

Back to [Telecommunications Utility Page](#)

## **The State of the Telecommunications Industry in Utah**

### **Second Annual Report to the Governor, Legislature, the Public Utilities and Technology Interim Committee, and Information Technology Commission**

by

**The Public Service Commission of Utah**

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#### **Table of Contents**

**Introduction 1**

**Commission Responsibilities Under The 1995 State and 1996 Federal Acts 2**

**Commission Efforts to Further Competition in Utah 5**

**Establish Rules Governing Competitive Entry 5**

**Certify Competitors. 5**

**Arbitrate and Approve Interconnection Agreements. 5**

**Establish Unbundled Network Element Costs and Prices. 6**

**Determine Wholesale Discounts for Retail Services. 8**

**Establish Terms and Conditions for Collocation. 8**

**Support Broadband Deployment in Utah. 9**

**Institute the New Universal Service Fund Required by State and Federal Law 9**

**Adopt Carrier-to-Carrier and End-User Service Quality Rules. 9**

**Establish IntraLATA Long Distance Competition and 1+ Equal Access Dialing 10**

**Implement Local Number Portability. 10**

**Permission for an Incumbent to Provide Interstate Long-Distance Service. 11**

**Other Representative Dockets. 11**

**1. US West Long-Distance Service Deregulation. 11**

**2. US West Directory Assistance Services Deregulation. 12**

**3. Wireless Competition. 12**

**Utah's Local Service Market is Not Yet Competitive 12**

**Table 1. Local Telecommunication Companies, Including Resellers, in Utah - Local Service 13**

**Table 2. US West 14**

**Table 3. Other Incumbent Local Exchange Carriers 15**

i

**Table 4. Competitive Providers of Local Service 15**

**Table 5. Competitive Local Exchange Carriers' Intrastate Revenue, Fiscal Year 16**

**Table 6: Effective Firms for the U S West Service Territory 1998 and 1999 17**

**Reasons Why the Transition to Competition is Slower Than Expected 18**

**Competition in the Near Future in Utah 19**

**Policy Recommendations and Conclusions 20**

ii

**Annual Report to the Governor, Legislature, the Public Utility and Technology Interim Committee, and the Information Technology Commission**

**The Status of Telecommunications Competition in Utah**

**Introduction**

In 1995, the Utah State Legislature passed H.B. 364, the Telecommunications Reform Act ("1995 State Act" or "State Act"), which requires the Utah Public Service Commission to prepare a biannual (amended to annual in 1999) report on the Utah telecommunications industry. UCA §54-8b-2.5 states:

Beginning October 15, 1998, and annually thereafter, the commission shall submit a report to the governor, Legislature, the Public Utilities and Technology Interim Committee, and Information Technology Commission on the state of the telecommunications industry and make recommendations for any regulatory changes necessary to achieve the policy of the state as set forth in Section 54-8b-1.1. The commission shall determine criteria to be used to evaluate the performance of price regulation and the information necessary to conduct the evaluation.

This second annual report evaluates telecommunications competition in Utah. We examine factors that enhance or inhibit the spread of competition, and provide an update on our efforts to promote competition. As technology, economics, and state and federal policy drive changes in the industry, the pertinent question is whether telecommunications competition is meaningful yet - are Utah customers paying less for service of equal quality? Based on data cited in this report, there have been competitive inroads this year compared to last year. New entrants in the market are providing service to approximately 48,000 telephone access lines today compared to 18,000 reported in our first annual report. Like last year, however, competitors are serving principally business customers. With the exception of one central office in Logan, all of the competitive activity for local service is occurring along the Wasatch Front.

The report has six sections. The first is an overview of Commission responsibilities under the 1995 State Act and the Federal Telecommunications Act of 1996 (1996 Federal Act). The second reviews Commission efforts to further competition in Utah. The next three sections assess the current state of competition in the telecommunications industry. Last are our recommendations to meet legislative policy declarations (UCA §54-8b-1.1).

## Commission Responsibilities Under The 1995 State and 1996 Federal Acts

The intent of these Acts is to develop a telecommunications industry for which the prices, terms and conditions of local service are established in the market by competition rather than by state and federal economic regulation.

Under terms of the 1995 State Act, services provided by US West Communication, Inc., a regulated public utility and incumbent local exchange carrier, are subject to a price ceiling which ends December 4, 2000. This date is three years after the Commission issued its Report and Order ending the last US West general rate case permitted by this statute. With that rate case, rate-of-return regulation of US West ended.

When the price ceiling expires, and until the transition to competition is complete, the form of regulation that will apply to US West is an indexed price cap regime, or, as it is generally called, price regulation.<sup>(1)</sup> This too is required by the 1995 State Act. Price regulation is intended to provide the Company greater flexibility in an evolving competitive market and to protect its "captive" customers - those for whom service providers other than US West do not yet exist.

From the point of view of promoting competition, the advantage of the indexed price cap regime is that it ties service prices to industry rather than company input prices and productivity. Efficient companies will retain a larger percentage of revenues as profits. Inefficient companies will either face losses or survive on lower profits. The prices customers pay, however, will be tied to costs an average firm would incur to provide service. In this way, the link in rate-of-return regulation between a company's historic (embedded) costs and the prices of its services is broken. Price regulation provides incentives for efficient company operation; it also protects customers from unjustified price increases.

