Telecom Regulatory Reform: Kentucky 2013

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NOTICE

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Executive Summary

History shows us that the issue of telecommunication regulatory reform at the state and federal levels can be cumbersome at best. Shifts in federal regulatory policy, new broadband technology and evolving competitive pressures often create imbalances in the telecommunications landscape at the state level that require periodic review and action.

Drawing from the experiences in surrounding states can be instructive. For example, in 2006, absent meaningful reform legislation at the federal level, Indiana acted on Digital Policy Institute ("DPI") recommendations to remove outdated legacy regulations and correct imbalances caused by increased competition in the telecommunication industry since 1996.[1] Indiana led the way by passing the most comprehensive telecom reform bill (HEA 1279) in over two decades, and with strong bi-partisan support. Indiana completed the deregulation review in February 2012, by passing HEA 1112, which eliminated federal-and-state redundant obligations on carriers and defined the competitive landscape wherein carriers could be relieved of "provider-of-last-resort" ("POLR") obligations. Clearly none of this happened in a vacuum; but these changes were supported by factors like the historical shift in competition within the telecommunications industry, and technological advances that rendered the past way of regulating the industry obsolete.

Looking back, seventeen years ago Congress passed the Telecommunications Act of 1996, and established the preconditions for efficient competition in the telecommunications marketplace. What Congress didn't do, as economist Alfred E. Kahn suggests in his 1998, book, is prescribe a regulatory off-ramp as the deregulated marketplace rapidly changed the competitive landscape.[2] Later, in a 2007, speech before the Federal Trade Commission, Kahn stated that continued comprehensive regulation of the telephone industry is not only unnecessary, but will likely "harm ratepayers by inhibiting competition and diminishing investment."[3]

Since 1996, the Federal Communications Commission (FCC) has been under mandate to conduct a biennial review of existing regulatory provisions to identify those legacy telecommunication regulations that are ripe for review and, where merited, removal.[4] Unfortunately, meaningful outcomes from that federal process are often delayed or derailed when the review takes a back seat to partisan politics and debate over ancillary issues like net neutrality. Individual states, like Kentucky, have often been left to chart their own course in the digital age.

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[1] HEA 1279, P.L. 27-2006

[2] Kahn, Alfred E. *Letting Go: Deregulating the Process of Deregulation, or: Temptation of the Kleptrocrats and the Political Economy of Regulatory Disingenuousness,* (Institute of Public Utilities and Network Industries, Michigan State University, 1998).

[3] Remarks of Alfred E. Kahn before the Federal Trade Commission (Feb. 13, 2007). Available at http://www.ftc.gov/opp/workshops/broadband/presentations/kahn.pdf

[4] Section 11 of the Communications Act, 47 U.S.C. § 161.

The major reform findings and recommendations of this paper are as follows:

- For Kentucky, the benefits of a "light regulatory" approach should be increased capital investment, new competition, and continued rollout of new fiber optic and digital technology in all areas of the state.

- Data continue to support deregulation where appropriate, and the traditional rationale for telecom utility regulation – *i.e.,* fixed landline telephone service as a natural monopoly – is now gone.

- The traditional landline telephone business in Kentucky continues to decline with consumer adoption of competing technologies. Today, there is no basis to claim that incumbent landline providers are, *per se*, "dominant" entities requiring the same, close government scrutiny of past decades.

- Upon review, Kentucky should modernize its POLR[5] requirements by passing SB 88 to eliminate unnecessary duplication with federal law, eliminate regulations which unfairly benefit some providers at the expense of others, and have a negligible impact on consumers, and sunset the remaining POLR state provision as soon as practicable.

[5] The term "Provider of Last Resort" (POLR) refers to obligations referenced under Section 278 of the Kentucky Revised Statutes, and is similar to the term "Carrier of Last Resort" (COLR) used in the literature, but is considered more inclusive.

Kentucky: The Evolution of Telecom Reform 2013

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1.0 Introduction

1.1 Introduction

The Kentucky General Assembly will be facing a number of critical issues in 2013, that will impact the Kentucky business environment and consumers for generations to come. It is no longer just a good idea for government to provide an environment conducive to a flexible and innovative business climate; it has become a necessity at all levels of governance to ensure that policy decisions set in place reflect a dedication to a dynamic business culture suited to compete in the ever-changing and increasingly fast-paced knowledge-based, global economy. This is especially true in the telecommunications sector, where out-of-date POLR regulations, drafted when carriers were monopolies, are still on the books.

