Approved: JAN. 27, 1999
Date

MINUTES OF THE SENATE UTILITIES COMMITTEE.

The meeting was called to order by Chairperson Sen. Pat Ranson at 1:30 p.m. on January 21, 1999 in Room 531-N of the Capitol.

All members were present except:
Sens. Hensley and Lee were excused.

Committee staff present:
Lynne Holt, Legislative Research Department
Mary Torrence, Revisor of Statutes Office
Jeanne Eudaley, Committee Secretary

Conferees appearing before the committee:
Tom Day, Kansas Corporation Commission
Brian Moline, Kansas Corporation Commissioner

Others attending:
See attached list

Sen. Ranson announced a list of Kansas Corporation Commission staff members (Attachment 1) has been distributed to the committee. She then recognized Tom Day, who presented a request from the Kansas Corporation Commission (Attachment 2) for introduction of proposed legislation. He briefly outlined those to the committee and stated he will work with the Revisor's Office in drafting the bills. Sen. Barone made a motion the committee introduce the bills, and it was seconded by Sen. Clark; and it was approved.

Sen. Ranson called the committees' attention to the Minutes for the January 19 meeting. Sen. Steffes made a motion the Minutes be approved, and it was seconded by Sen. Morris; the Minutes were approved.

Sen. Ranson recognized the three Kansas Corporation Commissioners, and Chairman John Wine and Commissioner Cynthia Claus introduced themselves and gave brief remarks.

Sen. Ranson then introduced Brian Moline, newly appointed Kansas Corporation Commissioner, who presented his personal history and proceeded with a presentation on regulatory history (Attachment 3). Attached to his testimony is information on "The TeleKansas Debate: Incentive Regulation or Deregulation", which he and Mr. Drexel authored.

Sen. Steffes complimented Mr. Moline on his presentation, and they briefly discussed regulators. Sen. Morris asked questions regarding the Texas Railroad Commission and the fact that Texas still has a Railroad Commission as well as a Public Utilities Commission. Other members questioned Mr. Moline regarding regulation and the impact on the economy. Mr. Moline finished his presentation by stating that he believes competition is superior to regulation. He warned that policymakers should be aware of the consequences to those who offer the services and those who use the services.

Meeting adjourned at 2;30.

Next meeting will be January 26.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

SENATE UTILITIES COMMITTEE GUEST LIST

DATE: JAN. 21, 1999

NAME	REPRESENTING
John Pinegar	SITA
Erin Carlson	Representative Holmes
WALKER HENDRIX	CURB
SUSAN DURAN	ISSUES MANAGEMENT GROUP
LARRY HEADLEY	UTILICORP UNITED INC.
Meg McGill	UtiliCorp United Inc
Bud Burke	Western Resources
ED SCHAUB	WESTERN RESOURCES
Whitney Damron	Kansas Gas Service
M LAVIN	SWBT
O. Cleek	SWBT
John Nine	KCC
Jamie Clover Adams	Governor's Office
Jon K Miles	KEC
Diane Gjerstad	Wichita Public Schools
Michelle Peterson	Peterson Public Affairs Group
Ron Hein	Hein + Weir Chtd
Dave Holthaus	Western Resources
Kathy Valentine	SRS
Philip Kaberline	Rep. Holmes

SENATE UTILITIES COMMITTEE GUEST LIST

DATE: JAN. 21, 1999

NAME	REPRESENTING
DICK CARTER	ENRON
Doug Lawrence	KEC
Bob Alderson	Atmos Energy Corp.
Amy A. Campbell	Midwest Energy
Heinemann	KU
Ron Gaches	McGill, Gaches & Asso.
Brian Moline	KCC
Tom Day	KCC

Attach. 1

KANSAS CORPORATION COMMISSION
Key Staff List (01/20/99)

Name	Title	Division	Phone
John Wine	Chair	Administrative Services	271-3350
Brian Moline	Commissioner	Administrative Services	271-3166
Cynthia L. Claus	Commissioner	Administrative Services	271-3350
David Heinemann	Executive Director	Administrative Services	271-3162
Tom Day	Legislative Liaison Information Resource Specialist	Administrative Services	271-3190
Glenda Cafer	General Counsel	Admin. Serv. / Legal	271-3199
Glen Froelich	Asst. General Counsel (Electric, natural gas)	Admin. Serv. / Legal	271-3119
Susan Cunningham	Asst. General Counsel (Electric, natural gas)	Admin. Serv. / Legal	271-3272
Rosemary Foreman	Director, Public Affairs and Consumer Protection	Administrative Services	271-3140
David Dittemore	Director of Utilities	Utilities Division	271-3221
Larry Holloway	Chief of Electric Rates	Utilities Division	271-3222
Glenn Smith	Chief of Natural Gas and Pipeline Safety	Utilities Division	271-3171
Anne Wickliffe	Chief of Telecommunications	Utilities Division	271-3228
Richard Kuzelka	Chief of Accounting and Financial Analysis	Utilities Division	271-3176
John Cita	Chief of Economic Policy and Planning	Utilities Division	271-3155
Maurice Korphage	Director of Conservation	Conservation Division	(316) 337-6233
Bill Wix	Assistant General Counsel	Conservation Division	(316) 337-6213

Senate Utilities
1-21-99
Attach. 1

A - 2

Kansas Corporation Commission

Bill Graves, Governor John Wine, Chair Cynthia L. Claus, Commissioner Brian J. Moline, Commissioner

January 20, 1999

Honorable Pat Ranson, Chairwoman
Senate Utilities Committee
Statehouse, Room 449-N
Topeka, Kansas 66612

Dear Senator Ranson:

The Kansas Corporation Commission would request the Senate Utilities Committee to introduce the following legislation. The legislation proposed for introduction has been routed through the Governor's office.

Attached please find a brief synopsis of the statutory change and proposed statutory amendment for number 2 and 3.

1) Amend KSA 66-127(transactions affecting the ownership or control of a public utility);
2) Amend KSA 66-117a (eliminate requirement of notice to secretary of administration in rate cases); and
3) Amend KSA 66-118l and KSA 66-1,168 (conform the effective date of most general commission orders with KAPA).

The Corporation Commission respectfully seeks introduction of the bills through the Senate Utilities Committee. Should you have questions, please feel free to call me at 271-3190.

Thank You,

Thomas A. Day
Legislative Liaison

Senate Utilities
1-21-99
Attach. 2

Number 1)
Amend KSA 66-127
Brief Summary
The purpose of these amendments will make explicit the Commission's authority to review transactions affecting the ownership or control of a public utility or a related entity.

Fiscal Impact
This proposal should not have an effect on internal staffing needs. The proposal would increase regulatory costs for those entities entering into transactions which fall under new definitions. A preliminary estimate of these costs is in the range of $5,000 - $50,000.

Number 2)
Amend KSA 66-117a.
Brief Summary:
The Commission's records demonstrate that within the last 15 years the Secretary of Administration has not intervened in a rate case before the Commission. Furthermore, with the advent of modern technology, the Commission's schedule is fully accessible on the Commission's web page. The Commission has one section in its web page where all prehearing and hearings are posted. Discussions have taken place with the Department of Administration. The Chief Counsel of the Department supports the proposed amendment.

Fiscal Impact:
This proposal should not have an effect on internal staffing needs. The savings cannot be identified at this time.

Number 3)
Amend KSA 66-118l and KSA 66-1,168.
Brief Summary:
This request would change the language to conform the effective date of most general commission orders with the Kansas administrative procedures act.

Fiscal Impact:
None.

Number 2)

66-117a. Secretary of Administration may intervene as party to certain rate hearings; ~~notice~~. The secretary of administration may intervene on behalf of the state of Kansas as a party to any rate hearing conducted by the state corporation commission in which the state of Kansas would be affected as a consumer by a proposed change in the rates considered at such hearing. ~~The state corporation commission shall give notice to the secretary of administration of the time and place of any such rate hearing~~.

Number 3)

66-118l. Same; time orders to become effective. All orders or decisions of the commission shall become operative and effective ~~30 days after the~~ upon service of the order or decision ~~as provided by law~~ in accordance with the provisions of KSA 77-530(a), and amendments thereto, unless otherwise ordered by the commission or a stay is granted. The commission may grant a stay or suspend, in whole or in part, the operation of any order or decision of the commission in accordance with KSA 77-528 and amendments thereto. ~~except that if a petition for reconsideration is filed, the order or decision shall become operative and effective 30 days after the order or decision of the commission denying the petition or if the petition be granted the order or decision as originally entered or as modified shall become operative and effective 30 days after the service of the order or decision of the commission on reconsideration.~~ After the lapse of the time period in which judicial review of such order may be taken, such determinations and orders shall be held to be conclusive as to the matters involved in any suit to enforce such order or in any collateral suit or proceedings.

