Report of the Telecommunications Study Committee to the 2015 Kansas Legislature

Co-chairperson: Senator Mike Petersen

Co-chairperson: Representative Joe Seiwert

Other Members: Senators Marci Francisco, Tom Hawk, Forrest Knox, Jeff Longbine, Julia Lynn, Ty Masterson, Robert Olson, and Greg Smith; and Representatives Rob Bruchman, Will Carpenter, John Doll, Randy Garber, Ramon Gonzalez, Annie Kuether, Ronald Ryckman, Sr., Scott Schwab, Jack Thimesch, and Brandon Whipple

Charge

- Study telecommunications and selected funding sources;
  - The Kansas Universal Service Fund; and
  - The Federal Universal Service Fund;
- The possibility of establishing a Kansas Broadband Fund; and
- Other issues determined by the Legislative Coordinating Council.

Telecommunications Study Committee

Annual Report

Conclusions and Recommendations

The Telecommunications Study Committee reaffirms the State public policy regarding telecommunications set out in KSA 66-2001, but suggests the Senate Utilities Committee and the House Utilities and Telecommunications Committee consider a review of subsection (d), which addresses advancing the development of a statewide telecommunications infrastructure.

The efficiency and effectiveness audit of the Kansas Universal Service Fund was extensive. The Senate Utilities Committee and the House Utilities and Telecommunications Committee should receive presentations by the audit firm during the 2015 Legislative Session.

Both the audit and other issues raised during the Committee's meetings need to be further considered during the 2015 Legislative Session. Accordingly:

- The Committee may meet at least once during the Session; and
- The Senate Utilities Committee and the House Utilities and Telecommunications Committee should study the definitions of telecommunications terms in existing law with a focus on "future-proofing" those definitions to accommodate the rapid changes in technology. Terms to be reviewed should include broadband (currently defined as a specific speed of transmission), telecommunications services, and telecommunications infrastructure.

Proposed Legislation: None.

Background

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

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

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

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

Committee activities

The Committee met once during the 2014 Legislative Interim, on December 16. The Committee received a presentation on the audit of the efficiency and effectiveness of the KUSF; discussed the State's public policy on telecommunications, as set out in KSA 66-2001; received a presentation on broadband funds in four states; and developed its recommendations.

Audit of the Efficiency and Effectiveness of the Kansas Universal Service Fund

Representatives of QSI Consulting, Inc., presented the results of the contracted audit of the KUSF. This section summarizes their findings. Overall, the auditor concluded the KUSF is well-run, with audit and affiliate transaction procedures in place to ensure the KUSF is appropriately sized, contributions are collected from the correct companies, and distributions to recipients are effectively managed. The passage of 2013 HB 2201—which capped KUSF high-cost funding for certain types of carriers, eliminated KUSF funding for certain others, and initiated a phase-out of funding for still other types of carriers—has ensured the KUSF will not grow out of control.

The audit evaluated Kansas statutes and rules governing operation of the KUSF, reviewed the Kansas Corporation Commission's (KCC) audit processes for the KUSF, analyzed factors that determined the level of KUSF support received by recipients from 1997 to 2013, and identified quantifiable benefits of the KUSF program. The audit scope statement developed by the Committee identified specific analyses the auditors were to include in conducting the review, and the report contains extensive appendix tables documenting this analysis in addition to a lengthy narrative. Major audit findings are discussed below.

Kansas statutes provide the KCC the necessary authority to administer the KUSF in an efficient and effective manner, but do not provide incentives for specific investments by providers other than guaranteeing Rural Local Exchange Carriers (RLECs) can recover the costs of all regulated telephone plants. Part of the review of statutory authority involved an assessment of whether KUSF statutes offered a balanced approach to investments while containing overall costs, and whether statutes allow for investment in technologies such as broadband and cable voice over internet protocol (VoIP).

Kansas telecommunications statutes do not address incentives to invest generally or to expand advanced service capabilities beyond those identified in 1996. The statutes do not address controls or limits on the amount of investment in network facilities and supporting expenses that are eligible for KUSF support.

The statutes are silent regarding the relationship between KUSF cost-based support and investment in broadband, cable VoIP, or other services that may or may not be considered telecommunication services. Only a limited class of broadband-capable facilities (schools, hospitals, libraries, and state and local government agencies) are included in the definition of universal service.