The importance of the periodic review and modernization of state laws that govern the growth and investment in Kentucky's information economy is clear. In the modern technology economy, Kentucky must ensure that it is developing and retaining policies that create welcoming environments to attract high-tech investment. This, in turn, will attract not just high-tech businesses but also support existing brick and mortar businesses and service industries that need modern technology to operate efficiently.

Recognizing the stagnation in the Federal telecom regulation arena as well as the success of neighbors like Indiana and Ohio in doing so, Kentucky State Senator Paul Hornback (R-Shelbyville) introduced Senate Bill 88 on February 5th, 2013. In his press release, he said, **"Kentucky has telecommunications regulations on the books which have not been updated since the 1930's**."[7] Hornback insists that if Kentucky fails to make necessary adjustments to the regulation of its rapidly evolving telecommunications industry soon at the state level, it will be left behind socioeconomically by the states that have made the appropriate adjustments.

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[6] The authors are all senior research fellows in the Digital Policy Institute, Ball State University. Prof. Umansky is a communication attorney, and Dr. Yadon is a communication policy analyst. Authors acknowledge the assistance of Sarah A. Herpst, graduate research assistant in development of this white paper. Information about the authors is available at www.bsu.edu/digitalpolicy.

[7] "Senator Paul Hornback Introduces Legislation to Update Kentucky's Telecommunications Regulations," press release, February 5, 2013.

1.2 Post Divestiture

The decision to deregulate telecommunications in the United States began first at the federal level and evolved over a number of years based on a number of factors. First, there was the general recognition that the regulatory and economic landscape of the telecommunications industry had changed drastically since the divestiture of AT&T in 1984. The dramatic shift in the competitive landscape was evident by the fact that in 1996, some 90 percent of the telecommunications market was voice, while wireless and data each were only five percent. Nine years later, those numbers shifted to where voice was only 40 percent of the total telecom market, while wireless and data increased to 30 percent each.[8]

The opportunity for regulatory relief finally came with the passage of the Telecommunications Act of 1996[9] which required the FCC to examine tariff rules and forebear enforcement if it found that the rules were not necessary to (1) ensure that carrier rates remain just and reasonable; (2) not necessary for consumer protection; and (3) the public interest would be served by eliminating the tariffing provisions.[10]

In its 1996 Detariffing Order, the FCC finally concluded that it was no longer necessary to require long-distance carriers to file tariffs because it would decrease incentives for innovation, make it harder to offer discounts and customized service arrangements, and increase the potential for coordination in price setting.[11] On April 28, 2000, the U.S. Court of Appeals (D.C. Circuit) upheld the Commission's orders requiring detariffing of interstate, domestic, interexchange services; and the FCC's detariffing rules went into effect.[12]

While the FCC provided an open window of opportunity for states like Indiana and Kentucky to address the removal of tariffs at the state level, it took 10 years and a supportive political environment to mount a comprehensive deregulation agenda that would gain wide bipartisan support in the Hoosier State. Now is the time for Kentucky to act as well to make sure it does not remain an outlier in the advanced telecommunications world.

1.3 Post Telecom Act of 1996

According to Indiana Senator Brandt Hershman, co-sponsor of HEA 1279, Indiana's comprehensive deregulation had its origins in legislation in Iowa (telephone rate deregulation) and Texas (statewide video franchising) and followed reform actions taken in Ohio and Michigan.[13]

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[8] See www.fcc.gov.

[9] Telecommunications Act of 1996, Pub. L. No 104-104, 110 Stat. 56. The 1996 Act amended the Communications Act of 1934, 47 U.S.C. 151 et seq.

[10] Indiana is under a similar mandate for the IURC to examine and eliminate telecom rules that are no longer necessary. This statutory language is located at IC 8-1-2.6-4.1(a)(2)

[11] Policy and Rules Concerning the Interstate, Interexchange Marketplace Implementation of Section 254(g) of the Communications Act of 1934, as amended, 11 FCC Rcd 20730, 20779 (1996).

[12] *MCI WorldCom, Inc. et al. v. FCC*, 2000 WL 390520, No. 96-1459 (D.C. Cir. 2000).