66-1,168. Same; time orders to become effective. All orders or decisions of the commission shall become operative and effective ~~30 days after the~~ upon service of the order or decision ~~as provided by law~~ in accordance with the provisions of KSA 77-530(a), and amendments thereto, unless otherwise ordered by the commission or a stay is granted. The commission may grant a stay or suspend, in whole or in part, the operation of any order or decision of the commission in accordance with KSA 77-528 and amendments thereto. ~~except that if a petition for reconsideration is filed, the order or decision shall become operative and effective 30 days after the order or decision of the commission denying the petition or if the petition be granted the order or decision as originally entered or as modified shall become operative and effective 30 days after the service of the order or decision of the commission on reconsideration.~~ After the lapse of the time period in which judicial review of such order may be taken, such determinations and orders shall be held to be conclusive as to the matters involved in any suit to enforce such order or in any collateral suit or proceedings.

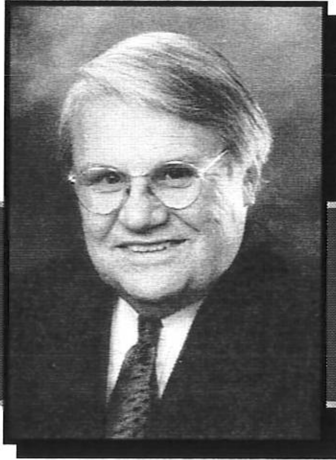
Attach 3

TESTIMONY OF BRIAN J. MOLINE, COMMISSIONER

KANSAS CORPORATION COMMISSION

January 21, 1999

Senate Utilities
1-21-99
Attach. 3



BRIAN J. MOLINE, COMMISSIONER

Brian J. Moline was appointed to the Kansas Corporation Commission on December 16, 1998, by Governor Bill Graves.

Mr. Moline served as General Counsel to the KCC from 1979 - 1985 and from 1991 - 1995. He has also been General Counsel to the Kansas Insurance Commissioner and the National Association of Insurance Commissioners. Throughout his career, he has alternated between state government service and Kansas Legal Services, the statewide public interest law firm he co-founded in 1978. At various times, he has been Executive Director for both the Wichita and Topeka programs.

Mr. Moline holds a Bachelor of Arts from Wichita State University, a Juris Doctor from Washburn University, and a Masters in Public Administration from the University of Kansas. He is the author of Regulation in Transition, a monograph of the KCC and has published numerous articles and book reviews. He is on the Board of Editors of the Journal of the Kansas Bar Association and has served as Chairman of the Ethics and Grievance Committee of the Topeka Bar Association and on the Board of Trustees. In 1993, he received the Topeka Bar Pro Bono award for continued commitment to legal services for the indigent and received the Distinguished Service Award of the Kansas Bar Association in 1994.

Mr. Moline and his wife Kathy have four grown children and reside in Topeka.

Commissioner Moline is serving a four-year term, which expires March 15, 2002.

January 1999

Testimony of Brian J. Moline, Commissioner
Kansas Corporation Commission
January 21, 1999

Public utilities have existed, in one form or another, for over three hundred years. The English common law courts soon noticed that certain business enterprises–ferries, highways, toll bridges, stagecoaches–had an important effect on the public welfare. It became gradually apparent that the public interest demanded that these enterprises be obliged to serve all who applied for service, without preference and at reasonable rates. The term of art that was used was and is "affected with a public interest".

In America, the first public enterprise recognized as affected with a public interest and subject to regulation was the railroad. The railroads were termed "common carriers" and it was early established that states had the right to regulate them.

In 1877, in the landmark case of *Munn* v. *Illinois*, this notion of common carriage was extended to include grain elevators owned by Munn. The United States Supreme Court found that this particular business stood at the gateway of commerce and "took toll of all who passed"; therefore, the court reasoned, the grain elevator business was really a part of the carriage of goods in commerce and, as such, properly subject to regulation as a public utility. *Munn* was the first of a chain of U.S. Supreme Court cases that greatly extended the theory of common carriage.

As the cases developed, the courts began to pay less attention to the carriage or transportation

aspects and more attention to the public interest characteristics of the enterprises. Financial services such as banking, insurance, certain health and environmental enterprises and firms delivering public utilities all fell under the rubric "affected with a public interest". Gradually, a two tier legal test began to develop to determine public utility status. First, the courts look for a special interest, inquiring what the consequence to the public would be if the particular enterprise went unregulated; second, the courts examine whether competition is present and effective as a regulatory force in the industry.

It was also determined quite early that certain utilities–such as gas, electric and water–are natural monopolies. This natural monopoly status is based upon a presumption that huge capital outlays were necessary to engage in these types of enterprises. It was believed competition in such industries would be ruinous and counterproductive. In order to induce investors to provide the capital needed to furnish these important public services, it was deemed necessary to grant exclusive franchises so that the economics of the industry would operate.

Public utilities, traditionally, are natural monopolies which are granted exclusive service areas, allowed to charge fair and reasonable rates, and allowed to impose reasonable conditions as to the terms under which services will be rendered. In return, the utilities must provide safe, adequate service to all who seek it in the service areas at fair and reasonable rates and without preference or discrimination. The duty of enforcing this delicate balance sometimes called the "regulatory bargain" falls upon the regulatory agencies.

The Kansas Commission was one of the first state regulatory bodies in the nation: a three member Board of Railroad Commissioners was established by the Kansas Legislature in March, 1883. Most of its early activities were confined to rates and services of common carriers. In fact, the first case on record was filed by an individual on April 19, 1883, in the form of a complaint against a railroad alleging overcharges for transportation of freight which in turn produced discrimination in favor of one particular city over another.

The Railroad Commission had power and authority to regulate all steam-operated railroads, express companies, sleeping car companies and inter-company electric lines. The members were appointed by the Executive Council. Membership in the early Railroad Commissions was so prestigious that a United States Senator from Texas left the Senate to seek election to the Texas Railroad Commission.

When the populists controlled Kansas government (1892-1900), they were convinced the existing regulatory mechanism was ineffective and created a "Court of Visitation". This appointed agency attempted to combine regulatory techniques with judicial authority. The commissioners were called judges and could exercise judicial power such as contempt and confiscation of property. However, the scheme violated the constitutional doctrine of separation of powers and was declared unconstitutional by the Kansas Supreme Court and a three member Railroad Commission was restored.

As telephone service and electric energy became a part of daily life, the Legislature created a

three member Public Utilities Commission in 1911 to replace the Railroad Commission. The new Commission also regulated telegraph and telephone companies, pipeline companies, water, light, heat, all power companies (except those municipally owned), mutual telephone companies and public utilities and common carriers situated and operated wholly or principally within any city. The members of this Commission were appointed.

For a brief period in 1920, the Legislature flirted with a rather curious institution called the Kansas Court of Industrial Relations. The Court of Industrial Relations combined traditional regulatory tasks with authority to arbitrate wages, hours, and other industry-labor disputes; however, there were procedural and conceptual difficulties with the idea, and after nine months experience, the Legislature abolished it and restored the Public Utilities Commission.

A successor agency was created by the 1925 Legislature: an appointed five-member Public Service Commission. Eight years later, the present regulatory body, the State Corporation Commission, was established with its jurisdiction extended to include the regulation of motor carriers. In 1933, Governor Alf Landon wanted intrastate sale of securities regulated because of the Finney bond scandal. He recommended regulation of securities be added to the Public Service Commission and the name changed to Corporation Commission to reflect the expanded jurisdiction. Gas conservation and supervision of plugging of abandoned wells to protect fresh and usable water from pollution by oil field practices were later added to Commission jurisdiction. In the late 1970s, mined land reclamation was also put under the aegis of the Commission. In 1982, the Securities Division was severed from the Commission and made a

separate regulatory agency and mined land reclamation was later transferred to the Department of Health and Environment. In 1991, the legislature removed most cooperative electric utilities from KCC regulation.