In contrast to rate-of-return regulation, price regulation does not guarantee recovery of investment or any other cost of providing service. When competitors make inroads into a public utility's formerly protected market, exposing it to the prospect of losses, customers are protected. They are not required to make the company whole as they would be under rate-of-return regulation. On the other hand, price regulation gives the Company greater flexibility to compete for business. These tradeoffs explain why in theory price regulation is the preferred form of regulation for the transition from regulation to competition. The Commission is now formulating a price regulation plan.

The 1996 Federal Act promotes competition in the local exchange service market. The Act expresses Congress's intent to replace economic regulation with market competition as the means by which consumer interests in telecommunications markets will be protected. To achieve this goal, the Act removes legal, regulatory, and economic barriers to market entry, encourages technological development, promotes a regulatory environment in which a telecommunications provider's success or failure is tied to customer satisfaction, and opens an incumbent's network to competitors.

New developments stemming from the 1996 Federal Act, particularly actions in the courts, are affecting the extent and slowing the pace of the transition to competition in Utah.

Chief among these actions is the suit brought by the Iowa Utilities Board in the Eighth Circuit Court of Appeals which sought to overturn new Federal Communications Commission (FCC) rules implementing the 1996 Federal Act. Parties argued that the FCC had overstepped its authority, intruded upon state authority, and imposed a process and requirements which would impede the transition to competition. In its July 18, 1997 decision, the Eighth Circuit Court largely agreed. A successful appeal to the United States Supreme Court (*AT&T v. Iowa Utilities Board*), however, resulted in that Court's Order of January 25, 1999, overturning all but one Circuit Court decision. In essence, the FCC rules were reinstated.

These rules describe three ways a competitor can provide service using an incumbent local exchange carrier's network (US West is an incumbent carrier). A competitor can lease the portions of an incumbent's network it needs to provide service; it can interconnect its own facilities with the incumbent's; and it can purchase an incumbent's retail services at wholesale for resale under its own brand name. Rules setting this scheme forward in detail were the subject of the Circuit Court challenge.

The rules require an incumbent to make specific elements of its network (called "unbundled network elements" or "UNEs") available for lease by competitors at prices determined by state commissions. Elements are either physical components of the network or functions of it that are the product of computer software. An incumbent must make these elements available whether a competitor has facilities of its own or not, and must not artificially separate combined elements before leasing them. Incumbents are required to offer retail services at wholesale to competitors, who can resell them under their own brand name. Unbundled network element and wholesale prices are set by state public service commissions.

State commissions arbitrate and approve all interconnection agreements. Each potential competitor must have an interconnection agreement with the incumbent. The agreements set terms for all interactions, including prices and how the network may be used, between the competitor and the incumbent. An FCC rule allows a competitor to "pick and choose" elements of previously approved interconnection agreements that are favorable to it, incorporating them into its own agreement. Finally, the FCC rules require prices for network elements that are based not on an incumbent's historical, embedded network costs, but on a hypothetical construct known as "forward-looking economic," or "total element, long-run incremental" costs. Adoption of models to estimate such costs is a state commission responsibility.

The 1995 State Act had already required that competitors be allowed to interconnect their networks one to another. The Act also mandated movement toward service prices based on "total service, long-run incremental costs." Total element, long-run incremental costs are a variant which shares the preferred use of forward-looking, economic, rather than historical, costs.

The Commission pursued these responsibilities in Docket No. 94-999-01 as well as in interconnection arbitration proceedings. Thus far, orders have been issued which establish wholesale prices, and, in spite of the lack of an acceptable forward-looking, economic cost estimation model, have set prices for certain unbundled network elements. We will review those prices again when the cost modelers refine and improve the models. Notable among the unbundled elements is the price for the local loop, the line connecting a household or business to the local office where the switching of calls takes place. Access to the local loop is required for the competitor to provide service. Duplication of these lines is usually too expensive for a competitor to undertake, and if done would disrupt public roads and infrastructure. As the discussion in the next section makes clear, other aspects of Docket No. 94-999-01 are pending.

### **Commission Efforts to Further Competition in Utah**

The preceding section indicates the scope of the Utah Commission's responsibilities under the 1995 State and the 1996 Federal Acts. We are required to establish a framework within which the local service market can evolve from regulated to competitive supply. Our efforts can be presented in categories. Each is briefly discussed below.

**Establish Rules Governing Competitive Entry.** To provide local service in Utah, a competitor must obtain a Certificate of Public Convenience and Necessity from the Commission. Procedures and rules for certification are in place.

**Certify Competitors.** Seventy companies have applied to the Commission for certificates. Forty-one have been approved.<sup>(2)</sup> Denials of certificate applications have largely occurred because applicants fail to produce information needed to establish, through investigation by the Utah Division of Public Utilities (Division), the applicant's intent and competence. Some companies have submitted generic applications intended to fulfill requirements of several states at once. These often do not contain information required here, making it impossible to determine the applicant's qualifications. Applicants (or their parent companies) which show a negative net worth on financial statements are also denied certification.

The average time for an applicant to complete the certification process is now approximately three months, down from the eight months required to examine and approve the first certificate application.