Because Kansas statutes do not prohibit or limit investment in facilities for providing broadband, cable VoIP, or other services that may not be considered telecommunication services from receiving KUSF support, the primary control mechanism is federal rules that govern cost allocation, separations, and affiliate transactions. The effect of using these federal rules is discussed later in this report.

Statutes do not directly address the impact of loss of lines on KUSF support, but they implicitly account for these losses because RLECs' embedded costs, revenue requirements, investments, and expenses are used to determine support. As an RLEC's revenue declines due to line losses, its need for KUSF support is likely to increase. However, support could be limited by the cap created in 2013 HB 2201. In contrast, the statutory support mechanism for CenturyLink is structured in such a way that its KUSF funding decreases in proportion to line losses.

The KCC follows standard processes when auditing the RLECs that receive cost-based support. The auditors found the timeframe to complete audits is reasonable and audit processes were consistent across companies.

Kansas' statutory framework historically tied KUSF distribution payments to the cost of providing service. Support for the two carriers who chose price-cap regulation, Southwestern Bell (now AT&T) and CenturyLink, was based on the number of supported lines served in high cost areas. The per-line support was calculated using a forward-looking cost model. KUSF support for the RLECs, who chose rate-of-return regulation, was based on each carrier's embedded costs, revenue requirements, investments, and expenses. Competitive eligible telephone companies (CETCs) were covered by an "identical support" rule that provided them the same level of support as the incumbent carrier.

That framework changed with the passage of 2013 HB 2201. Southwestern Bell, which chose to become an "electing carrier," is no longer eligible for KUSF support. CenturyLink's annual KUSF support has been capped – it is limited to the lesser of 90 percent of the support it received in the 12-month period ending February 28, 2013, or $11.4 million. RLECs are subject to a $30 million annual group cap. Payments to CETCs are being phased out over a four-year period.

The Federal Communications Commission separations and cost allocation rules used to determine KUSF support for rate-of-return RLECs are outdated. Under those rules, 75 percent of the cost of local loop facilities is allocated to intrastate jurisdiction, but because the rules were created before voice and broadband services began sharing the network, the costs are treated as if the facilities were used exclusively for voice service. To the extent the cost of loop facilities jointly used by voice and broadband services is allocated only to voice service, intrastate revenue requirement calculations, which determine KUSF support, will continue to overstate the cost of providing voice service. The audit offers three alternative approaches the KCC could use to allocate loop and other network costs between voice and broadband.

KUSF support has dropped significantly since its inception. Annual payouts dropped from a high of $96.4 million in 1998 to $41.9 million in 2013, largely because of the decline in support for Southwestern Bell beginning in 2000.

Since 2002, CenturyLink has been the largest recipient of KUSF support, with annual payments ranging from $9.5 million to $17.6 million. Within the RLECs, five carriers have received the most funding: Rural Telephone Service Company, Pioneer Telephone Association, Twin Valley Telephone, Craw-Kan Telephone Cooperative, and Southern Kansas Telephone. None of the five have received more than $5 million per year.

The number of voice lines for the local exchange carriers decreased by approximately 64 percent between 1997 and 2013 (an average decline of 6 percent per year), while broadband service lines have increased by approximately 22 percent per year since 2003.

KUSF support payments comprise about 23 percent of the average recipient's revenue. Combined KUSF and FUSF payments comprise about 51 percent of the average Kansas RLEC's total regulated revenues.

From 1997 through 2013, the KUSF paid out support of nearly $1 billion. Southwestern Bell and CenturyLink together received approximately 51 percent of the funding, while the RLECs received about 44 percent of the funding. On a net basis (when contributions are subtracted from distributions), the RLECs as a group benefited most. About 67 percent of KUSF contributions came from carriers that do not receive any KUSF support, including wireless carriers, VoIP providers, toll, and others.

Kansas also is a major beneficiary of the FUSF. Statewide, between 1998 and 2013, Kansas received approximately $2.6 billion in funding, while contributing only $0.9 billion to the FUSF.

The RLECs again benefited most, receiving about 70 percent of the funding for Kansas.

The auditors noted it is difficult to determine the exact impact of the KUSF on local telephone rates, but concluded local rates likely would have been higher than actual rates if the KUSF subsidy was not available. Over the time period reviewed, RLECs received an average subsidy of $23 per line per month.