[13] See http://www.csg.org/knowledgecenter/docs/slmw0606telecomm.pdf

Texas is credited with being the first out of the gate in the race toward telecom reform and statewide franchising. On September 7, 2005, Texas Governor Rick Perry signed into law Senate Bill No. 5, an "Act Relating to Furthering Competition in the Communications Industry," which many believed, accurately, would significantly reform telecommunications regulations in Texas. This Act also served as an early model for legislators in other states, like Indiana, who were seeking to reshape their telecommunications markets to meet the economic challenges of the 21st century.[14]

In response, the Digital Policy Institute (DPI) at Ball State University issued a report entitled, *The Economic Impact of Telecom Reform in Indiana: 2006*.[15] This report substantiated earlier research, including independent studies by federal agencies, major universities and think tanks, all of which came to a similar conclusion: only direct, head-to-head competition would lead to increased capital investment, increased broadband services, new jobs, and potential lower costs for Indiana consumers.

On March 14, 2006, Indiana became the second state to enact statewide franchising when Governor Mitch Daniels signed into law the state's most comprehensive telecom bill (HEA 1279) in more than two decades. With strong bipartisan support, Indiana's new reform legislation, including statewide video franchising, became the new legislative template that over 20 other states later would follow. A major reason for this notoriety is that Indiana didn't simply copy reform measures by other states; it improved upon them.

Unlike Texas, Indiana lawmakers were the first to ensure that cable television incumbents were allowed fairly to take advantage of the state's new franchise terms upon competitive entry. Also, Indiana was one of the few states to encourage long-term, outside capital investment by reducing risk and uncertainty from unwarranted sunset provisions. But Indiana's reform legislation went much further than simply statewide franchising.

Following the example set under the federal Detariffing Order, Indiana lawmakers also concluded that it was no longer necessary to demand intra-state carriers to file tariffs. The reasons ran parallel to federal thinking, because it would decrease incentives for innovation, make it harder to offer discounts and customized service arrangements, and increase the potential for coordination in price setting. Thus, Indiana's approval of HEA 1279 ended state authority to regulate landline telephone service rates for business and most residential customers.

While the impact of Indiana's telecom reform legislation continues to be evaluated over time, the early effects of reform were documented in a second report by DPI entitled, *An Interim Report on the Economic Impact of Telecommunications Reform in Indiana*,[16] released on February 15, 2008. In the nearly two years since passage of HEA 1279, the report uncovered a number of positive post-HEA 1279 events that, collectively, helped to gauge the impact of deregulation for Indiana citizens and the Indiana economy.

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[14] "Act Relating to Furthering Competition in the Communications Industry," S.B. 5, 79th Legislature, 2d Session, Texas 2005. See also Donald L. Alexander, Ph.D., *Telecommunications Deregulation in Texas: An Analysis of the 2005 Competition Act*, Tax Foundation (December 2005)
[15] See www.bsu.edu/digitalpolicy.
[16] Ibid.

These early findings included the accelerated deployments of digital subscriber line (DSL) services in more than 100 new rural Indiana communities, collective capital expenditures of more than $516 million in new infrastructure, new competition for video in multiple markets in Indiana, more than 2,200 new jobs created for Hoosiers, and, finally, a positive impact on price in the marketplace.

After five years, Indiana's reform legislation is still considered the most comprehensive state deregulation package enacted in the country. The Texas Public Policy Foundation recently observed in their *Legislators Guide to the Issues 2011/2012*:

> **"**Indiana has gone far beyond Texas in deregulating its telecommunications market, eliminating all rate regulation and tariffs. This has resulted in tremendous growth in telecommunications investment and services."[17]

2.0 Challenges of a Changing Landscape

Although Indiana had made substantial headway in telecommunications reform, the legacy issues surrounding the maintenance and administration of POLR regulations remained perplexing at the state level in this era of deregulation. Identified as a regulatory area ripe for review in earlier Digital Policy Institute research papers, the question of whether traditional copper wire "landline" telephone services should be available to all customers who request them, also addressing issues of uncertainty and inequity in a deregulated landscape, seemed paramount for Indiana and DPI review.

Firms in the telecommunications industry and their regulators at the federal and state levels continue to confront significant challenges in many areas, including how service best will be provided to consumers in urban, rural and now unserved geographic areas. Technological changes, including the development of broadband and IP services, have cast new light on old assumptions on how consumers can and should best be served. Moreover, several decades of judicial, legislative and regulatory actions have provided a new framework for service and for evaluation and fulfillment of public needs for telecommunications service.