Although Kansas has had a Railroad Commission, Court of Visitation, Public Utilities Commission, Court of Industrial Relations, Public Service Commission and Corporation Commission, only one regulatory agency has been in existence at a given time.

The Kansas Corporation Commission is, like most regulatory agencies, something of a hybrid in state government. Because they combine legislative, judicial and executive powers, promulgate rules and regulations having the force of law, "adapt" the rules of evidence, administrative agencies have been a traditional source of frustration to practitioners, academics, legislators and judges.

The administrative process emerged primarily because the logical government alternatives, the legislative and judicial processes, had historically proven unwilling or unable to provide the desired degree of regulation on those private businesses "affected with a public interest". Legislative bodies soon discovered they function best when determining broad outlines and general direction of major policy. Large legislative bodies, however, are ill suited for handling masses of detail or for sifting through the often conflicting ideas of economists, engineers, accountants and other experts essential to fair and effective regulation. Gradually, legislatures developed the custom of legislating only the main outlines of programs and leaving to

administrative agencies the task of working out subsidiary policies. This system facilitated not merely the promulgation of law through rules and regulations but also the correlation of rule making with such other necessary activities as adjudication, investigating, prosecuting and supervising.

Neither was the judicial branch suited to handle the type of business regulation an industrial society required. Courts are constrained by the evidence and witnesses the parties chose to present to them. Clearly courts could not investigate, supervise, fix rates, grant or deny licenses or perform any of the myriad regulatory tasks without an organization of accountants, engineers, rate specialists, economists and assorted other disciplines.

The Kansas Corporation Commission, then, exercises legislative authority delegated to it by the legislature but does so in a quasi-judicial fashion while being located in the executive branch of government.

The organic law that delegates legislative rate-making authority to the State Corporation Commission is found in chapter 66 of the *Kansas Statutes Annotated.* The regulatory power exercised by the Commission falls into three broad categories.

Licensing

Prior to doing business in this state, all public utilities and common carriers must be licensed and obtain a certificate from the Commission. The utility or common carrier must demonstrate that

the public convenience will be promoted by the transaction of such business. The statute was enacted to avoid unnecessary duplication and competition, and judicial decisions indicate that the public convenience should be the primary criteria.

Rate Making

Every public utility and common carrier under the Commission's jurisdiction is mandated to establish just and reasonable rates, and every unjust, unreasonable, discriminatory or unduly preferential rate is prohibited. The utilities and common carriers must publish and file with the Commission copies of all rates, rules, regulations and contracts. Kansas law confines the utilities or common carriers to charging rates on file.

Supervision over Business Practices

The Commission has been authorized to supervise certain business practices of the utilities and common carriers. A public utility can be required to furnish accounts, reports and other information detailing such items as depreciation, salaries, legal expenses, taxes, and rentals. Investor owned public utilities or common carriers are prohibited from issuing securities or from purchasing, acquiring or holding the stocks or bonds of a competing utility or carrier without Commission approval. The Commission has the authority to examine and inspect all accounts, books, papers, records, property, and memoranda of utilities and carriers.

The state's objective with respect to regulation of public utilities and common carriers is the same as all the other state and federal regulatory bodies–to see that the public interest is served by the rendering of sufficient, non-discriminatory service at such prices as will be fair, equitable

and reasonable to the customer, yet allow the enterprise such a return on investment as will be adequate. This same standard applies to the regulation of common carriers to the extent that regulation of motor carriers that still exists after federal deregulation and the Staggers Rail Act. In regard to the regulation of the production of oil and gas and the protection of fresh and usable water, the state objective is to conserve these precious natural resources and to protect correlative rights.

In a society committed to the general principle of free competition, the economic justification for rate regulation in certain industries has always been framed in terms of the exceptional conditions prevailing in those particular businesses. Public utilities as a class lend themselves readily to such touchstones of an integrated industrial structure, because of their enormous economic power. Such power often lends itself to abuse and tends to be concentrated in relatively few hands. Utilities, as a group, are either enterprises that move toward monopoly or those whose highest efficiencies may be reached under monopolistic operation. This characteristic may be due to a variety of reasons: The necessity of unitary management for adequate service, as with telephones, or the limited capacity of city streets, as with most municipal utilities. More strikingly, such monopolistic operations grow out of the huge investment in plant required in proportion to current income, the operation of that plant largely at joint cost, and the consequent necessity of a large and steady volume of traffic to maintain the investment. These circumstances under traditional regulatory theory, render complete competitive duplication of facilities improbable or impossible. If a duplicate exits, the facility is wasteful and uneconomical. New competitors are slow to enter, and old ones slow to leave an

secured, tends to perpetuate itself. On the other hand, competition, if it exists at all, offers only the alternatives of combination or destructive price cutting designed to maintain volume at any cost. The historic experience with railroads and other utilities suggests the likelihood of instability and waste, high rates, ruthless price cutting, inadequate service, and price discrimination. These dangers often follow from periods of unrestrained competition.

The traditional concept of regulation has been under critical examination for at least three decades. This examination began at the most logical and weakest assumption–the notion of limiting market entry to eliminate duplication of services. In a society generally committed to the concept of free, private, competitive enterprise, artificial barriers to entry are naturally suspect and often invalid. It also seems self-evident that regulatory activity that prohibits or controls price increases in goods and services during periods of substantial general price inflation will inevitably lead to shortages in the delivery of those goods and services. Today many economists and some policy makers hold the view that economic regulation of business enterprises actually can have a negative and counterproductive result on the industry without commensurate benefits, particularly in a time of rapid technological change.

Economic regulation has usually rested on two dominant theoretical underpinnings. First, where competition is non-existent or ineffective, regulation must replace competition in the form of rate or price determination. When true competition emerges in these industries, obviously the need for price regulation recedes and may ultimately become non-existent. Many believe the proper role for regulation where true competition has entered is three-fold: (1) to monitor and encourage

competition, ensuring a level playing field and controlling predatory pricing; (2) to ensure that all vestiges of artificial monopoly are ultimately dismantled; (3) allow the marketplace to set prices and quality of service while monitoring for abuses of market domination and ensuring access to service.

The second underpinning, however, is the one that is most troublesome–the concept that the public interest requires relatively equal access to services affected with a public interest which often translates to the notion that revenues from highly traveled routes or densely populated areas can and should be used to subsidize access in more sparsely populated areas.

A case can certainly be made that rural America and particularly rural Kansas has developed and prospered in no small part because of this aspect of traditional regulatory theory. Many observers have expressed concern that an inevitable consequence of deregulatory policy will be higher prices, limited access and lower quality of service to thin markets.

On the other hand, some economic theorists and policy makers argue that this aspect of regulatory policy is actually destructive. By disguising the true costs of service, regulation promotes economic distortions and sends misleading price signals that are ultimately counterproductive.

One hallmark of the last several decades has been the dramatic and often sudden economic changes that have drastically affected many of those industries we have traditionally thought of

as public utilities. The areas of transportation, telecommunications, electricity, and natural gas are at various stages in moving from positions of total natural monopoly to at least a mixture of natural monopoly and competition. In some instances, particularly telecommunications, they could well move completely away from being populated by natural monopoly suppliers to a totally competitive marketplace.

If there is one economic lesson we have all learned, it is that change, whether driven by economics, technology, or customer demand, is inexorable and unstoppable. To ignore change can be dangerous; to be unwilling to accept change can be potentially disastrous. It goes without saying that regulators and legislative policy makers can no more ignore competitive intrusions in a traditionally monopolistic industry than the industries themselves can. The presence of real and effective competitive factors can promote efficiencies and opportunities beneficial not only to the companies but to the consuming public. In that instance, it is the function of regulators to monitor developments and allow competition to flourish while maintaining vigilance that the competition is real and not illusory.

The presence of competition in those businesses historically affected with the public interest substantially changes the landscape. Once competition enters a traditional monopoly industry, the firms in that industry will experience an increase in business risks. That increase arises from the existing possibility that the firm may experience loss of business to competitors that they did not have to consider previously. Faced with an increase in business risks, the companies will attempt to adjust themselves to absorb competitive losses of revenues without experiencing

impairment to their financial well being. Competition drives firms to profit maximization. Profit maximization can force avoidance of thin or less profitable markets. It is this potential consequence that most concerns policy makers of both urban and rural orientation.

