The Florida Senate

Interim Project Report 98-41 *January 1999*

Committee on Regulated Industries Senator Tom Lee, Chairman

A REPORT ON TELECOMMUNICATIONS

SUMMARY

Chapter 98-277, Laws of Florida, directed the Florida Public Service Commission to perform several studies of the telecommunications market. The Commission soon will conclude its studies on fair and reasonable rates, costs and universal service, and access to tenants in multitenant environments. This report summarizes Commission staff's draft reports and highlights the policy issues most appropriate for legislative consideration. The report also summarizes the Commission's report on the status of local competition, which provides background information useful for framing the policy goals of the state in connection with deregulation of the telecommunications industry.

BACKGROUND

As reported in Interim Project Summary 97-P-12 (September 1997), the Telecommunications Act of 1995 (the "Florida Act") amended Chapter 364, F.S., to allow competition for the provision of local telecommunications services in Florida. The Florida Act:

- defines procedures for establishing the relationships between incumbent local exchange companies and new entrants necessary for competition,
- provides for continuation of the policy of ensuring universal access to local telecommunications services in a competitive environment,
- allows incumbent local exchange companies to elect price regulation in lieu of the traditional earnings regulation that governed rates in the monopoly environment,
- caps the rates incumbent companies may charge for basic local services and for network access services, and
- requires the Public Service Commission to annually report to the Legislature on the status of competition in the telecommunications industry.

Several months after the Florida Act took effect, Congress enacted the Telecommunications Act of 1996 to mandate that states open local telecommunications markets to competition. The Federal Act addressed many of the same issues as the Florida Act, though in somewhat different ways. Generally, the Federal Act left intact the traditional jurisdictional separation between federal regulation of interstate services and state regulation of intrastate services.

The September 1997 Senate Interim Project Report made several recommendations designed to address remaining barriers to competition. These proposals were refined during the 1998 session and enacted into law (Chapter 98-277, Laws of Florida).

The law:

- Provides for a $50 million dollar reduction in intrastate access charges for GTE and Sprint. Long distance companies must reduce their rates to return the benefits of this reduction to their residential and business customers.
- Extends the caps on basic residential local service, multi-line business service, and SUNCOM service for an additional year, until January 1, 2000.
- Creates the "Telecommunications Consumer Protection Act" to allow the PSC to adopt rules to prevent "slamming" and to require telecommunications companies to follow specific billing practices so customers will know what they are being billed for and whom to call if they have questions about their bills.
- Orders the PSC by February 15, 1999, to complete certain studies that could provide a basis of infor-

mation for legislation during the 1999 session regarding: a permanent universal service mechanism; a "fair and reasonable rate" for basic residential local telecommunications services; and access to multitenant buildings to provide competitive telecommunications services.

METHODOLOGY

This Interim Project Study involved monitoring Public Service Commission hearings, workshops and other meetings to keep abreast of the Commission's progress in carrying out the studies required by Chapter 98-277, Laws of Florida. Draft versions of each of the three studies are summarized in the "Findings" section of this report. To help frame the issues, however, the "Findings" section begins by summarizing the Commission's December 1998 Report on Competition in Telecommunications Markets in Florida.

FINDINGS

Report on Local Competition

The Commission's responsibilities for the regulation and promotion of competition in the telecommunications industry makes it well-suited to monitor and report market changes. In order to ensure that the Legislature is able to make sound policy decisions in this dynamic and complex industry, the Legislature has directed that the Commission annually report on the status of competition in the market. *See* Section 364.386, F.S..

On December 1, 1998, the Commission submitted its annual report to the Legislature on the status of competition in the telecommunications industry in Florida. The Commission identified a modest increase in competitive activity and specifically noted that 105 new alternative local exchange companies were certified from 1997 to 1998 and that 29 additional companies actually began providing service.

1. Universal service levels

The modest rise in competitive activity has had a negligible effect on the availability of universal service. In March 1998, 93.3% of Florida households had local telephone service, compared to an annual average of 92.8% in 1997. The Commission concluded that universal service is and will remain insulated from minor changes in the competitive environment.