**Arbitrate and Approve Interconnection Agreements.** Under the 1995 State Act, the Commission is to resolve

interconnection disputes between companies. Under the 1996 Federal Act, a company intending to compete with an incumbent local exchange carrier must enter into an interconnection agreement with the incumbent. Unless the agreement is successfully negotiated between the two, Commission mediation or arbitration is required. In either case, the Commission ultimately must approve the agreement in accordance with Section 252 of the 1996 Federal Act.

To date, 52 interconnection agreements have been filed with the Commission. Thirty-two have been approved.<sup>(3)</sup> The Commission will not approve an interconnection agreement between an incumbent such as US West and a competitive company unless the company has a certificate of public convenience and necessity.

With the first interconnection agreements, the Commission had to arbitrate virtually every issue, including the technical details of interconnecting network facilities and service quality requirements, because the parties reached a complete stalemate. These included agreements between US West and AT&T of the Mountain States (AT&T), Sprint Communications Co., MCImetro, and Nextlink. All except Nextlink's second agreement (approved in early 1999) were approved in 1996 and 1997. Since then, most agreements have not required Commission arbitration.

**Establish Unbundled Network Element Costs and Prices.** The Commission first had to resolve what unbundled network elements must be available for purchase. Though that was difficult, we have found even more arduous and complex the determination of the costs and prices for the unbundled network elements that competitors must purchase from US West in order to provide service to their customers. In protracted proceedings, the expert testimony of contending parties is often widely at variance. We are observing the results in administrative hearings of the contending business strategies of the incumbent and competitive carriers.

The major difficulty arises from the FCC requirement under the 1996 Federal Acts to use total service (or element) long-run incremental costs, rather than the incumbent's historical, accounting costs to set the network element prices.<sup>(4)</sup> These costs are intended to be the forward looking, economic costs (the least cost) of a hypothetical telecommunication network; in concept, the appropriate costs for a competitive market. Because they are not found on the books of any firm, they must be estimated by what is termed a "cost proxy model." After such costs are estimated in a manner and with a result the Commission finds acceptable, they must be used to set prices. That process has a tremendous impact on competition. If the Commission sets the prices too low, competitors have little incentive to build physical facilities. Building physical facilities takes time which can slow competition, but once in, physical facilities can enhance competition by extending network capacity in the state and serving as an alternative to the incumbent's network. On the other hand, if the prices are too high, competitors will not enter the market.

On June 2, 1999, the Commission issued an order in Docket No. 94-999-01 which established forward-looking economic costs and prices for certain unbundled network elements. Since the costs of unbundled network elements are derived from a hypothetical, rather than the incumbent's actual network, competitors can lease unbundled network elements at prices approximating the cost of new facilities in an optimal network. This is calculated to promote efficient competitive entry.

Two cost proxy models, one sponsored by AT&T and the other by US West, were analyzed in the proceedings, but the record was insufficient to allow the Commission to adopt either one. The two presented in the Docket are in an unacceptable state of development. The cost estimates they produce are not reliable. The Commission did determine to make limited use of them, however, as the basis for a range of cost estimates. From the range, we determined reasonable, forward-looking economic costs on which we based prices for the unbundled local loop and other network elements.

The Division has investigated the cost proxy models extensively. On the basis of this work and the guidelines previously established by the Commission, we expect further progress, but to date, there is still no reliable model. The FCC has issued a cost proxy model of its own for use in developing the costs of local basic service for the Universal Service Fund. The Division is evaluating this model for possible application here. If found acceptable in future proceedings, the model may be used or modified to estimate the costs of both unbundled network elements and local basic service.

**Determine Wholesale Discounts for Retail Services.** The 1996 Federal Act and implementing FCC rules require the Commission to establish wholesale prices for US West retail services that may be purchased by competitors for resale.

Wholesale prices are derived by discounting retail prices for the removal of retail costs that would be avoided if services were instead provided at wholesale. These costs include marketing, sales, billing, collections, and other general support expenses. Based on studies the Division performed, the Commission adopted interim wholesale discounts in December 1996.

Interim discounts that parties adopted in interconnection agreements were replaced by permanent discounts set in Commission orders issued October 24, 1997, and February 13, 1998, in Docket No. 94-999-01. In a petition that is currently pending before the Commission, the Division argues that based on more recent evidence, additional increases in discount levels are justified.

**Establish Terms and Conditions for Collocation.** The 1996 Federal Act requires incumbent firms to allow competitors to place equipment (to "collocate" it) in the incumbent's central office. In Utah, competitors have installed equipment at 99 collocation sites in 24 US West central offices.<sup>(5)</sup>

The Commission took up the general collocation issues in Docket No. 94-999-01. These proved both sensitive and contentious. Controversy may subside, however, with the publication on March 31, 1999, of new FCC rules requiring incumbents to make collocation arrangements available to requesting carriers.

These rules require an incumbent to permit a competitor to collocate any equipment the competitor deems necessary either for interconnection or access to unbundled network elements. An incumbent no longer may limit a competitor's use of the incumbent's network equipment, features, and functions. Competing carriers may also interconnect at the same premises with equipment needed to access the incumbent's unbundled network elements. This can be done without the necessity, formerly imposed, of constructing expensive cages to separate and house equipment. In essence, the FCC rules intend an efficient and effective collocation process. This Commission supports the FCC rules.