To summarize, I would state that there has always been a larger societal reason for the monopoly status of public utilities. The whole point of governmentally guaranteed monopoly in the public utility area was to remove competitive risk and replace it with an essentially cost plus return formula. In return, the public utility submitted itself to political decision making that tolerated, even encouraged, certain economic inefficiencies in return for the larger societal object: A regulatory imposed safety net that guaranteed access to those goods and services was deemed essential for survival at reasonable costs. As indicated earlier, technology cannot long be constrained or denied. Similarly, neither can economic realities be ignored for very long. Competitive factors into the formerly monopolistic areas are inevitable and inexorable. Competitive factors, however, put new risk elements into a precariously balanced equation.

Until recently, the existing legal framework and regulatory traditions of most state agencies have remained essentially unchanged since their creation, but it should also be recognized that in many respects, regulators were mirror images of the businesses they regulated. Insulated from competition, guaranteed an opportunity to earn a profit, holding a monopoly on a basic necessity of life, many utilities became complacent and resistant to change. Today the electric, gas and telecommunications industry face a host of significant economic, technological, political and philosophical issues. Virtually all firms, to one degree or another, have developed operational,

product market diversity and structural strategies to deal with the new environment.

Just as the utility industry was jolted from complacency by sudden and dramatic change, so regulators were jolted from their sedate and largely routinized existence. The same challenges that face this industry also face its regulators. Like the industries they attempt to regulate, regulators are in a transitional phase where long cherished assumptions and procedures must be tested, adapted and discarded if necessary. Some states are further along than others in adjusting regulatory techniques and procedures to new technical and economic realities.

A classic example of the evolution of a monopoly industry into the twilight between monopoly and completely competitive is the intra-state telecommunications business. I have attached a 1995 article from the Kansas Journal of Law and Public Policy co-authored by myself and William Drexel which highlights the complex policy dilemmas and competing values inherent in the transition from monopoly to competitive status.

Another example of regulatory evolution is the struggle virtually all states are experiencing in implementing the Federal Telecommunications Act which is designed to stimulate competition while retaining the traditional regulatory goal of providing affordable telephone service to all consumers regardless of costs. This effort illustrates the delicate balance of sometimes competing values involved in the process.

The TeleKansas Debate: Incentive Regulation or Deregulation?

Brian Moline

&

William R. Drexel*

TeleKansas I changed the KCC's historic rate base regulation, which monitored Southwestern Bell's profit, to an incentive pricing scheme.

Introduction

When originally enacted, TeleKansas was an agreement between the Kansas Corporation Commission ("Commission" or "KCC") and Southwestern Bell. Southwestern Bell agreed not to increase local, directory assistance, long distance, and access service rates, and in turn the Commission would not audit Southwestern Bell earnings. Moreover, Southwestern Bell had to spend around $140 million to improve its network, as well as cut some basic local service and toll rates.[1] TeleKansas I was to end in 1995. The Kansas Legislature adopted a proposal to extend the terms of TeleKansas I (subsequently to be referred to as TeleKansas II) for two more years.[2] In effect, the Legislature extended the Commission's TeleKansas order that the KCC not investigate Southwestern Bell earnings, while capping basic local service and toll rates.[3] In addition, TeleKansas II requires Southwestern Bell to spend an additional $64 million on improvements.[4]

To obtain different perspectives on TeleKansas, the *Kansas Journal of Law & Public Policy* invited attorneys from both Southwestern Bell and the KCC to comment. The first part of the article will focus on the plan's legislative background and details, as well as competition generally for local telephone service. The second part will consist of opinions from Brian Moline, former general counsel of the Kansas Corporation Commission, and William Drexel, general attorney for Southwestern Bell. This article intends to help readers decide for themselves whether TeleKansas is good public policy regulation that should be continued in 1997 or just an experiment in incentive rate-making that did not work.

I. History of TeleKansas

A. Legislative Background

The provisions of TeleKansas have been controversial both in form and substance. The bill that the House of Representatives passed had a different wording than the one passed in the Senate.[5] This caused concern that the bill did not meet constitutional bicameralism requirements. State Representative Carl Holmes requested the opinion of the Attorney General to address problems raised by the passage of TeleKansas II.[6]

The discrepancy between the bills that passed the House and Senate was the result of an amendment that was made in the Senate after the House had already passed its version.[7] The following sentence was amended in the Senate: "The Corporation Commission shall monitor each approved project and the expenditures therefore . . . "[8] The Senate Journal reflected that the word "monitor" was changed to "maintain" before the bill passed the Senate.[9] Because the

Brian Moline *is general counsel for the Kansas Insurance Commission. He was general counsel for the Kansas Corporation Commission during the passage of TeleKansas.* **William Drexel** *is general attorney for Southwestern Bell Telephone Company in Kansas.*

3-16

bill was on emergency action, the House "could only concur or not concur with the Senate amendments."[10] The bill as presented to the House for concurrence contained the word "monitor" rather than "maintain."[11] The House concurred, and the bill containing the word "monitor" was then enrolled and later signed by the Governor. The Attorney General opined that it was irrelevant that the House was under the impression that the discrepancy was a clerical error and not a true amendment.[12] Because of the discrepancies in the wording, the bill contravened the bicameralism and presentment requirements of the Kansas Constitution, Article 2, section 14, and was thus void.[13]

The Senate amended its journal to reflect the use of the word "monitor" in accordance with the enrolled bill.[14] The Attorney General opinion noted above did not address the issue of whether the Senate has the power to amend its journal to match the language of the enrolled bill. Thereafter, Attorney General Robert T. Stephan personally addressed this issue. He stated, "I have been asked repeatedly to elaborate on whether the Senate's attempt to correct its journal in regard to an amendment to House Bill 3039, the TeleKansas legislation, removes the constitutional impediment to its validity which was printed in an opinion earlier this week."[15] The general rule is that "enrolled bills may be impeached when the journals 'clearly, conclusively, and beyond all doubt' demonstrate that the enrolled bill differs from the one passed by the houses of the legislature."[16] Since the correction was made in the Senate Journal[17] and read into the journal by Senator Salisbury, the Attorney General ended in saying that it would be difficult to demonstrate that the passed bill was "clearly, conclusively, and beyond all doubt" different than the bill as signed.[18] Accordingly, the conclusion of the Attorney General was not to bring an "action to set aside the bill."[19]

B. TeleKansas: The Basics

The TeleKansas I plan can be found in the KCC order, *In the Matter of Southwestern Bell Telephone Company's Proposal for Network Modernization, Rate Stability and Pricing Regulation, a/k/a "TeleKansas"* dated February 2, 1990. On an experimental basis, TeleKansas I changed the KCC's historic rate base regulation, which monitored Southwestern Bell's profit, to an incentive pricing scheme. This plan[20] allowed Southwestern Bell to increase its overall earnings and pricing flexibility for certain services in exchange for rate reductions and service modernizations.[21] Under traditional rate based/rate of return regulation, the KCC sets a total profit margin for a company, then bases the utility's service rates on that margin. Under both TeleKansas I and II, the Commission directly sets prices for individual services, but does not otherwise regulate Southwestern Bell's profits.

Southwestern Bell was able to enter into such an agreement because of the plan's potential for improving efficiency in telecommunication services. On one hand, Southwestern Bell may see considerable earnings, even with caps on rates for an extended period, which Southwestern Bell can use to make modernizing investments. TeleKansas is thus appealing because customers can recognize benefits from the improvements while maintaining basic service prices.[22] On the other hand, declining costs have historically afforded regulators the opportunity to reduce the costs of basic local service, increasing the possibility that Southwestern Bell could earn more than a reasonable profit.

Major components of TeleKansas I, in effect from February 1990 until March 1, 1995, included:[23]

- Permanent reduction in MTS and WATS rates by $17.1 million beginning in year one.
- Reduction in intrastate interLATA access charges by $2 million beginning in year one.
- Waiver of all basic 911 service charges resulting in a $75,000 permanent reduction for customers beginning in year one.
- Reductions in residential touch-tone rates of 25¢, totalling a $1.6 million permanent reduction beginning in year one.
- Reductions in residential service connection charges for new customers by $5.15 and by $8.15 for reconnections, amounting to a $1.5 million permanent reduction beginning in year one.
- Introduction of the 1+ Saver Plan at an estimated reduction in annual revenue of $1.4 million, no later than the beginning of the third year of the plan.
- Increases in Directory Assistance rates by 10¢, totalling $1.3 million in year one.
- Increases in Rotary Hunt rates to $1.75 resulting in a $1.3 million increase in year one.
- Increases in Dual Party Relay Service expenses by $2 million per year.
- Establishment of an Assistance Fund for Local Service Rates to benefit low income households.
- Elimination or reduction in mileage charges as proposed by Southwestern Bell, and replacement of party line service by one-party service (although

3-17

customers must pay for the upgrade when it takes place).