2. Competitive provider performance

When surveyed by Commission staff, competitive providers responded that they face several barriers to entry into local exchange markets. In particular, competitors complained that the incumbents charge excessive rates for resale, interconnection, and unbundled network elements, and that the Commission has set insufficient resale discounts.

Competitors also noted problems in negotiating agreements for resale, interconnection and the purchase of unbundled network elements. They believe that cumbersome and lengthy negotiations have delayed market entry and frustrated the intent of pro-competitive telecommunications laws.

Notwithstanding these apparent difficulties, the Commission pointed out that, as of October 1998, more than 380 agreements have been successfully negotiated in Florida.

Competitive providers also point to parity of service and technical difficulties as obstacles to competition. Some complained that incumbents are causing unfair and discriminatory service delays. They asked the Commission to take steps to ensure that incumbent companies provide access to the full range of Operational Support Systems for pre-ordering, ordering, provisioning, maintenance, repairs and billing.

Competitors also recommended a statewide advertising campaign to inform customers about market options, performance standards and penalties to improve the level of service rendered to competitors by incumbent companies, and larger wholesale discounts.

Many of the certified competitive providers that have not yet entered the local market have expressed an intention to do so by the fourth quarter of 1999.

3. Effects on Consumers

Most competitive providers have entered the local market by way of resale agreements, so the level and types of services provided to customers are virtually identical to what are being offered by the incumbents. Choice of a provider, according to the Commission, therefore, generally is driven by price. A notable exception, however, is that some alternative companies have established profitable niches by marketing "local only" service at markedly higher rates to customers

who have been denied local service by incumbent providers (due to non-payment of phone bills). The Commission found that customers choosing competitive providers generally obtain service terms and conditions similar to those offered by the incumbent companies.

4. Impact of price regulation

The Commission noted that basic service rate caps provided in Florida's 1995 Telecommunications Act remain in effect until January 1, 2000, for GTEFL and Sprint-Florida and until January 1, 2001, for BellSouth (s. 364.051(2)(a), F.S.). Modest increases in local competition have not significantly diminished the market share of the incumbents. They continue to serve more than 98% of the market in their service areas. Therefore, the Commission concludes that price regulation has not adversely impacted the affordability of telecommunication services. Service quality levels have remained high and justified complaints against major providers actually decreased slightly in 1998.

5. The definition of basic local service

The Commission recommends no change to the definition of basic service.

Fair and Reasonable Rate Report

Incumbent local exchange companies assert that charges for intrastate access and other services are set well above costs in order to subsidize below-cost rates in the local residential market. They argue that although this pricing mechanism worked during the monopoly era, it cannot be sustained in a competitive environment. Specifically, the incumbent companies point to market entry statistics to show how new companies are targeting the incumbents' high priced services and luring away profitable customers.

The Legislature directed the Commission to test the incumbents' assertions, to report on the relationship between costs and charges, and to recommend a fair and reasonable rate for basic telephone service.

In order to comply with the Legislature's directive, the Commission analyzed cost studies filed by the local exchange companies, studied rates and rate actions in other states, and held 22 public hearings and one technical workshop.

The cost studies submitted by the incumbent local exchange companies, BellSouth, GTEFL, and Sprint-Florida, all attributed the entire cost of the local loop to the provision of basic local service. (In simplest terms, the "local loop" is the pair of wires connecting a customer to the phone company's central office.) Opponents of the cost studies argue that attributing the entire cost of the local loop to basic local service leads to inflated costs. They argue that the local loop is a shared, or common cost that should be spread across all services (and potential revenues) that rely upon it. The Commission staff, however, determined that the cost of the local loop is properly attributable entirely to the provision of basic local telecommunications services.

Attributing the entire local loop costs to basic local service results in costs for basic residential service that significantly exceed revenues. With this methodology, BellSouth had shortfalls ranging from $7.25 to $47.27, depending upon the rate group. Likewise, GTEFL and Sprint-Florida had shortfalls ranging from $12.42 to $51.94 and $3.12 to $45.49, respectively. Business-line losses were smaller and, in some cases, revenues exceeded costs.

