COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

REVIEW OF BELLSOUTH TELECOMMUNICATIONS, INC.'S PRICE REGULATION PLAN	)))	CASE NO. 99-434

O R D E R

This proceeding was established to review the terms of the Price Regulation Plan of BellSouth Telecommunications, Inc. ("BellSouth") and to examine options for modifications to it. This review of BellSouth's Price Regulation Plan was originally contemplated in the July 20, 1995 Order of Case No. 94-121.[1] That Order also required BellSouth to undergo a focused management audit pursuant to KRS 278.255. The Audit Report compiled by Vantage Consulting, Inc. ("Audit Report") was filed into the record October 25, 1999. BellSouth filed its response to the Audit Report on December 17, 1999. In addition, BellSouth proposed changes to its Price Regulation Plan, which it calls the Transition Regulation Plan. It submitted a tariff containing the elements of the proposed Transition Regulation Plan which the Commission suspended for further review.

The Audit Report includes a review of BellSouth's investment decisions, service levels, and financial performance under price regulation. The Audit Report also examines BellSouth's productivity trends, assesses the competitive environment in

[1] Case No. 94-121, BellSouth Telecommunications, Inc., d/b/a/ South Central Bell Telephone Company to Modify its Method of Regulation, Order dated July 20, 1995.

Kentucky, and evaluates BellSouth's response to competition in terms of its network marketing and operating plans and decisions. It recommends several changes to the manner in which BellSouth is regulated.

An informal conference was held April 10, 2000. A public hearing was held June 6, 2000. Prior to the public hearing BellSouth submitted a document entitled "Settlement Agreement," which indicated that AT&T Communications of the South Central States, Inc. ("AT&T") and Sprint Communications Company, L.P. ("Sprint") supported its proposals.

MCI WorldCom Communications, Inc. ("MCI"), also a party, did not participate in the "Settlement Agreement." In addition, the Attorney General's Office of Utility and Rate Intervention ("Attorney General"), a party to this case, has consistently opposed certain proposals made in the Audit Report and certain elements of the "Settlement Agreement."

In this docket, the Commission has reviewed the appropriateness of the components of BellSouth's Price Regulation Plan in the current telecommunications environment and has determined that certain modifications to the plan are warranted. The Commission adopts many components of BellSouth's proposed Transition Regulation Plan as a 3-year pilot plan. The Commission concludes that these elements are in the public interest at this time, but should again be reviewed in 3 years.

This Commission has adopted innovative regulatory changes when circumstances dictated. For example, BellSouth was permitted to implement an incentive plan in the late 1980s and a price cap regulation in the mid 1990s. The Commission's goals have been met in the past through these alternative regulation methods, and it now appears that additional innovations are necessary to enable BellSouth to adjust to the changing telecommunications environment. Competition is becoming more prevalent, business rates have moved much closer to competitive market rates, and new technologies have produced services no one envisioned only a decade ago.

One change proposed by the Audit Report and supported by BellSouth is to modify the objectives of the regulation plan itself. The Price Regulation Plan has five objectives: (1) to ensure that basic service is available at reasonable rates and that basic ratepayers are shielded from significant increases resulting from market changes; (2) to ensure that BellSouth provides quality service; (3) to ensure that customers' needs are met and to enhance efficiency in the provision of service; (4) to provide incentives for BellSouth to invest in new technologies and services; and (5) to ensure that BellSouth has flexibility to price its competitive services, to set depreciation rates, and to respond to the market. The Audit Report concludes, and the Commission agrees, that these objectives have generally been met and should continue to be goals of this Commission in future regulation of BellSouth.

The Audit Report proposes two additional objectives. The first is to permit BellSouth to adjust the prices of its retail services toward incremental costs based on market price. The second is to ensure that the introduction of competition to all markets in Kentucky is not hindered by the method of regulation. The Commission agrees that these goals must be adopted. To further these objectives, the Commission institutes changes to BellSouth's regulation, pursuant to KRS 278.512 and KRS 278.514.