As noted, one regulatory area left untouched in Indiana's earlier legislative and regulatory reform of its telecommunications law was that addressing the POLR obligations of legacy telecommunications carriers. Although the continuation, modification or elimination of this concept throughout the country is influenced by federal and state legislation, rules and policies affecting "universal service (USF)" and "Inter-Carrier Compensation ("ICC")" – and the impact of the new federal "Connect America" plan – deciding the fate of POLR lies exclusively with each state legislature. Indeed, the FCC's most recent pronouncement on USF and ICC states

[17] Bill Peacock, *Telecom Deregulation*, Texas Public Policy Foundation: Legislators Guide to the Issues 2011/2012. Available at http://www.texaspolicy.com/pdf/2011-TelecomDeregulation-CEF.pdf

specifically that POLR matters are still to be addressed at the state level and not preempted by federal law.[18]

State POLR requirements had their genesis decades ago, when competition for voice telephony was at or near zero. POLR requirements traditionally were assigned to wired "public switched telephone network (PSTN)" providers, a class which included former "Bell System" companies and, in some cases, independent local exchange firms. Moreover, these requirements were based on the notion that a company receiving a government franchise to provide service should take on a set of obligations in return for that government benefit.

Today, the competitive environment is vastly different. Rather than having voice service provided by a monopoly or near-monopoly local company, the landscape of voice service – in Indiana, Kentucky and elsewhere – is marked by robust competition of firms using not just traditional, wired voice technology but a range services based on internet protocol and wireless technologies.

Spurred on by the terms of the Telecommunications Act of 1996, and other federal and state statutory reforms, competition for voice and non-voice telecommunications services has been marked by federally-encouraged and state-encouraged entry of myriad new firms and the expanded service offerings of existing firms. Indeed, a policy designed only to ensure voice service in an era of limited providers is of questionable relevance to the situation we have today: active and often fierce competition among a multiplicity of providers and with a growing array of communications technologies.

Kentucky's telecommunications competition is typical of that found in many other part of the country. Indeed, based on Kentucky telecommunications reforms adopted in recent years, the levels of competition have been increasing at a fast pace. A clear picture of this growing competition is found in the FCC's Report titled "Local Telephone Competition: Status as of December 31, 2011."[19] Here we find an up-to-date and compelling showing as to the vast array of switched access, VOIP and mobile services offered by a growing number of firms throughout the Bluegrass State.

Clearly, the premises upon which Kentucky's POLR requirements were framed are no longer evident, as one surveys the number of competitors and the range of services (including the multiple ways of providing voice communication) offered residential consumers in their homes and while they are on the move. Incumbent carriers are now facing an onslaught of competition. In fact, continuing to impose voice-only POLR requirements on incumbent carriers only serves to place them at an artificial competitive disadvantage and to distract them from providing more broad-based telecommunications services that include but go well beyond voice-only offerings.

Current efforts of the Kentucky legislature to modify POLR requirements are being undertaken with full awareness that we are in an era of changed circumstances. That is, the basis for existing

[18] *Report and Order and Further Notice of Proposed Rule Making* ("R&O/FNPRM") in WC Docket No. 10-90, et al., FCC 11-161, released November 18, 2011.
[19] .http://transition.fcc.gov/Daily_Releases/Daily_Business/2013/db0114/DOC-318397A1.pdf

state regulation is shaky at best. Moreover, the Kentucky legislature also must take into consideration how the goals of state POLR requirements will be met through the interplay of other regulatory requirements. As set forth below, Kentucky should work to eliminate what now may considered to be not only duplicative requirements but also archaic mandates that actually may work against the interests of consumers desiring voice service, let alone the range of other services now offered by a variety of telecommunications carriers.

As well articulated in the 751-page FCC R&O/FNPRM,[20] there now is a new set of federal regulatory provisions – some effective now and some others becoming effective shortly – aimed at ensuring that all consumers, including those in rural and "high cost" areas, have access not only to voice communications but to the entire panoply of telecommunications services made possible in the digital, Internet-protocol age.

Key to this regulatory transformation is the "Connect American Fund (CAF)." The CAF is intended to ensure support not for mere voice communications but for a wide range of voice and data services. For now coupled with, and building upon, the concept of USF and ICC funding of carriers providing service in high-cost areas, the CAF mechanism is designed carry out federal policies of universal access to contemporary communications services.