The Commission staff noted that, for other services, like ESSX/Centrex, PBX trunks, other multi-line circuit-switched services, intrastate switched access charges, intralata toll, and vertical services (like call waiting and caller identification), revenues significantly exceed costs.

Embedded cost analyses show that in 1997, BellSouth, GTEFL and Sprint-Florida each earned a 20.3%, 18.8% and 13.4% return on equity respectively.

An affordability survey conducted by the Commission staff established that the typical Florida household has 1.3 telephone lines and that residents use their phones approximately 13.5 times a day. Some consumers also subscribe to a variety of optional calling features, such as call waiting or caller identification. The average monthly bill is $84.87 ($39.40 for local service and $45.47 for long distance). Some consumers indicate that a rate increase would increase the likelihood that they would curtail use of their home phones and use pay phones or switch to a wireless service. Customer testimony throughout the state indicates strong feelings against any rate increase and specifically against "add-ons" to the phone bill. Customers also express concern about the effect a rate increase would have on low-income and fixed-income consumers.

The Commission staff's comparative analysis of other states' basic local rates and rate actions found that Florida's rates are between $4 and $5 lower than rates

in other states and that previous rate increases by some states have ranged from $1 to $3.50 per month.

Based on these factors, the incumbent local exchange companies advocate raising basic rates and lowering charges for switched access and vertical services. Consumer groups counter that charges for switched access and vertical services can be lowered without increasing the cost of basic local service and with no significant adverse impact on the viability of the local exchange companies. The Consumer groups also dismiss the local exchange companies' argument that higher basic service rates will attract new market entrants.

The Commission staff concludes that basic local phone service is very valuable and that rates could be increased and still remain affordable to Florida consumers. Moreover, although there was general consensus that there is no significant competition in any residential telecommunications market anywhere in the nation, the Commission staff suggests that increased basic rates could serve as a catalyst for increased competition as wireless service becomes a more viable option. Specifically, the Commission staff recommends that:

(1) Price-regulated companies be allowed to increase residential and single line business rates from $0 to $5 per month, phased in over a 3 to 5 year period at not more than $2 per year;

(2) Access charges be reduced over the same 3 to 5 year period to parity with interstate rates, and TouchTone charges be eliminated;

(3) The new rate after these increases be capped until meaningful competition occurs or for 5 years, whichever is less;

(4) Increases in charges for non-basic services be capped by an index set by the Commission until meaningful competition occurs; and

(5) All companies implement a "no-frills" rate for customers.

Cost, LifeLine, and Universal Service Report

Universal Service is the concept that everyone have basic telephone service. The telephone provides a link to emergency services, government services and surrounding communities. Therefore, the Legislature has expressed its intent to make basic telephone service affordable for everyone.

In the monopoly environment, the telephone became an affordable link to the outside world for most citizens. Phone companies were obliged to serve all customers, even when costs exceeded revenues. On average, however, the companies were guaranteed a fair rate of return. The concept of "universal service funding" first arose after the break up of AT&T, as a potential source of funds that could be used to ensure Universal Service for low-income consumers and consumers in high-cost areas. The idea is to have all providers contribute to a fund that can be tapped by telecommunications companies to recover their costs of serving high-cost and low-income customers. The current Universal Service Mechanism in Florida is simply continuation of the old policy of implicit subsidies. The "state share" of the cost of serving high-cost and low-income customers is borne by the incumbent local exchange companies (the Federal Communications Commission has established a permanent universal service mechanism for the "interstate share.") As competition emerges, however, Florida will need to devise a competitively neutral universal service mechanism to fairly distribute costs. Therefore, the Legislature directed the Commission to study the costs of basic service in order to estimate the parameters of any potential fund.

1. The total forward-looking cost of basic local telecommunication service

Section 1 of Chapter 98-277, Laws of Florida, required the Commission to report the total forward-looking cost of providing basic local telecommunications service in Florida. Such baseline information could be used by policy makers to evaluate the need for and size of a universal service funding mechanism.