ELIMINATION OF THE TOTAL FACTOR PRODUCTIVITY INDEX

In adopting the Price Regulation Plan nearly 5 years ago, this Commission included a total factor productivity ("TFP") offset for services in the non-competitive basket at the level of 4 percent based on the change of the Gross Domestic Product-Price Index ("GDP-PI") as measured by the federal government. The Audit Report questions the effectiveness of the TFP, presenting alternatives that could prove more appropriate in the competitive telecommunications market.

In its discussion of TFP, the Audit Report gives a brief history and definition of this complex economic term, which is defined as the ratio of the percentage change in unit of output to the percentage change in the unit of input.[2] Economists have employed this theoretical measure of productivity for many years and used it in concert with other economic measures to control economic activity. The Audit Report points to ways in which a firm's productivity can be improved, including the reduction of input costs (including downsizing), technological advances, increasing sales, and economies of scale. TFP measures productivity gains resulting from any combination of these factors acting in concert upon a firm's production processes.

As with all subjective measures, TFP has been debated by economists and non-economists alike regarding the accuracy of the measure relative to a specific utility, the gains from labor versus investment, and appropriate differentiation between scale economies and management initiatives. Certainly, TFP is more accurate when measuring an entire industry or single-product firms, where differences from the full economy or similar firms might be more readily identified and recognized. When

[2] Audit Report at Chapter 5.

applying TFP to a multi-product, multi-regional firm such as BellSouth, accuracy diminishes as there are too many variables to identify these differences. For these reasons, the Audit Report surmises that the TFP was never intended to predict future changes in productivity gains or specific services at a state level.

The Audit Report states that BellSouth raised several concerns that it believes result from the TFP index having been set too high. BellSouth asserts that the continued reduction in revenue has resulted in reduced capital available for investment in new technologies. BellSouth also argues that for it to become competitive, the price of subsidized, below-cost services must be raised. The Audit Report concludes that such assertions are only valid if BellSouth cannot achieve the level of productivity gains necessary to meet the Commission's established criteria. BellSouth contends that large productivity gains achieved from its downsizing and from increases in sales are not expected to continue, as its market becomes more competitive. Although these productivity enhancements may be diminished, other factors such as continued innovative technological advances and enhanced economies of scale might still be sufficient for productivity gains to flourish. The addition of more products and services has led BellSouth to increase revenues rather than decrease revenues.

The TFP index in the current plan, the Audit Report concludes, should be eliminated, and rates for services in the non-competitive basket should be capped by inflation. The Audit Report further recommends that the elimination of the productivity index be accompanied by a directive that BellSouth invest in ways to achieve specific policy objectives such as enhancing quality of service, expanding economic development, providing greater rural access to innovative services, and accelerating competition. Each of these objectives can be met through a management strategy of investing in technologies necessary to achieve the highest degree of productivity gains.

BellSouth agreed with the findings of the Audit Report on these productivity issues. BellSouth proposed certain infrastructure improvements and economic development endeavors to further the Commission's objectives. Specifically, BellSouth offered to develop a framework of improving economic development incentives, high-speed Internet access in non-urban areas, and enhanced educational opportunities.

The Audit Report and BellSouth correctly conclude that the TFP index is imprecise. Moreover, the TFP index is not company-specific, and it may not be the best indicator of future benefits. To date, it has served its purpose well, allowing for substantial adjustments to BellSouth's revenues that were necessary to begin the process of rate restructuring. Furthermore, the Commission recognizes that productivity gains may still be achievable. Nevertheless, we will dispense with the current TFP index for the pilot period, while accepting BellSouth's commitment to invest in infrastructure as a surrogate for further rate reductions based upon a specified productivity index. The proposed investment is necessary to develop a framework of improving economic development incentives to all areas of the state, high-speed Internet access and broadband deployment in non-urban areas of BellSouth's service area, and enhanced educational opportunities for our communities.

BellSouth should understand that the level of investment necessary to "offset" the productivity gains would not be the same as if revenue reductions were used to capture the productivity gains. At the end of the pilot period, the investment and associated carrying charges and attributable revenues will be analyzed. Specific details concerning the investment in infrastructure will be discussed herein.

