residential access lines served by an eligible telecommunications carrier means that the USF payment per line will be relatively higher than would otherwise be the case. The Commission believes this policy will provide a crucial incentive for ALECs to construct facilities and compete with ILECs in the more rural parts of the state.

All ILECs will be designated as eligible carriers. The term "facilities-based" means that the retail end-user has an alternative means of connecting to the network at large by some means other than through the ILEC. USF payments to eligible carriers will be calculated in the following manner. The dollar amount of an ILEC's NTSRR will be taken out of access and toll rates and transferred to and collected through the USF. Though the ILEC will initially receive the same amount of money from the USF as before, the payment will be based upon the number of rural households served. Dividing the total USF revenue, what was formerly known as NTSRR, by the number of rural households served yields a USF payment per rural household served. If a facilities-based ALEC takes a rural customer from an ILEC, the USF payment for that household will be transferred to the ALEC serving that customer. ALECs will not receive USF payments for taking urban customers from ILECs. However, USF payments will decrease commensurate with basic local exchange rate increases. These matters will be addressed extensively in workshops.

The urban versus rural customer distinction is only relevant to BellSouth, GTE, CBT, and ALLTEL. All other ILEC customers will be designated as rural. Therefore, the USF payment for these other ILECs may be based upon their respective total numbers of residential customers. This issue, as all universal service issues, will be decided through a workshop process.

Since the goal is to promote basic connectivity to the network, only the first access line per household will be eligible to be counted toward the calculation of the subsidy. Second or multiple lines per customer will not receive the subsidy. Households with incomes capable of sustaining multiple communications lines into the house or subscribing to advanced technological services should not receive subsidies beyond those for their basic local exchange service. To do so would run counter to the spirit of universal service goals.

<u>Miscellaneous USF Issues</u>

Current universal service subsidization is, in part, funded through embedded rate elements in various service rates. The 1996 Act has mandated that future universal service subsidies be explicitly funded. Therefore, it is important that residential ratepayers be made aware of the amount of USF contribution to their monthly telephone service. The amount of USF subsidy should be listed as a credit on customers' bills to inform them of its existence and size.

The 1996 Act specifies that schools, libraries, and health care facilities must have access to technologically advanced telecommunication services and be supported through discounted rates.[108] Kentucky recently instituted a statewide telecommunications network called the Kentucky Information Highway.[109] In general, these facilities have access to the network at the discounted rates inherent in the Commonwealth's contract. Therefore, the Commission finds that Kentucky has already satisfied this requirement of the 1996 Act. However, if the existing Kentucky Information Highway contract fails to

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108 47 U.S.C. § 706.

109 See Case No. 95-151, Proposed Special Contract of South Central Bell Telephone Company on Behalf of the Local Exchange Telephone Carrier Group for the Kentucky Information Highway, RFP ET-41-95.

cover all entities covered by the 1996 Act, the Commission will undertake actions necessary to ensure appropriately discounted rates for all specified entities.

The Commission will closely monitor how facilities-based competition develops throughout Kentucky. Accounting and monitoring measures will be developed in a workshop.

Workshops

All workshops, as discussed below, are to be formed as soon as possible. Workshop participants will have 90 days to make recommendations to the Commission for final decision. Each party should designate representatives for the USF workshops within 30 days of the date of this Order. Commission staff will schedule the first meeting as soon as possible.

Workshop participants should work in a spirit of compromise, attempting to resolve all relevant issues to implement the Commission's policies. Workshops will operate under the auspices of the Commission, and staff will have the authority to mediate when necessary. If staff mediation fails, i.e., no accord can be reached, the issue will be brought to the Commission for decision.

The following are specific issues to be addressed by the USF workshops:

A. Defining Rural and Urban Customers

The workshop shall work within the general guidelines set out above and shall formulate a definition of rural and urban areas which accomplishes the Commission's universal service goals, i.e., to encourage facilities-based competition in the rural as well as urban parts of the state. The potential for distorted investment decisions which may occur as a result of subsidizing rural versus urban customers should be minimized.