- Cap on basic local residential and business rates for five years, except for increases due to party line elimination or exchange reclassifications.

- Institution of $140 million investment in network modernization.

- Flexible pricing of certain non-basic and discretionary services.

- Duration of the trial plan for five years, during which time neither the Commission nor Southwestern Bell will file or support a general rate case proceeding to alter rates.

TeleKansas presents serious questions about the role of government oversight in industries traditionally believed to be affected with a public interest.

The Commission order implementing TeleKansas I stipulated that Southwestern Bell and the KCC evaluate the result of the initial TeleKansas agreement and file recommendations regarding the continuation of TeleKansas I. At the end of TeleKansas I, however, Southwestern Bell argued that any evaluation of the program should not focus exclusively on a comparison of rates under the new and old plans because there were many ancillary benefits associated with the infrastructure modernization that enhanced statewide economic development.[24] The KCC staff responded that it was obligated to ensure just and reasonable rates; therefore, it was necessary to determine whether Southwestern Bell collected unreasonable earnings with TeleKansas I.[25] Based on their individual evaluations, neither party could agree on recommendations for a continuation of the regulatory plan and so the Commission never issued a second order.

As a result, the 1994 Kansas Legislature codified TeleKansas II, extending the Commission's TeleKansas I order until March 1, 1997.[26] In addition, Governor Joan Finney and Southwestern Bell Kansas President Susan Fox signed a Memorandum of Understanding, agreeing to use TeleKansas II to protect jobs and to provide advanced technology for Kansas schools.[27] The TeleKansas II plan accomplishes the following:[28]

- Continues the alternate price regulation plan until March 1, 1997. While the Commission staff cannot audit Southwestern Bell's earnings until 1996, the Commission does retain authority over prices of company services and complaints lodged by customers.

- Guarantees that the company will spend at least $64 million on infrastructure construction in the next two years, creating at least 100 temporary jobs.

- Maintains Southwestern Bell's work force in Kansas at the current level plus 100 new jobs in Kansas. The total payroll cannot be reduced.

- Provides price discounts averaging 42% on the use of fiber-optic video systems by Kansas educational institutions in Southwestern Bell areas.

C. Competition for Local Phone Service

One point of debate before its passage was whether the TeleKansas plan increased any monopoly power by Southwestern Bell over local phone and toll rates. The KCC regulates Southwestern Bell, as a "telecommunications public utility."[29] Accordingly, the Commission has the power to do all things necessary to ensure that "[e]very unjust or unreasonably discriminatory or unduly preferential rule, regulation, classification, rate, joint rate, toll, charge or exaction is prohibited, unlawful and void."[30] All public utilities[31] are entitled to charge reasonable rates for providing an efficient public service. Unfortunately, there is no magic formula for determining reasonableness. Rates must not be so low as to be confiscatory, nor so high as to be oppressive.[32] The utility is entitled to earn a reasonable return, but the profits must not be excessive.[33] Moreover, if operating costs go down, yet rates remain the same, the utility is making more than the prescribed reasonable return.

Increasingly, local telephone companies find themselves in a more competitive market than they have ever known before. This increase in competition results from two phenomena. First, long-distance carriers have begun to provide services traditionally offered exclusively by local telephone companies.[34] That is, long-distance companies have entered the intraLATA toll markets that historically were serviced only by Local Exchange Carriers (LECs). Second, new firms have begun to provide services previously offered only by local telephone companies.[35] Technological innovation has spurred this increase in competition within the local telephone market.[36] Furthermore, technological innovation has caused previously segregated markets to converge. "The lines between media formerly segregated by mode of transmission (radio vs. landline) and function (telephone, cable, broadcast, computer) are quickly disappearing. We are moving rapidly toward a myriad of mixed media (radio/landline), integrated, digital, broadband (video) networks, all interconnecting seamlessly to one another."[37]

3-18

Local Telephone as a Natural Monopoly

Traditionally, local telephone service has been perceived as a natural monopoly.[38] A natural monopoly exists when an industry with a single producer can supply the entire market more efficiently than two or more competitors.[39] Competition is not sustainable in a natural monopoly market in the long run because the natural monopoly will have economies of scale over the entire market.[40] The view of local telephone service as a natural monopoly developed based upon "[the] high cost of fixed plant, the steadily declining average cost of service, and the need for all customers to interconnect with one another."[41] As such, government has subjected the telephone industry to regulation designed to protect consumers from that monopoly power.

Technological Innovations

Although the local telephone market may have resembled a natural monopoly in the past, the market has evolved over time and now resembles a market capable of sustaining competition. Currently, local telephone companies must compete in the local telephone market for radio based services, especially cellular telephony, and local fiber networks.[42] Technological innovations have eliminated many problems initially encountered with cellular communications.[43] These cellular systems once relied upon the local telephone carriers for access to the local loop. Nevertheless, the cost of creating an independent wireless local exchange is not insurmountable, as demonstrated by the merger of AT&T and McCaw Cellular Communications.[44]

Furthermore, personal communication networks (PCNs) represent even more of a competitive threat to local telephone carriers. These systems "serve 'microcells' on microwave frequencies with low power, digital transmitters to provide mobile service over small areas, such as an office building or neighborhood."[45] PCNs may eventually evolve into ultra-light and fully mobile phones.[46]

Besides competing directly with the PCNs for customers, local telephone carriers face stiff competition from cable television companies for landline links.[47] As early as the late 1960s, the fledgling cable television companies realized that technology would eventually allow them to provide two-way services.[48] Although only some cable television systems presently have the capacity to compete directly with local telephone carriers, the development of fiber optics will eventually allow widespread competition between cable television and local telephone carriers.[49] Fiber-optic systems represent the most serious threat to the local telephone carriers' monopoly position because these systems have the potential to transmit up to 600 million telephone conversations or several hundred color television signals simultaneously.[50] Fiber-optic technology allows for the development of "full-service networks" that use "digital compression and advance technology for storage and retrieval of information and for signal switching."[51] This allows the system to provide interactive information services and will eventually allow for telephone service.[52] At least one cable carrier, Time Warner, has announced plans to upgrade one of its cable systems to a "full-service network."[53] Cable television carriers clearly represent a substantial competitor to local telephone carriers.

These developments have caused local telephone carriers to object to the lack of regulation in these areas. Local telephone carriers have argued that these new services should be regulated as common carriers.[54] If the Federal Communications Commission (FCC) regulated these new technologies as common carriers, providers would have to obtain state franchises and offer universal service.[55] Without such regulations, new service providers might supply service only to the low cost, high revenue consumers.[56] The FCC has not been sympathetic to the arguments of the local telephone carriers and has continued to regulate the new services as hybrids.[57]

Staff writers: B. Getty, E. Hodgkins, E. Moneymaker, L. Plaisted

II. The Debate

The original agreement between the KCC and Southwestern Bell was set to expire in March 1995. Instead, TeleKansas will exist for two more years, at which time the Commission "shall formulate a successor alternative regulation plan to take effect after March 1997."[58] With the creation and extension of TeleKansas as a public issue, the arguments for and against TeleKansas are convincing. In addition, as a statutory and constitutional creature, the Commission must employ staff (attorneys, accountants, economists, and others) to protect the public interest.[59] Thus, as political and legal forces tug at the public interest that the agency must protect, we should ask ourselves two questions: "[W]as the justification for this regulation reasonable?" and "[I]s the government utilizing the appropriate regulatory method or tool?"[60]

Comment by Brian Moline
(Former General Counsel for KCC)

TeleKansas was, and is, part of a systematic, nationwide attempt by RBOC's (Regional Bell Operations Companies) to: (1) freeze local rates at current levels; (2) prohibit regulatory review of profits while freezing prices at current levels; (3) position themselves favorably for what is expected to be an assault on their traditional monopoly on local services; and (4) gradually transition themselves into an unregulated environment.

The KCC approved the original TeleKansas proposal after considerable modification in 1989. The KCC order approving TeleKansas[61] made abundantly clear that the plan was considered an experiment in incentive ratemaking. The order clearly mandated a thorough review of Southwestern Bell earnings, before consideration of the next step.