INFRASTRUCTURE DEPLOYMENT

BellSouth has proposed to capture the benefits of its productivity gains by channeling investment into BellSouth's broadband infrastructure deployment commitments and expanded economic development initiatives.

As part of its proposed enhanced infrastructure broadband deployment plan, BellSouth has identified 35 wirecenters encompassing portions of 31 Kentucky counties and constituting approximately 75 percent of the infrastructure lines for future deployment of broadband technologies. BellSouth's rationale for the proposed deployment plan includes the following economic development initiatives: (1) deployment of broadband to core cities in approximately 40 percent of the BellSouth-served counties listed in the Kentucky Rural Economic Development Act as consistently suffering above-average unemployment; (2) promotion of jobs in counties identified by the Kentucky economic development agencies; and (3) deployment of broadband to BellSouth exchanges representing approximately 90 percent of BellSouth cities that are part of the Kentucky Community and Technical College System.

BellSouth's proposed enhanced broadband deployment plan would bring Kentucky access lines in broadband capable central offices to 75 percent by the end of December 2002. However, the broadband services would be available only in a limited coverage area nearest to the central office location.[3] The Commission is concerned

[3] See response to Commission's Oral Data Request filed June 21, 2000, Item No. 4. BellSouth identified 35 wirecenters and proposed coverage areas for ADSL service.

that BellSouth's proposed broadband deployment plan may not provide an adequate level of capital investment commensurate with the amount necessary to capture gains in productivity.[4] Furthermore, the Commission questions whether or not some level of the proposed investment in broadband deployment would occur absent any change in the current Price Regulation Plan.[5] In light of these concerns, the Commission finds that BellSouth's proposed enhanced infrastructure broadband deployment plan should be modified. BellSouth should expand the deployment of broadband technologies to all subscribers in the identified wirecenters rather than only to those nearest the central office. Such deployment will more adequately capture gains in productivity. In addition, this investment will expand the availability of enhanced services to Kentucky consumers, thereby increasing the potential for economic development in more rural areas.

ECONOMIC ZONE DISCOUNT TARIFF

BellSouth has proposed an economic zone discount tariff in conjunction with its proposed broadband deployment.[6] Under the tariff, qualifying entities will be provided a waiver or credit of service deposits and service connection installation charges and will be provided a 10 percent discount on the monthly charges for 12 months of applicable service. The Commission finds that this proposed tariff may assist the Kentucky Economic Development Finance Authority further its goals without harming the

[4] Obviously, some revenue will be derived from the capital investment that will offset the actual monies used to capture productivity gains.

[5] BellSouth admits that it has already deployed digital subscriber line service in Frankfort, Bowling Green and Pikeville. T.E. at 17.

[6] Attachment 7 to the December 17, 1999 filing of BellSouth.

Kentucky ratepayers. Thus, the tariff is reasonable and should be approved. However, the Commission intends to monitor the effect of this tariff including the quantification of lost revenues to BellSouth. Accordingly, BellSouth should file, on an annual basis, information on the use of this economic development tariff to include any associated revenues lost to BellSouth. If BellSouth loses revenues as a result of this tariff, such losses shall not be recovered from future increases to regulated services.

ACCESS CHARGE REDUCTIONS

The "Settlement Agreement" of BellSouth, AT&T, and Sprint seeks to resolve several important competitive issues. These parties propose to restructure BellSouth's rates. The twin goals of this restructuring are to price BellSouth's services more closely to their costs and to continue the process of removing cross-subsidies.

Under the Agreement, the switched access charge will be reduced to $0.0055 for originating and terminating traffic and the Non-Traffic Sensitive Revenue Requirement ("NTSRR") would be eliminated. The reduction of intrastate switched access is an amount equal to the rates adopted by the Federal Communications Commission ("FCC") in its Access Reform proceeding.[7]

BellSouth filed tariffs on July 3, 2000 to implement its proposed changes as necessitated in its annual filing of the Price Regulation Plan. On August 1, 2000, BellSouth filed its annual access charge filing in accordance with the requirements of Case No. 94-121 to mirror its intrastate access rates to its interstate access rates.