For purposes of determining USF payments per household, there are many ways to define urban and rural areas. For example, the definition could be based on the number of access lines served by a central office. Using population density as a factor is also a possibility. For example, only those customers residing within a set number of miles from a central office serving more than 15,000 access lines might be considered "urban" customers.

However, effort must be made to minimize potential distortion of investment decisions resulting from USF funding policies. Distorted investment decisions may occur between neighboring exchanges belonging to different ILECs because of differing levels of USF support. USF payments are proposed to vary depending on each LEC's NTSRR. The workshop participants should attempt to formulate policies that will minimize such distortions while accomplishing universal service goals.

B. Appropriate Service Territory At Time Of Certification For Local Service

To some extent, the market will define the geographic boundaries that constitute any particular local calling area. It is also probable that ALEC-defined local calling areas may never precisely conform to current ILEC local calling areas. However, cherry picking should be avoided and all customers equitably served in a timely fashion. One possible solution is to require all ALECs to serve an entire urban area, however defined, through some combination of resale and their own facilities. This requirement would ensure that urban residential customers who do not have USF payments associated with their households will be served in a timely fashion. To avoid preferential service offerings by ALECs, each ALEC should file as a special contract any off tariff rate pursuant to 807 KAR 5:011, Section 13, and should include appropriate cost support.

Situations in which USF payment unduly alters the investment decisions in ways that are contrary to the development of ubiquitous facilities-based competition should be avoided. Expansions of service territory outside an urban area may be defined by, at a minimum, end-office or exchange service territory. This definition would, at least, avoid service disparities within an exchange or area served by an end-office. For those ALECs planning to serve the entire state, such problems will not arise. Service territory issues will be covered in a workshop.

C. Monitoring Effectiveness Of Low-Income Programs

It is important to monitor the effectiveness of low-income programs and to address problems as they develop. The principal potential problem is, of course, failure to obtain acceptable increases in the state penetration rate. It may be appropriate to work with low-income support groups to isolate and track causes for such a problem. One obvious cause could be simple inability to pay the local portion of the telephone bill. Or perhaps the local portion of the bill is affordable, but not the toll portion. A standardized survey to be given to disconnecting, reconnecting, and new subscribers may help to pinpoint specific problems. In addition, a workshop, meeting on an as-needed basis, would provide a convenient forum for sharing data and discussing issues. Such a workshop could also coordinate surveys if necessary. The Commission will act as the organizing entity. Once new policies are implemented, penetration rate changes and other relevant statistics such as reasons for disconnection, reconnection histories, and mitigating circumstances will be tracked for a three-year trial period. Also during this three-year period, the Commission will consider whether in-depth studies of Kentucky-specific universal service issues should be conducted. Established aid agencies may also be requested to assist in locating and working with households without telephones.

D. Fulfillment of Universal Service Goals and Diminution of the USF

Future workshop issues will be determining how and when universal service goals have been achieved and the means to reduce the USF to some minimum maintenance level. It is possible that in the presence of a fully competitive market, the USF will remain necessary to maintain basic local service affordability. The workshop may involve developing criteria to determine the competitive nature of the markets, including whether any one firm is able to exert undue influence.

E. Fund Administration

The Commission finds that USF administration costs should be rolled into ILECs' assessments. However, a second key decision, the selection of a USF administrator, remains to be determined perhaps through a workshop. There was no information in the record specifying pricing, a third key issue.

There are four options for a fund administrator regarding which parties may file comments within 30 days. The first option is a third party, such as National Exchange Carriers Association ("NECA"). The second option is BellSouth. Administration by BellSouth appears to be an extremely cost effective choice. The Commission would regularly monitor the fund and create an audit record of the fund under this option. The third option is the Commission staff. Georgia has proposed this option and is issuing an order detailing the proposal. This option could also be extremely cost effective. The fourth option is to determine the fund administrator through a competitive bid process. The lower the cost of fund administration, the greater the benefit to Kentucky ratepayers.