3-19

When the KCC's staff began its evaluation in 1993, Southwestern Bell steadfastly opposed any regulatory review of earnings and insisted on immediate and permanent cloture to rate base regulation in Kansas. When Commission staff opposed such a drastic change in public policy, Southwestern Bell took the issue directly to the Kansas Legislature. A very similar scenario was played out in Missouri. After protracted and sometimes bitter debate, the legislature extended TeleKansas for two more years, prohibited regulatory review of Southwestern Bell earnings during the experimental period, and created a study committee to assess competition in the telephone industry with a charge to recommend appropriate, if any, regulatory constraints on telecommunication companies.

Southwestern Bell's flat refusal to allow review of profits freezes rates at the present level until the company decides otherwise.

The issue in the continuing TeleKansas saga is a simple but profound one: Whether ratepayers at the local loop will have an opportunity to share in the anticipated financial benefits of the "information superhighway." For some years, Southwestern Bell costs have been decreasing for a variety of reasons. Absent TeleKansas, state regulators would investigate the possibility of reducing local rates. Southwestern Bell's flat refusal to allow review of profits freezes rates at the present level until the company decides otherwise.

Active opponents of Southwestern Bell's legislative efforts to extend TeleKansas I included virtually every other provider in the state. Potential players in the telecommunications market expressed great concern about Southwestern Bell's absolute control of the local loop, massive financial resources, and traditional hostility to any efforts to penetrate the monopoly. Potential competitors support continued regulatory oversight of local service.

In a society committed to the general principle of free competition, the economic justification for rate regulation in certain industries has always been framed in terms of the exceptional conditions prevailing in those particular businesses. Public utilities as a class lend themselves readily to such key stones of an integrated industrial structure, control of which is evidenced by extraordinary economic power. Such power often lends itself to abuse and tends to be concentrated in relatively few hands. Utilities, as a group, are either enterprises that move toward monopoly or those whose highest efficiencies may be reached under monopolistic operation. This characteristic may be due to a variety of reasons: The necessity of unitary management for adequate service, as with telephones, or the limited capacity of city streets, as with most municipal utilities. More strikingly, such monopolistic operations grow out of the huge investment in plant required in proportion to current income, the operation of that plant largely at joint cost, and the consequent necessity of a large and steady volume of traffic to maintain the investment. These circumstances render complete competitive duplication of facilities often improbable or impossible. If a duplicate exists, the facility is wasteful and uneconomical. New competitors are slow to enter, and old ones slow to leave an industry in which participation involves such a large economic commitment. Monopoly, once secured, perpetuates itself. On the other hand, competition, if it exists at all, offers only the alternatives of combination or destructive price cutting designed to maintain volume at any cost. The experience with railroads and other utilities attests to the following dangers: Instability and waste of alternating high rates, ruthless price cutting, inadequate service, and price discrimination. These dangers often follow from periods of unrestrained competition.

The whole concept of regulation on the discretion of economic enterprises has been under attack for at least the last two decades. This attack began at the most logical and weakest point–the idea of limiting market entry to eliminate duplication of services. In a society generally committed to the notion of free enterprise, policy makers naturally questioned regulation prohibiting market entry. From this, it was just a matter of time before it was determined that regulatory activity prohibiting or controlling price increases in goods and services during periods of substantial general price inflation also leads to shortages in the delivery of those goods and services. From there it was just a short step to reach the political judgment that economic regulation had a generally negative and depressing effect upon regulated industries without commensurate benefits. Thus, for at least the past decade, federal and state policy makers have been on a course of weakening, if not dismantling, economic regulation. This deregulatory policy has had many positive effects for urban dwellers. Wider freedom from regulation has often led to new competitive factors that have reduced the costs of intercity airline services and long-distance telephone calls. Nevertheless, deregulation has had painful and sometimes disastrous effects on sparsely populated areas. The simple truth is, that whatever its symbolic, rhetorical, and often occasionally real value, deregulation of transportation, communication, and utility services in a rural state like Kansas could lead to economic and cultural desolation of the rural areas of the state if not properly managed.

Economic regulation has usually rested on two dominant theoretical underpinnings. First, where competition is non-existent or ineffective, regulation must replace competition in the form of rate or price determination. When true competition emerges in these industries, obviously the need for price regulation recedes and may ultimately become non-existent. The proper role for regulation where true competition has entered is two-fold: (1) to monitor and encour-

3-20

age competition, ensuring a level playing field and controlling predatory pricing; (2) to ensure that all vestiges of artificial monopoly are ultimately dismantled. As a regulator, I am occasionally disappointed and surprised to learn that some people's idea of emerging competition is, in actuality, little more than allowing an unregulated monopoly to function undisturbed.

The second underpinning, however, is the one that is the most troublesome. The theoretical concept is that the public interest often requires that revenues from highly traveled routes or densely populated areas can and should subsidize more sparely populated areas. History can be at least as instructive as economic theory in formulating public policy. The historical lesson is stark. Rural America, and particularly rural Kansas, has developed and prospered in no small part as a direct result of federal and state economic regulatory policy. Deregulatory policy unless carefully managed has and will continue to raise prices and cut quality of service to sparsely populated areas, what economists persist in calling "thin markets." When farmers and other rural Kansans are forced to bear the true costs of furnishing basic goods and services to sparsely populated areas, the consequences of policy decisions formulated by theoretical economic models and constructs in classrooms and hearing rooms become crushingly real.

One hallmark of the last several decades has been the dramatic and often sudden economic changes that have drastically affected many of those industries we have traditionally thought of as public utilities. The areas of transportation, telecommunications, electricity, and natural gas are at various stages in moving from positions of total natural monopoly to at least a mixture of natural monopoly and competition. In some instances, particularly telecommunications, they could well move completely away from being populated by natural monopoly suppliers to a totally competitive marketplace.

If there is one economic lesson we have all learned, it is that change, whether driven by economics, technology, or customer demand, is inexorable and unstoppable. To ignore change can be dangerous; to be unwilling to accept change can be potentially disastrous. It goes without saying that regulators can no more ignore competitive intrusions in a traditionally monopolistic industry than the industries themselves can. The presence of real and effective competitive factors can promote efficiencies and opportunities beneficial not only to the companies but to the consuming public. In that instance, it is the function of regulators to monitor developments and allow competition to flourish while maintaining vigilance that the competition is real and not illusory.

The down side of competition in public utilities concerns me most as a regulator. The presence of competition in those businesses historically affected with the public interest substantially changes the landscape. Once competition enters a traditional monopoly industry, the firms in that industry will experience an increase in business risks. That increase arises from the existing possibility that the firm may experience losses of business to competitors that they did not have to consider previously. Faced with an increase in business risks, the companies will attempt to adjust themselves to absorb competitive losses of revenues without experiencing impairment to their financial well being. Competition drives firms to profit maximization. Profit maximization virtually ensures avoidance of thin or less profitable markets.

To summarize, I would state that there has always been a larger societal reason for the monopoly status of public utilities. The whole point of governmentally guaranteed monopolies in the public utility area was to remove competitive risk and replace it with an essentially cost plus return formula. In return, the public utility submitted itself to political decision making that tolerated, even encouraged, certain economic inefficiencies in return for the larger societal object: A regulatory imposed safety net that guaranteed access to those goods and services deemed essential for survival at reasonable costs. As indicated earlier, technology cannot be constrained or denied. Similarly, neither can economic realities be ignored for very long. Competitive factors into the formerly monopolistic areas are inevitable and inexorable. Competitive factors, however, put new risk elements into a precariously balanced equation. The regulatory challenge of the 1990s and beyond will be to re-calculate the regulatory bargain to accommodate the inevitable competitive changes that will profoundly alter the landscape, while attempting to preserve some resemblance of access to goods and services necessary for survival to both the urban and rural elements of society.

Few observers would disagree that the telecommunication industry is changing at a dizzying pace. As the industry transitions into a more competitive arena, regulation must continue to play an important role in managing the transition, securing a level playing field for competition and guaranteeing universal access at reasonable rates. TeleKansas presents serious, perhaps profound, questions about the availability, cost, and fairness of telecommunication services and technology, and the role of government oversight in industries traditionally believed to be affected with a public interest.