**Support Broadband Deployment in Utah.** The 1996 Federal Act is intended to stimulate telecommunications innovation and investment. Likewise, a Utah policy goal expressed by the current administration is extension of advanced services capability to all Utahns.

One recent study shows that in response to public demand telecommunications carriers in Utah are beginning to develop networks capable of providing advanced services. Incumbents and competitors are developing and deploying new technologies for high-speed, high capacity services. Because the required investment is of significant magnitude, it is being placed strategically. Incumbent firms serving rural Utah now have networks capable of broadband services, though today such service is mainly provided to schools and libraries. In Utah, households and businesses, with few exceptions, have access to the Internet.

**Institute the New Universal Service Fund Required by State and Federal Law.** The fund formerly in place here in Utah (UCA §54-8b-12) has been replaced. The Commission has rules in place to govern the new Fund (UCA §54-8b-15), but we anticipate that these rules will be amended before the end of 1999.

In addition to operating procedures, the Commission must determine an appropriate cost model for today's emerging competitive markets. The cost estimate for local basic telephone service is needed to set the amount of Universal Service Fund (USF) support for telephone companies serving in high cost areas of the state. State and federal progress toward adoption of a capable cost proxy model, however, has been much slower than expected. A cost proxy model must be capable of estimating basic service costs for less densely populated areas in a service territory. Until such a model has been adopted, US West will not qualify for USF support in such areas. By statute we are to ensure that rural service prices for basic local telephone service remain reasonably comparable to the prices paid for that service in urban Utah. The support must be competitively neutral among all telecommunication service providers.

**Adopt Carrier-to-Carrier and End-User Service Quality Rules.** Carrier-to-Carrier rules (R746-365) became effective April 1, 1999. These are rules governing the service quality one carrier must provide another, and are therefore an integral part of interconnection agreements. US West took issue with the rules and appealed them to the Utah State Supreme Court and to the Federal District Court for Utah.

The Division is drafting end-user quality of service rules for consideration in Commission rulemaking proceedings.



End-user rules differ from carrier-to-carrier rules in that they govern aspects of service quality for customers other than carriers. The proposed rules would establish minimum standards for such things as service installation, repair, billing, and transmission quality.

**Establish IntraLATA Long Distance Competition and 1+ Equal Access Dialing.** US West's share of the retail intrastate long-distance market in its service territory had declined to 61.2 percent in 1997. The Division estimates that US West provided more than 45 percent of the wholesale local exchange switched access service competing long-distance carriers require to complete calls in that year. This means that US West billed customers or competing companies for 78 percent of all intrastate long distance calls in 1997.

Reports in 1998 and first quarter 1999 indicate a continued decline in retail market share but an increase in wholesale market share. The later reports reflect the effects of the July 1998 US West 1+ equal access conversion. Equal access permits customers to choose a primary 1+ long distance company for IntraLATA long-distance calling. "IntraLATA" refers to telecommunications services that originate and terminate in the same "Local Access and Transport Area" (LATA). With two small border exceptions, a single LATA covers the State of Utah.

Little competition for IntraLATA long-distance service now exists in the rural areas of Utah served by incumbent local exchange companies other than US West. These rural companies continue to provide 87 percent, and in some cases more, of the IntraLATA long distance calls in their service territories. Citizens Telecommunications, which serves about 22,500 customer lines in several Utah counties, faces the most long distance competition. Citizens was the first local exchange company in Utah to provide 1+ equal access dialing (August 1997). Of the other 11 incumbent rural local exchange companies, nine now provide 1+ equal access for competing carriers. One more will do so in November 1999, and one has an exemption until it must replace its local switching equipment.

**Implement Local Number Portability.** Local number portability permits a customer to change companies but keep the same telephone number. Permanent Local Number Portability began October 12, 1998, in designated Utah wire centers. Competitors participated in the selection of these wire centers. Currently, 30,481 numbers are ported from US West to competing companies.

**Permission for an Incumbent to Provide Interstate Long-Distance Service.** Section 271 of the 1996 Federal Act requires an incumbent telephone company to pass a 14-point test proving that its local service territory is open to competition before it can offer interstate long-distance service to customers there. In Utah, this section applies to US West only.

Though the FCC makes the determination, it must consult with the state commission before reaching its decision.

US West has filed Section 271 petitions in some of the states in which it serves, but not yet in Utah. Across the nation, incumbents have experienced difficulty in obtaining Section 271 approval. Though a few states attest that their incumbent firms meet the 14-point checklist, the FCC has not concurred. In the 14-state US West service territory, only Nebraska has ruled on a US West application, finding that the Company fails to comply with five of the 14 checklist items.

### **Other Representative Dockets.**

1. US West Long-Distance Service Deregulation. Based on its view of intrastate long-distance (toll) service competition, on August 14, 1998, US West applied to the Commission to deregulate long-distance services. The petition faced substantial opposition from the Division and the Committee of Consumer Services, and from competing toll providers. These parties argued that deregulation would permit US West to lower retail service prices relative to the wholesale price of the switched access services competitors must purchase from it. The result would be an anti-competitive price squeeze. The Division opposed deregulation on grounds that US West enjoys an inherent competitive advantage in its near monopoly of residential local basic exchange service.