Under federal law, in order for a telecommunications carrier to qualify for USF funding, it must be designated – usually the state; but in some cases by the federal government – as an "eligible telecommunications carrier (ETC)." [21] The authority of a state to identify and designate ETCs comes from provisions of federal law.[22] But, nothing in federal law now *requires* states to maintain traditional POLR requirements on specific, incumbent carriers. Indeed, the conditions attached to carriers seeking and obtaining ETC status well serve as a surrogate for familiar POLR obligations.

This conclusion that POLR reform is well overdue is not one limited to the views of the DPI; nor is it confined to the circumstances in the state of Indiana. Many observers have pointed out that increases in competition among telecommunications providers and telecommunications technologies compel a reassessment of traditional POLR requirements. And many states already have made these needed reforms.

Peter Bluhm,[23] in his February 2008, presentation to the NARUC Telecommunications Committee, argued that POLR duties should be reassessed.[24] His report, among others, notes the competitive unfairness of continuing to impose POLR requirements for serving outlying areas when an incumbent carrier's revenue potential (and, thereby, its financial capacity to provide population center and outlying services) is now dropping due to the entry of competitors vying for and securing significant if not dominant shares of revenues from population centers. That is,

[20] *Id.*
[21] 47 U.S.C § 254(e)
[22] 47 U.S.C. § 214 (e)
[23] Mr. Bluhm is a lawyer and policy advisor on telecommunications issues. Most recently, Mr. Bluhm was Principal for Telecommunications at the National Regulatory Research Institute.
[24] *Carriers of Last Resort – An Evolving Concept*, Peter Bluhm, National Regulatory Research Institute, February 28, 2008.

competing carriers are allowed to "cherry pick" customers in densely populated areas only, with no regard for, nor desire to, serve customers in outlying areas.

Similar conclusions, as to the reduced revenues of incumbent carriers in population centers, were reached in the comments filed in May 2009, by the Independent Telephone and Telecommunications Alliance ("ITTA").[25] There too we find compelling documentation as to the need to reassess statutory and regulatory requirements imposed on a small set of a vastly growing number of telecommunications competitors.

More recently, Peter Bluhm and two of his colleagues -- Natelle Dietrich, and John Ridgway – again argued that "last resort" duties traditionally attached to telephone companies as conditions of their government franchise should only be imposed on carriers receiving federal support funding, and not as a state-imposed condition of a franchise to operate.[26] Thus, a wide range of commentators have argued that the time is now for reassessment of these state "last resort" obligations.

We can look to the states of Indiana, Wisconsin and Michigan as contemporary examples of how state legislatures have chosen to modify or eliminate POLR requirements in light of both the state of competition in the industry and the existence of federal programs that will ensure the provision of basic voice services to all citizens.

Indiana

On February 2, 2012, Indiana's House Enrolled Act 1112 (HEA 1112) was signed into law by Governor Mitch Daniels. The focus on the reform was on the kind of POLR requirements now before the Kentucky legislature. Specifically, the Indiana legislation provides as follows:

Sec. 17. (a) Subject to subsection (b), upon notice to the commission by an incumbent local exchange carrier that is the provider of last resort in one (1) or more parts of the incumbent local exchange carrier's service area, the incumbent local exchange carrier is relieved of its obligation as the provider of last resort in any part of the incumbent local exchange carrier's service area in which there are at least two (2) ETC eligible communications service providers, one (1) of which may be the incumbent local exchange carrier, offering a voice service through any technology or medium, including any of the following:

(1) Wire communication (as defined in 47 U.S.C. 153).
(2) Internet Protocol enabled services.
(3) Commercial mobile service (as defined in 47 U.S.C. 332).

(b) After June 30, 2014, upon notice to the commission by an incumbent local exchange carrier that is the provider of last resort in one (1) or more parts of the incumbent local exchange

[25] Comments of ITTA in CC Docket No. 96-45 and WC Docket No. 05-337, filed May 8, 2009.

[26] *Carriers of Last Resort, Eligible Telecommunications Carriers and State Administrative Roles, A White Paper To The State Members Of The Federal-State Joint Board On Universal Service*, Peter Bluhm, Natelle Dietrich, and John Ridgway, February 7, 2011

carrier's service area, the incumbent local exchange carrier is relieved of its provider of last resort obligation with respect to any part of its service area identified in the incumbent local exchange carrier's notice to the commission under this subsection.