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[7] See Access Charge Reform, CC Docket No. 96-262, Sixth Report and Order, rel. May 31, 2000.

The Commission finds that these access reductions are in the public interest and should be adopted. BellSouth should file tariffs to implement these access reductions within 30 days of the date of this Order. All inter-exchange carriers that pay NTS rates to BellSouth must file tariffs demonstrating that they have reduced intrastate long-distance rates in an amount equal to the access charge reduction associated with this filing.

LIMITED RATE RESTRUCTURE

BellSouth proposes a schedule of rate changes to occur in two annual steps. These changes would increase most basic residential rates by 10 percent each year, except that Rate Group 5 rates would increase 4.84 percent in one step. Other rates that would increase include certain vertical features, directory assistance rates, toll rates, and some business rates, all within the parameters of the current plan. Those rates that would decrease would be access charges including the NTSRR discussed previously. The total effect of all rate changes proposed by BellSouth is revenue-neutral.

The Commission herein adopts a modified version of BellSouth's proposal. In the first year, residential rates will increase in all rate groups, with the exception of Rate Group 5, by 5 percent for a total of $6,372,490. The rates in Rate Group 5 will only increase by 4.84 percent ($0.85) in the first year of the plan. We will also eliminate the message toll service discount, as proposed by BellSouth, which will cause an increase to revenues of $1,879,000. Offsetting rate decreases will occur in business touch-tone rates. These rates will decrease from $3.00 to $2.80, for a total of $552,000. The NTSRR access charges will be eliminated for a total of $7,726,800.[8]

In the second and third years of this pilot plan the Commission will allow BellSouth to make additional rate changes to its residential rates on a revenue neutral basis. The amount of the increase for residential rates in the second and third years will be limited to $5,000,000 annually. This restructuring of residential rates should be targeted to those areas of highest cost. The Commission's goal is to permit the retail rates of BellSouth to move toward incremental cost or market price. The Commission has reviewed many different cost models that demonstrate that, in varying degrees, residential rates are below cost and other rates provide subsidy. BellSouth's rate changes should be based on a review of those subsidies that may exist, and, based on that review, should consider increases and decreases as appropriate. This process may include redefining the current rate group structure. Further, the Commission will schedule informal conferences with BellSouth in the future to discuss and formulate future rate changes. It is anticipated that the cost studies filed in Administrative Case No. 382[9] will be valuable in the evaluation of future rate adjustments.

BellSouth should file tariffs to conform to this schedule within 30 days of the date of this Order. BellSouth should also file with those tariffs supporting calculations and revenues that show these tariffs to be revenue-neutral. BellSouth's supporting exhibits

[8] The NTSRR prior to the Commission's Order in Case No. 94-121, dated July 31, 2000 was $14,764,068. In that Order it was ordered to be reduced by $7,037,268 leaving a balance of $7,726,800.

[9] Administrative Case No. 382, An Inquiry Into the Development of Deaveraged Rates for Unbundled Network Elements.

should use line count and revenue data that is no older than May 2000. BellSouth may propose minor adjustments that follow the intent of the Commission's decision to ensure revenue neutrality.

UNIVERSAL SERVICE FUND WAIVER

In addition, BellSouth agreed to waive its share of funding from the intrastate universal service fund ("USF") and assess a line item on its customers' bills only if BellSouth's customers are required to pay for the high cost USF areas of GTE South Incorporated and Cincinnati Bell Telephone Company. The Commission will not adopt this portion of BellSouth's proposal. Having not yet determined USF funding issues,[10] BellSouth's proposal is too uncertain to be in the public interest at this time.