RURAL COMPANY EXEMPTIONS

During the proceedings, the parties were asked if there were any economic arguments to support shielding rural telephone companies from competition. Generally, the parties responded that, although there are no economic reasons, there may be policy reasons. The ITG opined that the 1996 Act provides an exemption for small rural telephone companies in Section 251(f)(1).[110] The ITG further stated that the 1996 Act provides for a suspension of all 11 specific duties placed on ILECs in Section 251(f)(2).[111] Finally, the ITG asked the Commission to consider the pleadings, data responses, testimony and its brief as its petition for a suspension of all of the requirements imposed on ILECs in Sections 251(b) and (c) of the 1996 Act for a period of 10 years. TDS stated that the 1996 Act effectively provides small rural telephone companies an opportunity for gradual transition to local exchange competition and called for the Commission to grant the small, rural LECs a five-year suspension of competition pursuant to Section 251(f)(2) of the 1996 Act.[112]

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110 ITG Brief at 4.

111 Id.

112 FCC Order at paragraph 1262.

Section 251(f)(1) of the 1996 Act grants rural telephone companies an exemption from Section 251(c) until the utility has received a bona fide request for interconnection and the state commission has determined that the request is not unduly economically burdensome, is technically feasible, and is consistent with universal service objectives. This exemption is applicable to each ITG company, ALLTEL, TDS, and part of GTE. Bona fide requests for interconnection have been received from AT&T and MCI in GTE's area and are pending Commission review.[113]

Section 251(f)(2) allows LECs with fewer than 2 percent of the nation's subscriber lines to petition a state commission for a suspension or modification of any requirements of Section 251(b) and (c). The FCC concluded that Congress intended Section 251(f)(2) only to apply to companies with fewer than 2 percent of subscriber lines nationwide at the holding company level.[114] Suspension or modification is granted if necessary to avoid a significant adverse economic impact on users of telecommunications services generally, to avoid imposing a requirement that is unduly economically burdensome or that is technically infeasible and is consistent with the public interest, convenience and necessity.[115] Suspension or modification may be requested by all Kentucky ILECs except BellSouth and GTE.

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[113] Case No. 96-313, Application of GTE South Incorporated for The Rural Telephone Company Exemption from Certain Requirements of the Telecommunications Act of 1996; and Case No. 96-440, Petition by MCI for Arbitration of Certain Terms and Conditions of a Proposed Agreement with GTE South Incorporated Concerning Interconnection and Resale under the Telecommunications Act of 1996.

[114] FCC Order at paragraph 1264.

[115] Id. at paragraph 1250.

The FCC has determined that the decision to allow a telephone company to maintain an exemption or to be granted a suspension or modification of Section 251 of the 1996 Act should be left to state commissions. Generally, the FCC opined that Congress intended exemptions, suspensions and modifications to be the exception and not the rule and to apply only to the extent and for the period of time that policy considerations justify such exemption, suspension or modification.[116] Congress did not intend to insulate smaller or rural telephone companies from competition.[117]

More specifically, the FCC stated that to justify a continued exemption under Section 251(f)(1) of the 1996 Act after receipt of a bona fide request, a LEC must offer evidence that application of those requirements would likely cause undue economic burdens beyond the economic burdens typically associated with efficient competitive entry. The FCC stated that those decisions should be made on a case-by-case basis.

It is clear from the FCC Order that under either Section 251(f)(1) or (2) of the 1996 Act, each utility asserting that an exemption should continue or claiming that a suspension or modification should be granted must prove that its specific claim is appropriate. Therefore, the ITG's request to have all of its members treated as a group is inconsistent with the 1996 Act and should be denied.

Whether a LEC seeks a suspension or modification under Section 251(f)(2) or the maintenance of an exemption under Section 251(f)(1), the Commission's inquiry will be substantially the same. These shields from competitive entry are temporary to allow

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116 Id. at paragraph 1262.

117 Id.

adequate time for preparation. The Commission expects rural ILECs to undertake all steps necessary to compete effectively in an expeditious manner.

Rural companies have generally not been required to do detailed cost studies. Accordingly, their pricing of interconnection and network elements will be a significant undertaking. Rate rebalancing, another action potentially necessary for competition, has not been fully addressed. Network modernization may be required by some rural companies. The cost study development, additional rate rebalancing, and network modernization may need to occur prior to effective competition in areas served by rural companies.