(c) Relief from a provider of last resort obligation under this chapter does not affect an incumbent local exchange carrier's obligations under federal law.

(d) As used in this section, "ETC eligible communications service provider" means a communications service provider that provides, using any available technology or medium, the voice telephony services described in 47 CFR 54.101, regardless of whether the communications service provider has been designated as an eligible telecommunications carrier.

These Indiana reforms – effective now – are providing a regulatory environment that removes archaic, redundant state regulations but have not been shown to threaten the availability of voice communications availability to residents of the state. The current Kentucky proposed legislation (SB.88) would replicate much of the Indiana reforms; however, the current language of that Kentucky bill would not eliminate POLR requirements fully in exchanges with fewer than 5,000 housing units.

Wisconsin

On May 26, 2011, Wisconsin Bill SB 13 was signed into law. Section 117 of the bill provides for a new Section 196.503 of the Wisconsin Statutes and Annotations to establish an interim mechanism for waiver of state POLR requirements and a total elimination of those requirements as of April 30, 2013.

Specifically, the Wisconsin statute takes a revised approach to the provision of "basic voice services." The new law does require an ILEC – until April 30, 2013 – to make basic voice (defined as "two-way voice communication service within a local calling area") to all residential customers within the ILEC's local exchange area. However, the law now provides that the ILEC may provide such basic voice service through an affiliate and through the use of "any available technology or mode."

More importantly, the law provides that an ILEC may apply to the state Public Service Commission (PSC) for a waiver of these requirements. The PSC must grant a waiver if the waiver is "in the public interest" or if "effective competition" is found to exist in the local exchange area. If the PSC fails to decide on the waiver within 120 days of its filing, the waiver is deemed granted. After June 1, 2012, if a waiver request is based on an earlier finding of effective competition, the waiver is deemed granted unless the PSC issues a decision within 20 days of the waiver request's filing. The law also "grandfathers" all previous PSC rulings relieving particular ILECs' POLR obligations. As noted above, all Wisconsin POLR obligations will "sunset" as of April 30, 2013.

Michigan

Also instructive are the steps taken in Michigan's recent reform of its telecommunications laws. Signed into law on June 14, 2011, Michigan Public Act No. 58 (House Bill No. 4314) states that:

> "…any telecommunications provider that provides either basic local exchange or toll service, or both, shall not discontinue either service to an exchange unless 1 or more alternative providers for toll service, or 2 or more alternative providers for basic local exchange service, are furnishing a comparable voice service to the customers in the exchange. A comparable voice service includes any 2-way voice service offered through any form of technology that is capable of placing and receiving calls from a provider of basic local exchange service, including voice over internet protocol services and wireless services."[27]

The Michigan Act goes on to provide a requirement for public notice of any request by a telecommunications provider to discontinue service and a deadline by which the Michigan Public Service Commission must act on the request. The act also requires a 60-day notice to customers of action by the Michigan PSC. Importantly – and underscoring how federal law exists to serve the interests of consumers – the Michigan Act states that "…discontinuance of basic local exchange service under this section by an incumbent local exchange carrier does not affect the requirements of that incumbent local exchange carrier under federal law."[28]

Next Steps for Kentucky

So, the path for similar regulatory reform in Kentucky is now clear. Although the Kentucky legislature certainly may adopt SB 88 or statutory language of its own choosing, the key elements of other states' actions should serve as useful guides. No longer is there a need for a state to require provision of voice service where that service and other telecommunications services are provided by other companies in the same service area.

Although Kentucky still will be in the business of designating ETCs under the provisions of federal law, it is federal law that will serve as the mechanism for ensuring consumers' access to basic voice, among other services. ETCs' federal service obligations (keyed to ETCs' receipt of Universal Service or Connect American Fund support) will not be affected by these incumbent carriers electing to opt-out of any Kentucky POLR requirements on conditions (similar to those specified in the Indiana, Wisconsin and Michigan revised telecommunications laws) when there is competition for voice and other services at the local level. But, the need for obtaining an opt-out "waiver" from Kentucky POLR requirements should not be the ultimate goals of Kentucky telecommunications reform in this area. Rather, DPI recommends that Kentucky follow the lead of other states in adopting a near-term "sunset" of all Kentucky-based POLR obligations, including the provision that would still require PLOR obligations in exchanges with fewer than 5,000 housing units.