In the end, all parties reached a stipulation allowing US West to flexibly price long distance service, but the prices cannot exceed current levels until December 4, 2000, the end of the price ceiling established by the 1995 State Act (UCA §54-8b-2.4). The Commission approved the stipulation in January 1999. In consequence, US West now faces

relaxed filing requirements for long-distance service prices, bringing it to regulatory parity with competitors.

2. US West Directory Assistance Services Deregulation. On March 12, 1999, US West petitioned the Commission to deregulate Directory Assistance Services. The Division, several competitors, and others, opposed the petition on grounds that competitive providers of directory assistance services have pricing flexibility but are not deregulated. In addition, parties argued that many residential customers lack access to competitive directory assistance alternatives.

Extensive negotiations between the parties led to a stipulation which was presented to the Commission on May 14, 1999. The stipulation contemplates regulatory parity by allowing US West pricing flexibility for, but not deregulation of, these services. Hearings were held May 25, 1999. The Commission approved the stipulation in October 1999.

3. Wireless Competition. Wireless telecommunications technology is evolving rapidly and use of both cellular telephones and digital personal communications systems (PCS) is growing. Subscribership in Utah now amounts to nearly a third the number of conventional wireline subscribers. Wireless transmission, in spite of slow data transmission, is also growing, and is being used by competitors on occasion as a substitute for the incumbent's local loop (the "last mile connection"). Nevertheless, wireless service remains a supplement to, not a substitute for, traditional wireline service.

The FCC regulates the wireless spectrum. Neither the prices nor the profits of wireless telephony providers are regulated by the State.

One wireless company, however, has recently filed an application with the Utah Commission for eligibility to obtain universal service funding from the state and federal funds to support a local basic service offering in rural areas. The case will establish precedent. The application is pending before the Commission. The legal issues were heard October 25, 1999.

### **Utah's Local Service Market is Not Yet Competitive**

Real competition requires a relationship between incumbent firms and competitors which permits timely and effective network interconnection, purchase of unbundled network elements, and resale of the incumbent's services under the competitor's brand name. Conflicting business strategies and litigation have slowed the pace.

Though the Commission has granted certificates to 41 competitors and 32 have interconnection agreements, only six report providing local service. These operate in US West's service territory. Two competitors, Reconex and Tel-link of Utah, serve customers solely by reselling US West services. AT&T, Electric Lightwave (ELI), Nextlink and Brooks Fiber Communications of Utah (MCI/WorldCom), provide local service using their own facilities in combination with unbundled network elements purchased from US West.

Competition continues to center on business customers in metropolitan areas in Salt Lake, Davis, Utah and Weber Counties - a total of 46,975 business local access lines, up nearly 29,000 lines from the 18,000 we reported last year. By comparison, US West serves 334,729 business lines, 86% of the business market in its service territory.

While competition for local business service increases, there is little sign yet of substantial competition for local residential service. As of September 1, 1999, US West serves 763,238 residential access lines (See Table 2); competitors serve 826 - solely through resale of US West service.

Utah is served by 12 other incumbent local exchange carriers in addition to US West. These rural companies serve a total of 57,225 access lines (Table 3). To date, there is no competition for local service in the territories of the other 12 incumbent providers.

**Table 1. Local Telecommunication Companies, Including Resellers, in Utah - Local Service**

| Companies Providing Service | Competitors Present |
|-----------------------------|---------------------|
|                             |                     |



| County     | Incumbent Wireline Providers                     | Competitive Providers                                | Business | Residential |
|------------|--|--|----------|-------------|
| Beaver     | USWC, South Central Utah                         | Reconex  | No       | Yes, resale |
| Box Elder  | Albion, Beehive, Citizens, USWC                  | Tel-Link   | No       | Yes, resale |
| Cache      | Bear Lake, USWC                                  | Reconex  | No       | Yes, resale |
| Carbon     | Central Utah                                     | Reconex  | No       | Yes, resale |
| Daggett    | Union Tel.                                       | Reconex  | No       | Yes, resale |
| Davis      | USWC   | AT&T, Nextlink, Tel-Link, Reconex                    | Yes      | Yes, resale |
| Duchesne   | Uintah Basin, USWC                               |  | No       | No          |
| Emery      | Emery  |  | No       | No          |
| Garfield   | Beehive, Citizens, South Central Utah            |  | No       | No          |
| Grand      | Citizens, Emery                                  |  | No       | No          |
| Iron       | Beehive, South Central Utah, USWC                | Reconex  | No       | Yes, resale |
| Juab       | Beehive, Skyline, USWC                           |  | No       | No          |
| Kane       | Beehive, South Central Utah, USWC                |  | No       | No          |
| Millard    | Beehive, Citizens, USWC                          |  | No       | No          |
| Morgan     | USWC   | Reconex  | No       | Yes, resale |
| Piute      | South Central Utah                               |  | No       | No          |
| Rich       | All West Comm., Bear Lake, USWC                  |  | No       | No          |
| Salt Lake  | USWC   | AT&T, ELI, Nextlink, Tel-Link, Brooks Fiber, Reconex | Yes      | Yes, resale |
| San Juan   | Navajo, Citizens, CenturyTel                     |  | No       | No          |
| Sanpete    | Central Utah, Skyline, Manti, Gunnison, USWC     | Reconex  | No       | Yes, resale |
| Sevier     | South Central Utah, USWC                         | Reconex  | No       | Yes, resale |
| Summit     | All West, Union Tel., USWC                       | AT&T, Reconex  | Yes      | Yes, resale |
| Tooele     | Beehive, USWC                                    | Reconex  |          | Yes, resale |
| Uintah     | Uintah Basin, USWC                               | Reconex  | No       | Yes, resale |
| Utah       | Central Utah, Skyline, USWC                      | AT&T, ELI, Nextlink, Tel-Link, Reconex               | Yes      | Yes, resale |
| Wasatch    | All West Comm., Central Utah, Uintah Basin, USWC | Reconex  | No       | Yes, resale |
| Washington | South Central Utah, USWC                         |  | No       | No          |
| Wayne      | Beehive, South Central Utah, USWC                |  | No       | No          |
| Weber      | USWC   | ELI, Nextlink, Reconex, Tel-Link                     | Yes      | Yes, resale |