To determine total service long run incremental costs incurred by the three large incumbent local exchange companies, BellSouth, GTEFL, and Sprint-Florida, the Commission staff selected a cost proxy model. To determine costs incurred by small local exchange companies, the Commission staff used a fully embedded cost study, as permitted by the law.

For purposes of the cost proxy model study, the Commission staff determined that the statutory definition of "basic local telecommunications service" was appropriate. Section 364.02(2), F.S., defines basic local telecommunications service as:

> voice-grade, flat-rate residential and flat-rate single-line business local exchange services which provide dial tone, local usage necessary to place unlimited calls within a local exchange area, dual tone multifrequency dialing, and access to the following: emergency services such as 911, all locally available interexchange companies, directory assistance, operator services, relay services, and an alphabetical directory listing.

Therefore, all of these components were considered in the cost model.

The Commission staff chose the "Benchmark Cost Proxy Model" (BCPM) 3.1 sponsored by BellSouth and Sprint-Florida, over the "Hatfield Model" (HAI) 5.0a favored by the major interexchange (long-distance) carriers, including AT&T and MCI. Although the Commission staff determined that both the BCPM and the HAI Models were deficient in some respects, the Commission staff believes the BCPM, as modified by the Commission staff, generates more reasonable cost estimates. The Commission staff's modifications to the BCPM were made to better model cable requirements in low density areas and switching costs.

The Commission staff further determined that the total forward-looking cost of basic local telecommunications service should be modeled at the wire center level. A wire center is a physical structure that houses one or more central office switching systems. There are 477 wire centers in Florida.

Inputs to the BCPM fall into four general categories: financial, unit investment, expense, and engineering design. The Commission staff assessed each input in terms of the appropriateness of its degree of geographic specificity and economic efficiency. The Commission staff found that several of the inputs to the BCPM in the "expenses" category, including nonrecurring charges, billing and collections for toll and access and advertising, might overstate the cost of basic service. It adjusted these inputs accordingly, but even with the adjustments the Commission staff remains concerned that the final outputs still overstate costs to some degree. Therefore, the Commission staff recommends further study of expense inputs and repeatedly warns that its cost-study typifies the inexact nature of costing models.

The results of the fully-embedded cost studies for the small local exchange companies (which include embedded, instead of forward-looking costs and are generally expected to produce higher costs) generated costs generally *below* costs produced for those same territories by the BCPM proxy model.

2. Support necessary to fund LifeLine

Section 1 of Chapter 98-277, Laws of Florida also directed the Commission to determine the amount of support necessary to subsidize residential basic telecommunications service for low-income customers under Florida's LifeLine Assistance Program. Customers who participate in any one of several assistance programs (including Medicaid, WAGES, Supplemental Security Income (SSI), food stamps, Federal Public Housing and Section 8, or the Low-Income Home Energy Assistance Program (LIHEAP)) qualify for LifeLine support. To estimate the total pool of customers eligible for LifeLine support, the Commission staff, in conjunction with the various agencies, identified households qualifying for any of the programs and then subtracted duplicates from the tally. This total number of eligible customers (816,278 for 1998) was then multiplied by $3.50, Florida's match to earn the maximum $7 credit from the Federal Communications Commission, resulting in a $34.3 million maximum support requirement. The Commission staff projected modest increases in the maximum LifeLine support requirement for 1999 and 2000, based on agency estimates and census data.

In 1997, only 130,664 households participated in the LifeLine program (state match of $457,000). Therefore, unless subscribership levels increase dramatically, the Commission staff's estimates significantly exceed actual funding requirements.

3. Permanent Universal Service Mechanisms

In 1995, the Florida Legislature was concerned about maintaining universal service in a competitive environment. Therefore, it established an interim period wherein incumbent companies were required to remain as carriers of last resort in their service areas. Section 364.025(1), F.S. provides that the interim period expires upon approval of a permanent mechanism or on January 1, 2000, whichever comes first.