Any request to maintain an exemption or to be given a suspension or modification that relies on failure to complete the cost study, rate rebalancing, or network modernization must contain a specific schedule for addressing each of these items. As of three years from the date of this order, the Commission will no longer consider lack of compliance with these three items as an adequate basis in support of petitions to maintain an exemption or to be given a suspension or modification.

The Commission will fully and carefully review each petition balancing the company's need to prepare for competition and the potential benefits of competition. If a petition is approved, the Commission will attempt to maintain the exemption or grant the suspension or modification for a period it deems necessary for a company to prepare itself for competition. The Commission has been in the forefront nationally in encouraging interLATA and intraLATA toll competition and will continue to encourage competition in local exchange markets, balancing the interests of consumers and telecommunications providers alike within the parameters mandated by Congress and the FCC.

RATE REBALANCING

It is reasonable to expect competitive pressures to force ILECs to price local services closer to cost, requiring them to rebalance existing rates. Also, as competition increases, ILECs may seek to be regulated in some manner other than rate of return. The ITG has stated that its companies must be permitted to move toward price regulation and has proposed a simple price cap plan.[118] The ITG has also proposed to work out the details of its plan in a workshop. Most of the rural ILECs have not been before the Commission in a rate proceeding since the early 1980's. Given the significance of the change from rate of return to alternative regulation, it is critical to establish appropriate earnings at the outset of any new regulatory plan as was done for BellSouth prior to the adoption of its Price Cap Regulation Plan. Therefore, an ILEC wishing to rebalance its rates and to be subject to some form of regulation other than the regulatory scheme embodied in KRS Chapter 278 may be subject to a full earnings review. Alternative regulation and rate-rebalancing petitions will be considered on an individual company basis.

MONITORING REQUIREMENTS

Competition in the local exchange market is unlikely to develop at the same pace throughout the state. As a result, it will be necessary for the Commission to evaluate

[118] ITG Brief at 13.

whether the objectives of the 1996 Act relative to opening the local market are being achieved in all geographical areas of the state.

Therefore, the Commission will require each LEC to file the following information for Kentucky operations only: (1) Whether it is facilities-based or resale-based and the extent to which it is using its own facilities or is using unbundled elements or resold services obtained from an incumbent LEC; (2) Whether it plans to provide business and residential exchange and access service and the dates these services will be available. This information will be required only at the time of initial operations; (3) The number of access lines by type of customer served (business and residential); (4) A description of existing facilities; (5) A description of plans for future construction; (6) Traffic volumes by month for the six-month reporting period; (7) Areas served; and (8) Maps of service territory.

The information will be due by January 31 and July 31 of each year. The Commission will review the six-month filing requirement periodically and, if warranted, will change the reporting intervals.

In addition, ALECs will be required to file the "Report of Intrastate Gross Operating Receipts Report" for nondominant carriers pursuant to KRS 278.140. Those companies previously authorized to provide other telecommunications services should combine the intrastate revenues from those services with their local exchange and local exchange access revenues for reporting purposes.

IMPLEMENTING LOCAL COMPETITION

The Commission favors a pro-competitive policy for all geographic areas of Kentucky and expects that the decisions made in this and subsequent orders will ensure compliance with the 1996 Act while providing the benefits of competition to all of the Commonwealth's citizens.

Accordingly, the Commission will allow implementation of local competition as soon as possible. Many negotiated interconnection agreements and arbitration petitions await Commission review, and will be dealt with as expeditiously as possible. In addition, the Commission finds it appropriate to alter its restrictions on CAPs. At present, CAPs doing business in Kentucky are authorized to provide access to IXCs' networks but prohibited from providing intraexchange traffic pending the establishment of a USF. This stricture is no longer in the public interest and is therefore abolished.