**Table 2. US West**

|  | 1998          | 1999          |
|--|---------------|---------------|
| Number of Local Access Lines Served (As of September)                | 1,072,051     | 1,108,650     |
| Residential  | 717,202       | 763,238       |
| Business   | 344,128       | 334,729       |
| Other  | 10,721        | 10,683        |
| Annual 1999 Utah Revenue (Estimated based on Figures as of April 30) | \$481,673,444 | \$497,995,287 |

**Table 3. Other Incumbent Local Exchange Carriers**

|  | 1998         | 1999         |
|--|--------------|--------------|
| Number of Local Access Lines Served (as of May 1)                        | 52,478       | 57,225       |
| Residential  | 37,220       | 41,249       |
| Business   | 13,119       | 15,032       |
| Other  | 2,139        | 944          |
| Utah 1999 Operating Revenue (Estimated based on YTD figures as of May 1) | \$54,889,447 | \$59,772,618 |

|   |             |              |
|---|-------------|--------------|
| Utah Basic Local Service Revenue (Estimated based on YTD figures as of May 1) | \$9,522,682 | \$11,603,871 |
|---|-------------|--------------|

**Table 4. Competitive Providers of Local Service**

|   | 1998          | 1999         |
|---|---------------|--------------|
| Approximate Number of Local Access Lines Served (as of Sept. 1)                       | 18,000        | 47,859       |
| Residential   | 0-200         | 826          |
| Business  | 17,800-18,000 | 46,975       |
| Other   | 0             | 58           |
| Utah 1999 Fiscal Year Revenue (Based on YTD figures as of May - See below for detail) | \$29,696,038  | \$49,512,661 |

**Table 5. Competitive Local Exchange Carriers' Intrastate Revenue, Fiscal Year<sup>(6)</sup>**

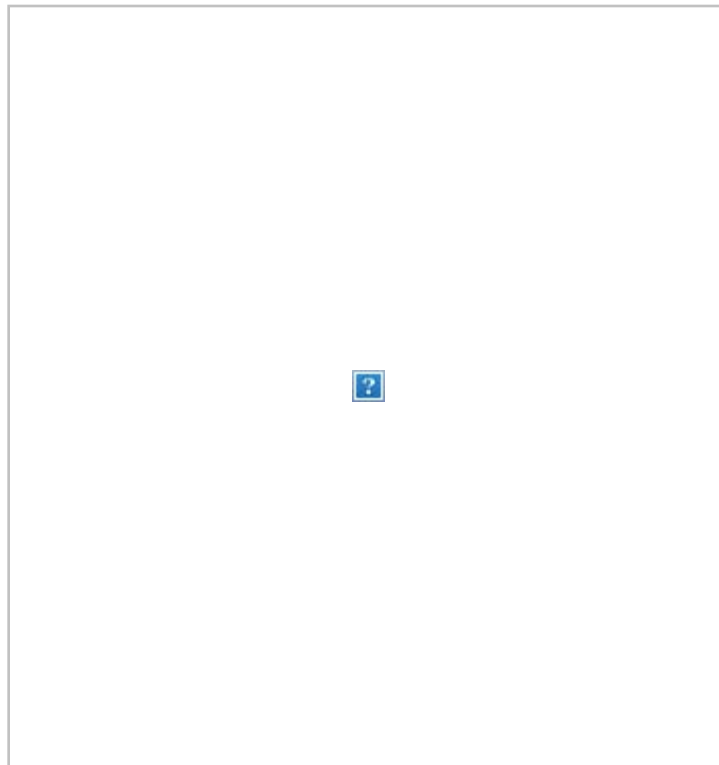
| Category of Revenue                                       | 1997/1998    | 1998/1999    |
|---|--------------|--------------|
| Residential Local Exchange                                | \$0          | \$688,458    |
| Business Local Exchange                                   | \$3,686,570  | \$14,805,728 |
| Vertical Services   | \$258,565    | \$216,156    |
| Private Line and Special Access - Local and Interexchange | \$4,164,714  | \$5,487,784  |
| Network Interexchange                                     |              |              |
| Switched Access   | \$760,345    | \$1,697,310  |
| Toll  | \$20,385,435 | \$25,643,442 |
| Other   | \$440,409    | \$973,758    |
| Total   | \$29,696,038 | \$49,512,661 |

Our first annual report introduced an objective economic measurement, the Herfindahl Index, to test the competitiveness of Utah telecommunications markets. This Index has a value one when a single firm serves the entire market (monopoly). It moves toward zero (full competition) as competition increases.