[27] Section 313 (1), Michigan Public Act No. 58.
[28] Section 313 (4), Michigan Public Act No. 58.

3.0 Economic Impact of POLR Reform

Robert W. Crandall, noted economist of the Brookings Institution, advised policymakers to deregulate completely in his 2005 book, *Competition and Chaos*.[29] The economic lesson from the history of regulation is that regulation and competition are a bad emulsion. Once the conditions for competition exist, it is best for regulators to abandon the field altogether. This is particularly true in a sector that is undergoing rapid technological change and therefore requires new entry and new capital. The politics of regulation favor maintaining the status quo, not triggering creative destruction.

Later, in a 2007 speech before the Federal Trade Commission, economist Alfred Kahn confirmed that the transition [in the telecom industry] is complete and that comprehensive regulation of landline phone services is both unnecessary and will likely harm consumers by inhibiting competition and diminishing investment.[30]

The provision of Provider of Last Resort requirements for regulated firms is predicated on the existence of a natural monopoly for a single product, with low substitutability across competing technologies. The POLR regulation was designed to prevent provider exit, and insure some minimal service would continue in all geographic regions to preserve local service and network externalities without regard to the changing regulatory landscape. POLR regulation is a common feature of the early stages of devolution from a regulated monopolist to a workably competitive market.

Economic considerations surrounding POLR reform in Kentucky's telecommunications markets hinge upon two issues. The first is the effect of deregulation within markets for telecommunications services in Kentucky. Second is the level of substitutability among competing technologies, the degree of competition within these markets and the role incumbent mandated POLR regulation generates asymmetry in the regulatory environment, reducing social welfare. We address these in turn.

Deregulation of telecommunications markets through the past decade and half have generated significant gains to telecommunications penetration. For example, Indiana's House Enrolled Act 1279 crafted, among other things, statewide franchising for telecommunications services. Two subsequent analyses of this act attribute significant gains to telecommunications take rates as a result.

Two separate 2010 studies (DPI, 2010; Bohannon and Hicks, 2010) addressed the effect of statewide franchising legislation in the United States from the mid 1990's through 2009. Due to unavailability of data on private cable access TV take rates and prices for bundled service, these studies examined the effect of statewide franchising on broadband take rates. An empirical model that tested the effects of the legislative change along with factors that would influence

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[29] *See*, Crandall, Robert W. *Competition and Chaos* (Brookings Inst. 2005) at 166.

[30] Remarks of Alfred E. Kahn before the Federal Trade Commission (Feb. 13, 2007). Available at http://www.ftc.gov/opp/workshops/broadband/presentations/kahn.pdf.

take rates across states isolated the impact of statewide franchising rules. These effects ranged from broadband take rate increases from 1.66 percent to 5.32 percent, with the differences largely attributable to the date of enactment. In Indiana, a state which had only recently permitted statewide franchising, the legislation boosted broadband take rates by 2.47 percent, or by more than 226,000 households and businesses.

A separate review of actual investment and market penetration in Indiana, performed by the Indiana Utility Regulatory Commission in 2011 provides a similar story with respect to video provider services in Indiana. In 2006 (the year HEA 1279 was passed) saw three new video providers in the state, servicing 3,064 new Census Blocks. In 2007, when the legislation became effective, 6 new providers entered the market serving 18,911 new Census Blocks. This growth was sustained in both 2008 and 2009, with 7 and 9 new firms serving 31,962 and 35,861 new Census blocks respectively. The IURC study also reviewed expansion and service provision in MSA's in Indiana, finding significant new investment in both incumbent video providers and new entrants.

This data and analysis supports the view of Kahn (2007) who argued that the transition from natural monopoly to workably competitive markets in telecommunications is mature, and that continued comprehensive regulation of these services is not needed and will lead to reduced competition, loss of consumer welfare and lower levels of investment.[31]

The migration from natural monopoly to workable competition has occurred due to the high level of substitutability between differing technologies for a wide range of services. For example simple wireline telephony is no longer the dominant technology for voice telecommunications services in Indiana. Wireless, broadband enable voice, and other technologies have superseded, but not replaced traditional wireline services. The abundance of providers and the technology options available to consumers suggests a nearly complete migration of services to workable competition. For these regions, POLR regulation remains a legacy regulation which asymmetrically requires incumbent wireline services. It is not needed in these locations.