Comment by William R. Drexel
(General Attorney for Southwestern Bell Telephone Company)

Five years ago, the KCC adopted a bold plan to streamline telephone regulation in Kansas by directly regulating the reasonableness of prices rather than indirectly doing so through earnings reviews. This plan, known as TeleKansas I, implemented a price regulation plan for Southwestern Bell that provided the company with strong incentives to streamline its operations while increasing its investments in modernizing Kansas telecommunications infrastructure. The Kansas Legislature extended the TeleKansas I plan through March 1, 1997, in order to provide time to study the need for more pervasive changes in regulatory policies.

Price regulation may be an appropriate alternative to traditional rate of return regulation for many public utilities. Price regulation is

3-21

particularly appropriate in the telecommunications industry due to the dramatic changes facing the industry and the importance of telecommunications to an information-based service economy.

Technological changes are causing a convergence of the local telephone, cable television, long-distance telephone, and wireless communications industries in a manner that assures increased competition in traditional local telephone markets. With increasing competition, a cornerstone of traditional rate of return regulation, the KCC's ability to provide existing telephone companies a reasonable opportunity to achieve a fair return on their investment, is increasingly in doubt. This is especially true in view of the regulatory-prescribed depreciation periods that spread investment recovery over periods as long as thirty years.

TeleKansas brought rate stability to all Kansas customers by capping Southwestern Bell's local service, long-distance, and intrastate access rates.

TeleKansas, while constituting an improved form of regulating prices directly rather than indirectly through rate of return analysis, clearly does not constitute deregulation. Indeed, the TeleKansas stipulation expressly stated it was not intended to deregulate Southwestern Bell's telecommunications services in Kansas.[62]

During TeleKansas, Southwestern Bell has been prohibited from raising basic local residential and business prices. Southwestern Bell also has been required to prove the reasonableness of proposed price changes for other non-basic services, to provide the KCC staff a list of potential filings for new services and new prices every six months and to file those proposed changes twenty to thirty days in advance of the proposed effective date, with the KCC retaining the discretion to take up to eight months to review each tariff. Indeed, the extent of the remaining regulation is illustrated by the fact that the re-regulation of the cable television industry via the 1992 Cable Television Consumer Protection and Competition Act ("Cable Act") imposes less exacting regulation than Southwestern Bell has faced under TeleKansas.[63] For example, under the Cable Act, services provided on a per channel or per program basis are not subject to any regulation.[64] Moreover, the Cable Act allows cable companies to increase prices for basic programming service on an annual basis at the same rate as increases in the Gross National Product price index.[65] In contrast, Southwestern Bell's basic telephone service rates have frozen during TeleKansas. The heart of the debate thus is not whether TeleKansas has deregulated Southwestern Bell. The debate instead is whether the focus of TeleKansas on price, not profit, regulation serves the public interest.

Price regulation accommodates the uncertainty associated with increasing competition by equally placing the risks and benefits of increased investment on the regulated firm. By shifting both the risks and benefits of increased investment, price regulation helps reduce the chilling effect traditional rate of return regulation would otherwise have on an existing provider's investment decisions.[66]

Price regulation also provides the basis for a more flexible and adaptive form of regulation that is better suited to accommodate the way in which competition has spread into some but not all telecommunications services or areas simultaneously. Specifically, price regulation of services that continue to be provided by only one firm is particularly appropriate where that firm also provides other services subject to competition; in such cases a price regulation plan insures there are no incentives for cross-subsidies. The firm will not have any financial incentive to shift costs from competitive to non-competitive lines of business because such cost-shifting could not lead to increased prices for the non-competitive services.

An objective review of the results under TeleKansas I confirms the propriety of the KCC's action in originally adopting this improved form of regulation. TeleKansas I provided network modernization throughout Kansas, offered rate stability for local service, brought pricing flexibility to the market, and provided efficiency incentives through elimination of traditional rate base regulation.

TeleKansas Spurred Network Modernization

Under TeleKansas I, Southwestern Bell satisfied its commitment to modernize the telecommunications network in Kansas. By the end of TeleKansas I, Southwestern Bell replaced all of its remaining 131 electro-mechanical offices with digital switches, replaced over 1,000 miles of interoffice analog N-Carrier facilities with digital facilities, and replaced all party-lines with single line service. Southwestern Bell would not have completed these improvements in this timeframe without TeleKansas. Traditional rate base regulation impedes the incentives for this type of new capital investment and improved efficiency.

TeleKansas I brought investment in modern telecommunications services to customers in even the most remote Kansas locations. A partial list of services that TeleKansas brought to the market faster than would have occurred under traditional regulation includes: 911 Universal Emergency Number service, Single-Party service, Call Waiting, Call Forwarding, Equal Access, MaxiMizer 800®, Plexar®, and 900/700 Restriction. TeleKansas also was instrumental in Southwestern Bell decision's to select Wichita, Kansas as the first city in Southwestern Bell's five-state region to test new Advanced Intelligent Network services. One of these services is, for example, Intelligent Call Forwarding, which forwards incoming calls to multiple telephone numbers with multiple routing features. Another is

3-22

Selective Call Acceptance, which screens incoming calls based upon a list of telephone numbers from which calls will be accepted while routing remaining calls to another number.

The economic and customer benefits of this modernization effort have been significant. Customers report that the quality of service in rural areas remains high. Rural communities have been able to attract industries that operate on an international level. Metro-area hospitals, schools, and businesses are able to communicate effectively and efficiently with their rural patrons. Farmers are utilizing home computer networks to obtain information they had to travel miles to get before TeleKansas. Small town families are able to have the same modern telecommunications services that metro customers often take for granted.

TeleKansas Provided Rate Stability for Kansas Customers

TeleKansas brought rate stability to all Kansas customers by capping Southwestern Bell's local service, long-distance, and intrastate access rates. During TeleKansas I, the Consumer Price Index increased 13.2% while local service rates remained the same.

Price comparisons with national averages also reflect the reasonableness of local service rates in Kansas. Kansas is well below the national average for basic local service rates with monthly residence rates about $2.00 below the national average and business rates about $10.00 below the national average. Further, the affordability of telephone service is reflected in the fact that the percent of households with telephone service in Kansas averaged 95.6% during 1993, which was higher than the national average of 94.2%.

Southwestern Bell customers enjoyed rate stability even though many Kansas telephone companies experienced an increase in the cost of providing telecommunications service during the TeleKansas period. One indication of these increased costs is that eleven independent telephone companies not subject to TeleKansas filed for intrastate access rate increases during the TeleKansas period.

Pricing Flexibility Has Worked

TeleKansas initiated pricing flexibility and streamlined filing and approval procedures for discretionary and non-basic services. Incremental costing methodology was used to determine pricing floors, while value of service pricing was used to determine the price ceilings. Southwestern Bell continued to offer promotions on a wide range of services, but with reduced filing requirements. Promotional discounts for certain services stimulated sales. With these procedures in place, Southwestern Bell was able to respond to the marketplace more quickly and be a more competitive provider.

With flexible pricing, Southwestern Bell was able to offer more cost-effective telecommunications services to customers. Business customers were particularly supportive of the Plexar® product line and appreciative of Southwestern Bell's ability to offer competitive pricing. As a result of Southwestern Bell's ability to flexibly price Plexar-II and Plexar-Custom, the company increased sales of these products and offered customers more cost-effective, state-of-the-art service. Flexible pricing allows for both upward and downward movement of rates. In several instances, downward pricing stimulates the market. While it would be expected that customers would not welcome rate increases, the KCC received no complaints regarding the flexible pricing rate changes.

Efficiency Incentives Have Been Successful

With the absence of rate base regulation, TeleKansas provided Southwestern Bell incentives to streamline its operations and pursue process improvements. Southwestern Bell restructured the company and re-engineered job functions as it strove to improve the ways it serves customers, utilizes employees and equipment, and stays competitive in the rapidly changing telecommunications industry. One example of the restructuring is the market center approach that focuses attention and resources on the unique aspects of individual market areas.

Another direct benefit to customers has been Southwestern Bell's pioneering effort to implement a quality program in Kansas. TeleKansas reaffirmed and encouraged the company's focus on quality as a way of doing business. Because of TeleKansas, Kansas became the pilot state within Southwestern Bell's region for a process improvement program known as Excellence Through Quality (ETQ). ETQ establishes methods to provide quality customer service in the most cost-effective manner. Because the company retains earnings generated from the increased efficiencies, and absorbs any losses associated with decreased efficiencies, Southwestern Bell has a renewed incentive to improve efficiency. Reduced clearing time for trouble reports, improved customer communications, and improved billing accuracy are just a few of the success stories of ETQ which directly benefit customers. ETQ demonstrates the efficiency incentives brought about by TeleKansas.