DEAVERAGED UNE RATES

The parties have agreed that permanent deaveraged rates for unbundled network elements will be determined in Administrative Case No. 382, in which BellSouth soon will file cost studies for all unbundled network elements ("UNEs").[11] They have also agreed on an interim basis that BellSouth will provide new deaveraged UNE rates that are lower than those adopted on an interim basis in the Stipulation in Administrative Case No. 382. The Commission adopts this proposal and will mandate that the UNE rates proposed by BellSouth be adopted on a prospective basis by Order in Administrative Case No. 382, to be entered shortly.

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[10] USF funding is pending Commission review in Administrative Case No. 360, an Inquiry Into Universal Sercie and Funding Issues.

[11] The informal conference on July 12, 2000, BellSouth requested that it be allowed to defer filing its cost studies in September 2000.

SERVICE OBJECTIVES

BellSouth proposes to change or eliminate reporting requirements for several of the Commission's service objectives contained in 807 KAR 5:061. BellSouth bases its proposal on recommendations contained in the Audit Report.

The Audit Report recommended that reporting requirements for various service objectives relating to provision of service, dial service requirements, answering time, and service interruption be eliminated.

The Commission finds that the reporting requirements for 807 KAR 5:061, Section 10(2) and Section 15(1), are no longer necessary. Requests for re-grades have been eliminated since the conversion to one-party service. Electronic switching systems have eliminated systemic delays to obtaining dial tone.

However, at this time the Commission finds that the reporting requirements for the other service objectives should not be modified. These minimal reporting requirements provide the Commission necessary information regarding the essential services. Furthermore, the reporting requirements proposed to be eliminated continue to be required by other jurisdictions in which BellSouth operates. Pursuant to KRS 278.512, the Commission concludes that the deviations requested, except for those concerning 807 KAR 5:061, Sections 10(2) and 15(1), are not in the public interest and should therefore be denied.

SERVICE CATEGORY CHANGES: CLASSIFICATIONS AND TERMS

Currently BellSouth's services are divided into three categories: non-competitive services, interconnection services, and competitive services. The non-competitive service category includes basic residential and business services, as well as services closely associated with or considered an extension of these basic services. The interconnection service category includes carrier access services. The competitive service category consists of Centrex; ISDN; billing and collection services; interconnection; operator-assisted and calling card services; optional calling plans; toll trunks and packet switching network services and other competitive services. Each of these service categories has been regulated by unique terms and pricing formulas.

For the non-competitive category, rate changes have taken effect on 30 days' notice to the Commission. There has been a price freeze on basic residential services pending the creation of a universal service fund. Aggregate rates for the services in this category other than basic residential service have been adjusted according to changes in inflation as measured by the GDP-PI, minus a productivity factor. Increases to individual services in this category have been limited to 10 percent each year. Reductions have been required when based on a given formula.

For the interconnection services category, switched access rates mirror interstate access rates and are effective within 30 days of the approval of an FCC tariff.

As to the services in the competitive category, BellSouth has full discretion to set their rates, terms, and conditions, but it has given the Commission 30 days' notice on price changes. These proposed price changes are subject to suspension and review.

BellSouth now proposes that the service categories for its Price Regulation Plan be entirely revamped. It proposes three categories: Retail, Access and Industrial. The Retail category includes basic exchange and vertical services with a cap on increases limited to inflation. The Access category includes carrier common line, high capacity, and switched access. Switched access charges would continue to mirror interstate levels on a going-forward basis. The Industrial category consists of UNE rates and resold services. BellSouth proposes that it be controlled by UNE rate policies and resale requirements.

The Commission believes that these proposed categories are acceptable, but finds that the pricing structure and the terms within the retail and the industrial categories are inappropriate at this time, as discussed infra.

TERMS AND CONDITIONS OF TRANSITION REGULATION

In conjunction with its transition regulation plan, BellSouth proposes a tariff containing the terms and conditions of its regulation. The Commission has reviewed this tariff in detail and finds that the following changes to the proposed conditions are required to ensure that BellSouth's regulation is in the public interest.

BellSouth has proposed that no cost studies be required for new services or proposed changes to existing services in its retail category.[12] Services in the retail category are those for which BellSouth experiences the least amount of competition. In order for the Commission to evaluate the public interest associated with the pricing of these services, cost studies must be furnished.