In addition, any authorized utility that has a final interconnection agreement or has necessary facilities in place, as well as an approved tariff for local service, may provide intraexchange local service under the following condition, pending establishment of a USF: it must demonstrate to the Commission that it has posted a bond or created an escrow account to pay its USF obligations in an amount equal to 6 percent of its gross receipts from the provision of intrastate service.[119] Refunds or additional payments may

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119 This percentage is based on the Commission's best estimate of universal service obligations of $90 million and expected gross receipts during the first year following implementation of local competition of $1.5 billion. The annual universal service obligation consists of NTSRR, Lifeline, and USF administrative costs.

be required depending on the Commission's decisions regarding USF obligations after workshops have been held.

Carriers which have not yet been authorized to provide service in Kentucky and which plan to provide local service shall file a proposed tariff, and the following information: (1) the name and address of the company; (2) articles of incorporation or partnership agreement and certificate of authority to do business in Kentucky; (3) name, street address, telephone number and fax number (if any) of the responsible contact person for customer complaints and regulatory issues; (4) a notarized statement by an officer of the utility that the utility has not provided or collected for intrastate service in Kentucky prior to filing its application or, alternatively, a notarized statement by an officer that the utility has provided intrastate service and will refund all amounts so collected; (5) whether it plans to provide business and residential exchange and access service and the dates these services will be available; and (6) whether it will be facilities-based or resale-based and the extent to which it will use its own facilities or unbundled elements or resold services of an ILEC. Carriers planning to construct facilities to provide local exchange service shall, of course, comply with KRS 278.020.

Further, the Commission finds that all carriers providing local service should fully comply with Commission statutes and regulations unless specific exemptions are granted pursuant to KRS 278.512. In addition, all carriers providing local service shall obtain, and shall retain for one year, electronic or written evidence that each of its customers knowingly chose it as his local exchange carrier.

The Commission, having considered the extensive record, and being otherwise sufficiently advised, HEREBY ORDERS that:

1. Commission approved, negotiated arrangements for interconnection shall be the primary means for implementing local competition and, thus, Kentucky-specific rules shall not be implemented.

2. Interconnection and unbundling workshops shall not occur at this time.

3. No minimum list of services subject to resale will be established at this time.

4. On an interim basis, a single discount rate of 19.20 percent is established for BellSouth; a single discount rate of 18.81 percent is established for GTE; and a single discount rate of 17 percent is established for all other ILECs.

5. Avoided cost studies as prescribed herein shall be filed as soon as available, but unless otherwise ordered by the Commission, not later than 12 months from the date of this Order. Exempted utilities shall file avoided cost studies, unless otherwise ordered by the Commission, not later than 3 years from the date of this Order.

6. Workshops shall be conducted on all issues related to universal service and the USF.

7. Within 30 days of the date of this Order, parties may file comments to be considered in the universal service workshops.

8. Per the 1996 Act, the ITG companies, ALLTEL, and the TDS companies are exempted until and unless a bona fide request for interconnection is received and the Commission addresses the public interest issues; however, the ITG request for a

blanket exemption for a set number of years is denied. But, the Commission shall review requests for suspensions and modifications on a company-specific basis.

9. After three years of the date of this Order, the Commission shall not consider failure to complete a cost study, rate rebalancing or network modernization to enable competition as an adequate basis for maintaining an exemption or granting a suspension or modification.

10. Petitions for rate rebalancing shall be considered on a company-specific basis.

11. All LECs shall comply with the monitoring requirements set forth herein.

12. An authorized utility may provide local service immediately upon complying with the following conditions:

a. An approved interconnection agreement or facilities.

b. An approved local service tariff.

c. A bond posted or an escrow account to pay its USF obligations in an amount equal to 6 percent of its gross receipts from the provision of intrastate service.

13. CAPs previously authorized to serve shall no longer be restricted from providing intraexchange traffic.

14. Any carrier not yet authorized to provide service in Kentucky and which plans to provide local service shall include in its application a proposed tariff and each of the items specified herein.

15. All carriers providing local service shall fully comply with Commission statutes and regulations unless specific exemptions are granted pursuant to KRS 278.512.

Done at Frankfort, Kentucky, this 26th day of September, 1996.

PUBLIC SERVICE COMMISSION

Linda K. Breathitt
Chairman

Vice Chairman

Robert M. Davis
Commissioner

ATTEST:

Don Mills
Executive Director