The Herfindahl Index for local service in US West's Utah service territory is 0.919, an improvement, from the standpoint of competition, from last year's 0.967. For local business service, in which some competitive activity is occurring, the Index stands at 0.775 compared to last year's 0.904. The Index value for the residential service market is 0.998, essentially unchanged from last year. This result reflects an increase in residential lines resold by competitive local exchange carriers that was more than outweighed by growth in the number of residential lines served by US West in its service territory.

A second measure, the Effective Firm Index (the inverse of the Herfindahl Index) also shows the lack of effective competition in the market. In US West's Utah territory, the Index value is 1.087. This means that only one-twelfth of an effective competitor is present. The business sector effective firm index is 1.291; about one quarter to one third of an effective competitor is present. Table 6 below summarizes these results.

**Table 6: Effective Firms for the U S West Service Territory 1998 and 1999**



In our opinion, competition in the Utah local service market is not effective. This market remains under the control of one firm.

In the absence of effective competition, price regulation, as contemplated in the 1995 State Act, is necessary not only to protect customers who lack alternative service providers from which to choose, but to ensure efficient and effective competitive entry.

### **Reasons Why the Transition to Competition is Slower Than Expected**

When the 1995 State and 1996 Federal Acts became law, the expectation was that competition would begin quickly. That expectation has proven to be wrong. It has taken time for new entrants to open offices in Utah, hire employees, and build and place their facilities and equipment to begin serving customers. In addition, the two Acts contemplated that the entrants would rely on the incumbent telephone company's network to reach their customers because duplicating the entire system would be too expensive and unacceptably slow. Establishing the rules under which new entrants can access the incumbent's network has been very difficult and time consuming. The Commission has had to examine the above-noted cost studies in formal and informal proceedings to lay the groundwork for prices of unbundled parts of the incumbent's network.

Apart from the cost models being too theoretical and unreliable, the task of setting the compensation for the incumbent and the competitors has been complicated further by conflicting business strategies. Where the incumbent seeks to maximize the prices it obtains from its competitors, competitors in turn seek prices low enough to enable profitable entry into the local market. That is reflected in the cost modeling the parties do in Utah and throughout the nation causing incessant argument and continuous model refinement. As a result, the time required in hearings has been much longer than it would have been had the data been reliable and the Commission has been left to make decisions with unsatisfactory evidence. We still have not adopted a cost proxy model because we are not satisfied that any of them accurately or fairly reflect the incumbent's forward-looking costs.

Conflicting business strategies and the change in public policy that occurred in 1995 and 1996 have also resulted in a significant litigation. Most of the substantive decisions the Commission has rendered concerning interconnection or unbundled element pricing are on appeal to the federal district court for Utah or the Utah State Supreme Court.

The laws and rules for rate of return regulation developed over many years based on precedents set by regulatory agencies and courts. The new laws set new policy that relies on competitive markets rather than regulation to set prices for customers' local telephone service. The extent and application of the laws have no precedent because they have not been tested. For that reason, much of the current litigation in state and federal court was inevitable, but it has substantially slowed competition. Until the affected parties know the outcome of their cases, it is difficult to forge ahead and commit limited capital resources that would help expand competitive choice in the Utah local telephone service market. Any new laws that Congress or the Legislature passes will invariably lead to additional new litigation.

### **Competition in the Near Future in Utah**

Competition has begun to take hold in Utah and the prospects for the future are bright. Based on the central offices where competitors have collocated with US West, competitors could reach over 80 percent of US West's business customers and 75 percent of their residential customers. None of the new entrants, however, have devoted the resources yet to actually begin serving all of those customers.

AT&T began a trial in October using the TCI cable network to serve some of their employees along the Wasatch Front. If the trial is successful, AT&T may begin serving residential customers within the next year or two. AT&T has already begun deploying high-speed cable modem service to communities along the Wasatch Front. That, plus US West's and other competitors' DSL offerings, promise broadband service for many Utahns.

Wireless telephone service is another factor that could affect competition in Utah. Wireless service is still an imperfect substitute for traditional wireline service. Though the price for wireless has come down considerably, it is still a more expensive service. In addition, wireless data transmission is limited. Nevertheless, it has penetrated a large sector of Utah's market as a supplement to traditional wireline service. Actions by wireless service companies to enter the local service market may prove to be a turning point by giving new definition to the meaning of local basic telephone service. Wireless service could ultimately become a viable alternative to wireline service, particularly in rural Utah.

We may see additional progress when US West seeks authority under Section 271 of the Federal Act to enter the interstate long distance market. The Company will have to show, first this Commission and then the FCC that it has completely opened its local service market to competition. The United States Department of Justice and the FCC scrutinize those applications to ensure that no impediments to competition exist. To date, no Bell Operating Company has been given interstate authority.

Finally, the Commission intends to continue working this year on the development of a legitimate cost proxy model for unbundled network elements. The result should be greater certainty in the marketplace. That, together with similar work occurring at the FCC, should help hasten the pace of competition in Utah.