The Commission staff suggested that a permanent universal service funding mechanism may be needed to counter the effects of competition on incumbent local exchange companies, if their responsibility to serve as "carriers of last resort" are continued beyond

January 1, 2000. The Commission staff explained that to maintain long-term profitability, the companies that are obliged to serve high-cost and low-income customers must tap new revenues as competitors target their most profitable services and customers. Market entry data support the Commission staff's conclusions. The Commission staff suggests that sooner or later it may be appropriate to allow for explicit funding to providers in exchange for the assurance of affordable basic service rates for high-cost and low-income customers.

For LifeLine, the Commission staff believes it ought to be sooner. The current funding mechanism is neither equitable nor competitively neutral; the burden of providing the intrastate matching monies falls entirely on the incumbent local exchange companies. In order to correct this inequity, the Commission staff recommends an explicit competitively neutral mechanism to pay the entire cost of the LifeLine program. As mentioned above, the total fund requirements could reach $36.5 million, although, this figure assumes dramatic increases in LifeLine subscribership.

The Commission staff also identified a potential need for explicit funding to support service for high-cost customers. However, Commission staff believes this need will emerge later, when competition becomes more prevalent. Although the Commission staff admits that defining such a moment is problematic, it suggested several ways to identify the need for explicit funding. One alternative would be to leave it to the incumbents to prove that support is necessary, pursuant to the petition process already in effect (s. 364.025(3), F.S.). Another alternative would be to choose one of several market benchmarks as the trigger for commencement of explicit funding. Suggested benchmarks include a competitor's market share, an indirect measure of lost contribution, or some designated key event like a competitor's carrier of last resort petition.

If and when any explicit high-cost mechanism is implemented, the Commission staff recommends that all telecommunications companies be required to contribute to the fund pursuant to a revenue-based assessment scheme. The Commission staff identified the National Exchange Carrier Association (NECA) as a potential fund administrator and advised that providers should be forbidden from mislabeling or otherwise misrepresenting the nature of any explicit charge placed on a customer's bill.

Report on Access to Tenants

As new competitors make their way into the telecommunications market, they are often required to overcome significant barriers. In implementing federal and Florida telecommunications policy, the Commission and the Legislature have assumed an active role in ensuring that anti-competitive barriers are removed. There is some indication that the goal of bringing competition to the basic residential market is being thwarted by building owners in multitenant environments. Competitors argue that some building owners see them as an economic opportunity and are charging access fees to install facilities in their buildings.

On the other hand, building owners are asserting that they are constitutionally entitled to compensation for access. They also point to space, safety, and aesthetic concerns regarding the influx of new companies seeking to do business with tenants.

Section 5 of Chapter 98-277, Laws of Florida, required the Commission to study issues associated with telecommunications companies serving customers in multitenant environments (MTEs). The Legislature recognized that access to tenants is an important component for promoting competition. It directed the Commission to recommend ways to promote competition in this area, with due regard to applicable federal requirements, landlord property rights, rights of tenants, and other matters identified through mandated public workshops and staff research.

The PSC report identifies a difference of opinion as to the definition of an MTE. Incumbent local exchange companies generally favor a broad definition of MTE, encompassing all types of new and existing structures with residential or commercial tenancies. The Florida Apartment Association (FAA) and Central Florida Commercial Real Estate Society and the Greater Orlando Association of Realtors (REALTORS) favor excluding residential property from the definition of MTE. Because a broader definition maximizes the opportunities for competition, the Commission staff opted to define MTE to include all types of structures and tenancies except (1) condominiums (defined in Chapter 718, F.S.); (2) cooperatives (defined in Chapter 719, F.S.); (3) homeowners' associations (defined in Chapter 617, F.S.); (4) short term tenancies specifically included in Rule 25-24.610(1)(a), Florida Administrative Code (also known as the PSC's "call aggregator" rule); and (5) tenancies of 13 months or less in duration.