State Public Policy on Telecommunications

The Kansas Telecommunications Act of 1996 set out a telecommunications policy framework which is codified in KSA 66-2001. The Act declares it to be the public policy of the State to:

- Ensure every Kansan has access to a first-class telecommunications infrastructure that provides excellent services at an affordable price;
- Ensure consumers realize the benefits of competition through increased services and improved facilities and infrastructure at reduced rates;
- Promote consumer access to a full range of telecommunications services, including advanced services that are comparable in rural and urban areas throughout the state;
- Advance development of a statewide infrastructure capable of supporting applications such as public safety, telemedicine, services for persons with special needs, distance learning, public library services, access to internet providers, and others; and
- Protect consumers of telecommunications services from fraudulent business practices and practices that are inconsistent with the public interest, convenience, and necessity.

Committee members discussed possible changes to the policy, which has not been modified since it was adopted in 1996. Issues debated included whether broadband and data are encompassed within the term “telecommunications”; how to allocate costs between data and voice; recognition that VoIP “voice” transmissions are actually data; whether it is possible to determine the nature of transmissions passing through the networks; the difficulty of determining appropriate statutory terminology given the rapid changes in communications technology; and whether the phrase “advance development of a statewide infrastructure” was written to create Kan-Ed. Staff were directed to explore the Kan-Ed issue and to request the KCC provide information on what is running through the networks. Committee members agreed all of the issues should be further discussed in the standing committees.

State Broadband Funds

Staff from the Kansas Legislative Research Department reviewed broadband funds created in four states. Broadband was expanded in many states using federal moneys provided through the American Recovery and Reinvestment Act of 2009. More recently, some states have created or renewed funding for state broadband funds. Four state programs were reviewed as follows:

- The **California** Advanced Service Fund supports projects that provide broadband to areas without access and, if funds are available, supports additional build-out in underserved areas. The Fund is supported by a 0.464 percent surcharge on intrastate telecommunications services. Infrastructure grants are available for up to 70 percent of project costs in unserved areas and 60 percent in underserved areas. Companion loans provide supplemental financing for grant recipients of up to 20 percent of project costs. The Fund also provides grants and loans to cover the costs of installing broadband in public housing. Eligible applicants include telephone and wireless companies, as well as governmental units in limited circumstances. Public housing authorities can apply for public housing grants.
- The **Maine** ConnectME grants provide funding for last-mile infrastructure to provide broadband in unserved areas.

Grants are funded by a 0.25 percent surcharge on instate communications services. Grants provide up to 50 percent of the cost, matched with funding from an internet service provider, of bringing affordable access to unserved homes and businesses which then pay a monthly access fee to the service provider. Eligible applicants include local governments and authorities, private for-profit companies that provide broadband, and any other group deemed capable.

- The **Minnesota** Border-to-Border Broadband Development grants provide funding for middle-mile and last-mile infrastructure that supports broadband service scalable to speeds of at least 100 Mbps download and 100 Mbps upload in unserved and underserved areas. Grants are funded by a one-time appropriation of $20 million from the general fund and require matching funds equal to at least 50 percent of the total project cost. Eligible applicants include incorporated businesses or partnerships, political subdivisions, Indian tribes, and certain Minnesota nonprofit groups.

- The Connect **New York** Broadband Grant Program provides funding for last-mile projects to expand broadband in unserved and underserved areas. The program is funded with $25 million in state funds, and requires matching funds equal to 20 percent of the total project cost. Eligible applicants include incorporated organizations, tribal organizations, local units of governments, cooperatives, private corporations, and limited liability organizations.

Conclusions and Recommendations

The Telecommunications Study Committee reaffirms the State public policy regarding telecommunications set out in KSA 66-2001, but suggests the Senate Utilities Committee and the House Utilities and Telecommunications Committee consider a review of subsection (d), which addresses advancing the development of a statewide telecommunications infrastructure.

The efficiency and effectiveness audit of the KUSF was extensive. The Senate Utilities Committee and the House Utilities and Telecommunications Committee should receive presentations by the audit firm during the 2015 Legislative Session.

Both the audit and other issues raised during the Committee's meetings need to be further considered during the 2015 Legislative Session. Accordingly:

- The Committee may meet at least once during the Session; and

- The Senate Utilities Committee and the House Utilities and Telecommunications Committee should study the definitions of telecommunications terms in existing law with a focus on "future-proofing" those definitions to accommodate the rapid changes in technology. Terms to be reviewed include broadband (currently defined as a specific speed of transmission), telecommunications services, and telecommunications infrastructure.