The continual decline in the number of complaints and inquiries to the Commission since the implementation of TeleKansas also reflects Southwestern Bell's commitment to quality of service and customer satisfaction. In fact, in 1992 only about 7 out of every 100,000 customers in Kansas had a justified complaint against Southwestern Bell, as determined by the Commission complaint staff.

Earnings Were Reasonable Under TeleKansas

The TeleKansas plan suspended Southwestern Bell's rate of return reviews with the stated intent of the parties "not to merely return to rate base regulation at the end of five years."[67] The intent and purpose of TeleKansas was to move away from earnings-type analyses, focusing instead on price regulation and technology delivery.

Financial results are relevant in determining whether Southwestern Bell has incurred significant financial windfalls under TeleKansas or, conversely, whether TeleKansas has caused Southwestern Bell

irreparable harm. Actual financial results of Southwestern Bell's intrastate telephone operations during TeleKansas showed that the company experienced earnings in line with its cost of capital.

Indeed, even under the earnings analysis of the KCC staff, Southwestern Bell's commitment to invest in modernizing Kansas telecommunications infrastructure resulted in above normal investments that were 50% more than any alleged "overearnings" during the TeleKansas period. In any event, financial results cannot properly serve as the sole criteria for reviewing the success of the TeleKansas plan, which was designed to address broader social policy goals.

TeleKansas Objectives Were Met

Under TeleKansas, Southwestern Bell modernized the Kansas telecommunications network faster than would have been possible otherwise, successfully implemented flexible pricing procedures, capped over 70% of its revenue base, streamlined its operations, and improved universal service, while continuing to provide Kansans with basic telephone services at prices 10-25% lower than nation wide averages.

Future Public Policy Must Build On the Success of TeleKansas

In setting the future regulatory framework for telecommunications in Kansas, public policy makers must build on the success of TeleKansas. Other states increasingly have followed the KCC's lead in recognizing that pure price regulation serves an important role in streamlining regulation in a way that encourages telecommunications network modernization. Admittedly, there are other areas in which telecommunications regulation must be altered to reflect the dramatic changes occurring across the telecommunications industry. For example, steps must be taken to ensure that regulatory policies are equally applied to all firms and artificial regulatory restrictions on competitors entering each other's businesses are simultaneously lifted for all providers. The promise to Kansas customers of the benefits of competition cannot be fully realized without such regulatory parity. Equally important, policy makers must ensure that the chief goal of telecommunications policy for the last fifty years, namely the universal availability of affordable telecommunications service, is not jeopardized by the authorization of additional competition.

Notes

* The views expressed by Mr. Drexel in this article are his own and do not necessarily reflect the views of Southwestern Bell Telephone Company.

1. Kansas Corporation Commission Order, Doc. No. 166, 856-U, In the Matter of Southwestern Bell Telephone Company's Proposal for Network Modernization, Rate Stability and Pricing Regulation a/k/a "TeleKansas" (Feb. 2, 1990) [hereinafter TeleKansas I].
2. Kan. Stat. Ann. § 66-1,197 (Supp. 1994) [hereinafter TeleKansas II].
3. TeleKansas II, *supra* note 2.
4. TeleKansas I, *supra* note 1.
5. Op. Att'y Gen. 94-60 (1994); TeleKansas II, *supra* note 2.
6. Op. Att'y Gen. 94-60 (1994).
7. *Id.* at 2-3.
8. *Id.*
9. *Id.*
10. *Id.* at 3 (emphasis added).
11. *See id.* at 4.
12. *Id.*
13. *Id.*
14. *Id.*
15. Statement of Kansas Attorney General Robert T. Stephan regarding House Bill 3039, TeleKansas II (April 29, 1994).
16. *Id.*
17. Senate Journal, State of Kansas, 76th Cong., 1994 Session, at 1601 (Mar. 8, 1994).
18. *Id.*
19. *Id.*
20. *See generally* TeleKansas I, *supra* note 1.
21. Memorandum from the Kansas Corporation Commission to Internal Staff (undated) (available from the KCC Topeka) [hereinafter KCC Memo].
22. Kansas Legislative Research Dep't, Report to the Senate Commerce Committee, at 4-5 (Feb. 2, 1994).
23. *See* TeleKansas I, *supra* note 1, at 15.
24. KCC Memo, *supra* note 21, at 5.
25. *Id.* at 4.
26. TeleKansas II, *supra* note 2.
27. John Petterson, *Finney Signs Bell Profits Plan*, Kan. City Star, Apr. 15, 1994, at C-1.
28. *Id.*
29. Kan. Stat. Ann. § 66-1,187 *et seq.* (1992).
30. Kan. Stat. Ann. § 66-1,189 (1992).
31. Kan. Stat. Ann. § 66-104 (1992).
32. 73B C.J.S. *Public Utilities* § 34 (1983).
33. Smith v. Ames, 169 U.S. 466, 523 (1897).
34. William J. Baumol & J. Gregory Sidak, Toward Competition in Local Telephony 6 (1994).
35. *Id.*
36. *See* Michael K. Kellogg et al., Federal Telecommunications Law 53 (1992).
37. *Id.*
38. *Id.*
39. *Id.* at 423.
40. *Id.*

41. *Id.* at 1.
42. BAUMOL & SIDAK, *supra* note 34, at 6.
43. *See* KELLOGG ET AL., *supra* note 36, at 53-54 (providing a thumbnail sketch of the technological problems overcome in the cellular communications industry).
44. BAUMOL & SIDAK, *supra* note 34, at 16.
45. KELLOGG ET AL., *supra* note 36, at 651.
46. *Id.* at 712.
47. *See id.* at 693.
48. *See* Eli M. Noam, *Towards an Integrated Communications Market: Overcoming the Local Monopoly of Cable Television*, 34 FED. COMM. L.J. 209, 236 (1982).
49. *Id.*
50. Marshall Yates, *The Promise of Fiber Optics*, PUB. UTIL. FORT., Aug. 15, 1990, at 14.
51. BAUMOL & SIDAK, *supra* note 34, at 14.
52. *Id.*
53. Johnie L. Roberts & Mary Lu Carnevale, *Time Warner Plans Electronic Superhighway*, WALL ST. J., Jan. 27, 1993, at B10.
54. KELLOGG ET AL., *supra* note 36, at 712-13.
55. *See generally* KELLOGG ET AL., *supra* note 36, at 712-13; Frank W. Lloyd, *Cable Television's Emerging Two-Way Services: A Dilemma for Federal and State Regulators*, 36 VAND. L. REV. 1045, 1049-50 (1983).
56. KELLOGG ET AL., *supra* note 36, at 712-13.
57. *Id.*
58. *See generally* S. Con. Res. 1627, 76th Cong., 1994 Session (1994)(providing legislative history on TeleKansas II).
59. *See Midwest Gas Users Ass'n v. KCC*, 5 Kan. App. 2nd 653, 659 (1981); 73B C.J.S. *Public Utilities* § 61 (Supp. 1994).
60. SIDNEY A. SHAPIRO & JOSEPH P. TOMAIN, REGULATORY LAW AND POLICY vii (1993).
61. *See generally* TeleKansas I, *supra* note 1.
62. TeleKansas I, Appendix A, *supra* note 1, at 2.
63. *See generally* Cable Television Consumer Protection and Competition Act § 47 U.S.C 521 *et seq.* (Supp. 1994)[hereinafter Cable Act]. Unlike TeleKansas, under the Cable Act, the market rather than government regulates services subject to competition. *See also* FCC Order, Doc. No. MM 92-266, *In re* Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, at 6 (April 1, 1993).
64. FCC Order, *supra* note 63, at 7.
65. *Id.*
66. To completely eliminate any skewed investment biases, regulatory policies must be applied the same to all providers. Today there are many disparities, some of which must be addressed at the federal level, such as the equal ability of local telephone, and long-distance telephone and cable television companies to simultaneously enter each other's businesses on the same terms and conditions. Others may need to be addressed at the local level, such as the disparate regulatory treatment of different providers.
67. TeleKansas I, Appendix A, *supra* note 1, at 9.

3-25