More recently, a study by Hance Haney and George Gilder[32] comes to a very similar conclusion, and in the context of the legislation currently pending in Kentucky. Their study observes: Outmoded regulatory mandates prevent telecommunications providers from offering competitive services and generating revenues for broadband expansion. They serve chiefly as obstacles to investment that reduce asset values of all telecom suppliers. Wherever consumers can choose between alternative providers of voice service, the following reforms are recommended:

- Terminate obligations to serve, which impose significant costs on telephone service providers but not their competitors.
- Clarify that rates will be market-based and not subject to commission jurisdiction so all providers of voice service have an equal chance to compete.
- Eliminate filing requirements at the expiration of the rate cap period so that competitors do not receive notice of product and service improvements and sales promotions.

[31] Ibid.
[32] Kentucky Telecom Law Needs Update, Discovery Institute, January, 2013.

By embracing regulatory reform, legislators will expand consumer choice, decrease prices, and ignite the broadband expansion necessary to economic growth and technological progress.[33]

The economic argument for altering the regulatory landscape with respect to POLR is a familiar one to DPI. In Indiana, the state already recognized that new technologies exist that can supplant traditional wireline telephone service of the incumbent local exchange.[34] Yet the former regulatory environment unintentionally supported incumbent wireline technology for POLR obligations without regard to the efficiency or cost effectiveness of alternative technologies. This could only result in low cost service by accident. A regulated environment which (1) constrains deployment of preferred telecommunications options due to outdated determination of the optimal technology, or (2) has no mechanism which allows the lowest cost technology to assume POLR obligations in a competitive environment, has several consequences which are incompatible with public welfare and consumer choice.

The current regulatory environment delimits investment in the least cost technology (unless that happens to always and everywhere be wireline telephony). The current POLR regulation can result in high prices, higher deployment costs, reduced access and therefore reduced consumer and producer surplus in every location where a lower cost technology than wireline telephony exists. While there may be places where incumbent wireline services offer the lowest marginal cost of a limited suite of telecommunications services, the changes proposed here permit continued POLR and USF support for those carriers. Elsewhere, in a competitive environment, it is cost, not legacy, that should determine the POLR firm in a region. Any alternative would result in less access, to a suite of telecommunications services, higher cost for services and reduced welfare for firms and consumers engaged in the production and consumption of telecommunications services.

4. 0 Summary and Conclusions

In summary, the Digital Policy Institute (DPI) finds that data continues to support deregulation where appropriate, and the traditional rationale for telecom utility regulation – *i.e.*, fixed landline telephone service as a natural monopoly – is now gone. The traditional landline telephone business in Kentucky continues to decline with consumer adoption of competing technology. Today, there is no basis to claim that incumbent landline providers are, per se, "dominant" entities requiring the same, close government scrutiny of past decades.

The Digital Policy Institute (DPI) further concludes that based on industry trends and the changing competitive landscape of the telephone industry (voice) in Kentucky, the Kentucky Revised Statutes should be modernized to reflect a transformation to a flexible service obligation. Where Provider of Last Resort (POLR) obligations are concerned, we recommend the

[33] Id. at 9.
[34] IC 8-1-32.4-11

elimination (1) of unnecessary duplication with federal law, and (2) those regulations that unfairly benefit some providers at the expense of others.

For example, In Indiana under Title 8, a provider of last resort was required to offer local exchange service throughout a defined geographic area.[35] Yet this same, redundant, service obligation also exists at the federal level and is tied to a carrier's status as an Eligible Telecommunications Carrier (ETC). A carrier must be designated an ETC to receive Universal Service Fund (USF) dollars. Thus, once the state designates a provider as an Eligible Telecommunications Carrier, former separate but redundant state service obligations are assumed and covered by federal law with a negligible impact on consumers.

In spite of misinformation by opponents to the contrary, the provisions of SB 88 properly reduce incumbent regulations that are tied to a legacy landline telephone environment that is no longer dominant in Kentucky or surrounding states. Where two or more communications service providers, regardless of technology, are in competition within a service area, and each holds a certificate of territorial authority issued by the PUC, the existing provider of last resort should be able to be relieved of the POLR obligations upon notice to the Commission. Looking ahead, as with Indiana and Wisconsin, POLR obligations in Kentucky should sunset as soon as practicable. This would have no impact on the carrier's service obligations under federal law.

[35] IC 8-1-32.4-9