The Commission staff also addressed which telecommunications services fit the definition of "direct access." Section 364.02(11), F.S., provides that telecommunication service "be construed in its broadest and most inclusive sense." Nevertheless, the Commission staff expressed concern that, in this case, an expansive definition might soon be obviated by a proliferation of unregulated technologies like wireless, roof-top satellite dishes, and coaxial cable voice and data services. Therefore, Commission staff limited the scope of services to which its regulation of multitenant access would apply to two-way telecommunications service to the public for hire within this state, as defined in Chapter 364, F.S. The Commission staff further recommended that the definition of telecommunications services in Chapter 364, F.S., not be amended.

Commission staff considered whether the term "demarcation point" should be set based on the Commission's current definition (*see* Rule 25-4.0345, Florida Administrative Code) or on the federal Minimum Point of Entry (MPOE) guideline. A demarcation point is the physical point in a telecommunications network where responsibility of the telecommunications company ends and that of the customer begins. The location of that point is critical for establishing responsibilities for maintenance, repair, or removal of telecommunications equipment or wiring and for marking the point of competitive access to an MTE. The Florida rule puts the point at a place easily accessible to the customer in the customer's premises. The federal MPOE guideline allows the landlord more latitude in identifying the demarcation point. As such, it could operate to allow alternative local exchange companies easier access to network wiring. Unable to resolve this issue, Commission staff recommends a staff workshop as a prelude to possible rulemaking.

Commission staff also considered whether restrictions to direct access are warranted and specifically considered the propriety of exclusionary contracts. Landlords and building owners raise important physical access issues, grounded on takings law. Recognizing the need to respect property owners' rights, the Commission staff recommends standards for reasonable and nondiscriminatory access in MTEs and further recommends that incumbents, competitors, landlords and tenants be encouraged to negotiate MTE access issues in good faith. The Commission staff also recommends that exclusionary contracts be prohibited and that landlords be required to disclose to potential tenants the existence of any telecommunications marketing agreements.

Regarding compensation, the Commission staff concluded that the costs building owners charge to telecommunications companies should be reasonable and not discriminatory. The Commission staff also provided that alternative local exchange companies and property owners could negotiate appropriate compensation for installation, easements, or other costs related to providing service to the tenant.

Commission staff also identified jurisdictional concerns. The Commission has only limited jurisdiction regarding property rights and contract disputes, and it alerted the Legislature to consider these limitations in any new legislation. In particular, the Commission staff believes it would need specific legislative authority to determine issues regarding physical space requirements, the reasonableness of access decisions, the costs of access, and related issues. Furthermore, Commission staff recommends that any grant of authority should define the threshold for initiating an action for access and the appropriate standards of review. In this regard, Commission staff proposes the following guidelines:

(1) Tenants, landlords, and telecommunications providers should make every reasonable effort to negotiate access to a tenant requesting service.

(2) A landlord may charge a utility or tenant the reasonable and nondiscriminatory costs of installation, easements, or other costs related to providing service to the tenant.

(3) The tenant should be responsible for obtaining all necessary easements.

(4) A landlord may impose conditions reasonably necessary for the safety, security, and aesthetics of the property.

(5) A landlord may not deny access to space or conduit, previously dedicated to public service, if that space or conduit is sufficient to accommodate the facilities needed for access.

(6) A landlord may deny access where the space or conduit required for installation is not sufficient to accommodate the request or where the installation would harm the aesthetics of the building.

(7) A landlord may not charge a fee for the privilege to do business with an MTE.

RECOMMENDATIONS

Coincident with the writing of this report, the Public Service Commission is holding hearings on and making significant changes to the proposed findings and recommendations contained in its staffs' draft reports. Therefore this Interim Project Report cannot summarize the final reports, which the Commission will file with the President of the Florida Senate and the Speaker of the House of Representatives by February 15, 1999. It is recommended that these final reports be reviewed upon receipt and that any responsive legislation which may be appropriate to promote competition be considered.

COMMITTEE(S) INVOLVED IN REPORT ***(Contact first committee for more information.)***
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MEMBER OVERSIGHT
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