### **Policy Recommendations and Conclusions**

The only recommendation we offer in this report is that the Legislature should make no substantive changes to the 1995 State Act in the 2000 General Session. While the road to competitive local telephone service has been arduous and slower than expected, the clear message of this report is that the Act has begun to work. The proof of that is the progress we have seen over the last year. In our 1998 presentation we reported that 26 companies had certificates to compete in Utah. The comparable number today is 41. Of the 26 companies with certificates in 1998, only ten had approved interconnection agreements. Today, 32 of the 41 certificated companies have approved interconnection agreements which demonstrates a growing interest to begin competing in the state. Customer access lines served by competitors have increased 167 percent from 18,000 in 1998 to 48,000 in 1999. Despite the increase in the competitors' market share, US West's revenues will have increased \$16 million in Utah in 1999 over 1998.<sup>(7)</sup> That is important because it shows that the telecommunications market is expanding and both US West's and the competitors' revenues are growing.

Changing the law now will harm competition. Many of the foundational rules to implement the 1995 State Act are now in place. That is one of the reasons for the increase in the competitors' market share this year. Altering the law will slow that growth because there will be no implementation rules in place and litigation will ensue to test the extent and application of the new law.

Eliminating UCA §54-8b-2.4 (5) (a) and (b)<sup>(8)</sup>, the price index section, as US West suggests, would leave exposed customers in areas where there is no competitive choice when the price ceiling terminates at the end of 2000. That will remove the only protection left for those customers. The 1995 Act already contemplates that the price index section will not apply where there is competition. There is no reason therefore to change the law now. Additionally, the 1995 Act allows the incumbent provider to price its services flexibly after competitors have entered and begun providing the service. That is exactly how competitors price their services today; in other words, the incumbent has parity with the competitors. The only difference is that the incumbent must show that it has allowed competitors to interconnect with its network. Eliminating the showing required by UCA §54-8b-2.3 (2) (b) (iii) and simply giving the incumbent the power to price services flexibly by statute will remove that essential incentive to open networks and further competition. That action may also leave customers with price listed services who actually have no choice in service providers. Collocation in a US West central office does not guarantee that the competitor is serving the entire area served by that central office. The incumbent could increase those customers' prices and the customers would have no recourse.

To the degree there is sentiment that the telecommunications industry has changed while the 1995 Act has remained static, that is a misperception. First, technology has not overtaken the Act because the Act was progressive and forward looking. Second, the Legislature has reviewed and amended the Act several times since its original passage. In 1997 US West proposed an amendment providing for another rate proceeding to change prices.<sup>(9)</sup> That amendment was never used. US West also asked that five considerations be added to the price index statute in 1997.<sup>(10)</sup> The competitors recommended new language in the interconnection portion of the Act to resolve network blocking and network planning problems they had experienced.<sup>(11)</sup> Finally with respect to 1997, the Division and the Commission asked the Legislature to reform the universal service fund that protects high cost rural service to reflect the new regulatory environment.<sup>(12)</sup> In 1998 the competitors requested that the Legislature add a section to expedite enforcement proceedings in interconnection disputes.<sup>(13)</sup> Every change in the 1995 Act has been endlessly scrutinized and hard fought within the telecommunications industry at the Legislature.<sup>(14)</sup>

The Commission has actively pursued the policy goals set by the Legislature in the 1995 Act. That Act provides for regulatory parity between competitors and the incumbent as competition unfolds. That has already begun to happen. We believe the pace of competition will quicken if the 1995 Act is left in place and allowed to work. Changing the law now will slow that pace, cause new litigation, and have opposite effects than those intended by the Legislature.

1. Price regulation is the dominant form of regulation in the United States today. The District of Columbia and 29 states index prices within their respective jurisdictions. Eleven states continue to regulate on a traditional cost of service, rate of return basis.
2. Ten applications have been denied, 16 are pending, and four have been withdrawn.
3. Thirteen agreements have been denied and seven are pending.
4. The 1995 State Act only requires that total service long run incremental cost be considered in determining the cost of a service. UCA §54-8b-3.3 (1).
5. The central offices where competitors have collocated include: Bountiful, Clearfield, Cottonwood, Draper, Holladay, Kaysville, Kearns, Logan, Midvale, Murray, Ogden Main, Orem, Park City, Provo, Riverton, Salt Lake East, Salt Lake Main, Salt Lake South, Salt Lake West, Lehi, Pleasant Grove, American Fork, Springville, and Spanish Fork. Six of the collocations are for purposes of providing digital subscriber line (DSL) service exclusively, not voice service.
6. The data in Table 5 were reported in competitors' annual reports. 1998 fiscal year data appeared in the 1999 annual report. Where possible, these figures have been updated to show the most current data.

7. See Tables 2 and 4 above.

8. This section was added to the 1995 Act at US West's suggestion. A price ceiling to protect customers in non-competitive areas has been in place since December 4, 1997, the date of the Commission's final US West rate case order. The price index provision does not take effect until the end of 2000 and was intended to protect customers in non-competitive areas after the price ceiling is lifted. Price indexing is the dominant form of regulation in the United States. See footnote 1.

9. UCA §54-8b-2.4 (3)(b).

10. UCA §54-8b-2.4 (5)(b).

11. UCA §54-8b-2.2 (1)(a)(ii), (1)(e), (3)(b)(ii).

12. UCA §54-8b-15.

13. UCA §54-8b-17.

14. There were other attempts to change the 1995 Act but the Legislature did not accept them.

Back to [Telecommunications Utility Page](#)