BellSouth proposes that tariffs and promotions be presumed valid on one day's notice to the Commission.[13] While BellSouth has provided information to the Commission sufficient to justify modifying regulatory requirements applicable to it, the most essential services BellSouth provides, including dial tone for basic residential and business customers, remain largely a monopoly. Accordingly, the Commission and

[12] BellSouth's General Subscriber Services Tariff ("GSST") A36.1.3.B.4.

[13] GSST A36.1.3.B.5.

other interested parties must have adequate time to review proposed changes in prices and other conditions of service. All rate changes for the industrial and retail categories shall continue to require 30 days' notice to the Commission, and proposed price increases shall continue to require customer notice. Rate changes in the access service category, which are designed to mirror interstate rates, may be made on one day's notice to the Commission.

Certain proposals in the retail service category shall also be modified.[14] BellSouth's proposed changes to residential prices are specifically denied. For reasons stated elsewhere, BellSouth may increase its residential rates no more than 5 percent for the first year and as determined by the Commission in the second and third years. However, at the conclusion of the pilot program, prices of basic residential services shall be frozen until further Commission Order.

BellSouth proposes certain changes to its financial reports and monitoring.[15] BellSouth's proposal that service objectives (other than the three it proposes) shall not be required is specifically rejected. Also rejected is BellSouth's proposal that it shall file the same annual financial reports as all the telecommunications companies.

BellSouth proposes that the method of Commission review for contract service arrangements or special assembly filings be unchanged.[16] The Audit Report finds that the contract service arrangement filings were appropriate. However, given the steady volume of such arrangements and the potential for discriminatory practices through

[14] GSST A36.1.3.C.3.

[15] GSST A36.1.3.E.

[16] GSST A36.1.3.B.7.

such individual rate determinations, the Commission finds that BellSouth should, through a separate filing due 30 days from the date of this Order, describe its classifications for contract service arrangements and the criteria it uses to develop and finalize these arrangements.

CONCLUSION

Accordingly, the Commission, having considered BellSouth's proposed modifications to its regulation plan and all responses thereto, HEREBY ORDERS that:

1. Certain elements of the transition regulation plan proposed by BellSouth are adopted as described herein.

2. Elements of the proposed transition plan that have not specifically been adopted herein are denied.

3. The TFP index as a measure of productivity gains for BellSouth is eliminated.

4. BellSouth shall deploy broadband services as described herein within 3 years from the date of this Order.

5. BellSouth shall file reports and meet from time to time with the Commission Staff and others regarding deployment of broadband as directed by the Commission.

6. The economic zone discount tariff is approved.

7. Within 12 months of the date of this Order and continuing annually thereafter, BellSouth shall file information regarding its use of the economic development tariff and shall include information regarding lost revenues, if any.

8. BellSouth shall implement the rate increases and rate decreases as described herein.

9. Within 30 days of the date of this Order, BellSouth shall file a tariff containing the rate reductions and rate increases and other terms and conditions as specified herein, giving the Commission 30 days' notice for review of the tariff.

10. BellSouth may eliminate the reporting requirements contained in 807 KAR 5:061, Sections 10(2) and 15(1).

11. Within 6 months of the date of this Order, BellSouth shall file its proposal for the implementation of the rate increases ordered herein for the second and third years of this trial transition plan.

12. Within 30 days of the date of this Order, BellSouth shall file the information ordered herein regarding its contract service arrangement filings.

13. Within 3 years of the date of this Order, BellSouth shall file information regarding the method of regulation that it proposes at the conclusion of this pilot program.

14. By October 1, 2000, all inter-exchange carriers that pay NTS rates to BellSouth shall file tariffs demonstrating that they have reduced intrastate long-distance rates in an amount equal to the access charge reduction associated with this Order and with Case No. 94-121.

Done at Frankfort, Kentucky, this 3rd day of August, 2000.

By the Commission

ATTEST:

Executive Director, Acting