



ATTORNEY GENERAL OF MISSOURI

JEFFERSON CITY

65102

JEREMIAH W. (JAY) NIXON  
ATTORNEY GENERAL

P.O. Box 899  
(314) 751-3321

September 10, 1993

OFFICIAL CASE FILE

David Rauch, Executive Secretary  
Missouri Public Service Commission  
Truman State Office Building, 5th Floor  
301 West High Street  
Jefferson City, Missouri 65101-1517

Re: TC-93-224, TO-93-192

Dear Mr. Rauch:

Enclosed herewith for filing in the above referenced case please find an original and fifteen (15) copies of the State of Missouri's Initial Brief in connection with the above-referenced matter. Please file stamp the extra copy and return it for our records.

Sincerely yours,

JEREMIAH W. (JAY) NIXON  
Attorney General

JANE E. EILERMANN  
Assistant Attorney General

JEE:lkp

Enclosures

FILED

SEP 10 1993

MISSOURI  
PUBLIC SERVICE COMMISSION

OFFICIAL CASE FILE

BEFORE THE  
PUBLIC SERVICE COMMISSION  
STATE OF MISSOURI

The Staff of the Missouri Public Service )	
Commission v. Southwestern Bell Telephone )	No. TC-93-224,
Company, a Missouri Corporation )	et al.

INITIAL BRIEF OF THE STATE OF MISSOURI

Submitted by:

JEREMIAH W. (JAY) NIXON  
Attorney General

JANE E. EILERMANN  
Assistant Attorney General

P. O. Box 899  
221 West High Street  
Jefferson City, MO 65102  
(314) 751-8817

Attorneys for State of  
Missouri

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## I. INTRODUCTION

In this consolidated proceeding, Southwestern Bell Telephone Company is requesting the adoption of its Telefuture 2 proposal in lieu of the \$150 million revenue reduction requested by the staff of the Missouri Public Service Commission based on traditional rate of return regulation.

In examining the statutory authority granted this Commission in Chapters 386 and 392, RSMo, it is apparent that this Commission lacks the authority to implement the alternative regulation portion of Telefuture 2 because (1) it constitutes retroactive ratemaking, (2) it contains an unlawful moratorium provision, (3) it creates a variable rate scheme in violation of § 392.240, RSMo Supp. 1992, and (4) constitutes "one issue" ratemaking in violation of § 392.240, RSMo Supp. 1992. Additionally, the modernization proposal raises serious legal concerns.

Even if this Commission were to find that it has the authority to adopt TF2, the reasonableness of its adoption is not supported by competent and substantial evidence. Therefore Telefuture 2 should be rejected in its entirety and this Commission should set just and reasonable rates according to ratebase rate of return regulation.

Although this brief does not address all the issues contained in the hearing memorandum, the Attorney General reserves the right to comment or respond on any of the issues raised in the other parties' briefs. Additionally, the omission of any

issue does not represent acquiescence on behalf of the Attorney General to any particular position regarding such issue.

Furthermore, the Attorney General supports the Staff's position on all revenue requirement issues including Yellow Pages and supports the \$150 million revenue reduction requested. This brief will address the alternative regulation and modernization issues raised by Telefuture 2.

## II. PROCEDURAL BACKGROUND

On December 18, 1992, this Commission established Case No. TO-93-192 styled "In the matter of proposals to establish an alternative regulation plan for Southwestern Bell Telephone Company" to consider the possible future extension of the existing alternative regulation experiment for Southwestern Bell Telephone Company (hereinafter referred to as "SWBT").

The current alternative regulation experiment for Southwestern Bell was adopted by this Commission in Case No. TO-90-1. TO-90-1 was the result of the settlement of Case No. TC-89-14 where this Commission ordered a \$101 million intrastate revenue reduction and found the reasonable return on equity for SWBT to be 12.61%. The terms of the settlement adopted in TO-90-1, required a rate reduction, an investment in SWBT's infrastructure and the introduction of an earnings sharing plan. The plan's duration was set at three years ending in December 1992 at which time a general rate or complaint case could be filed by the Staff or the OPC.

On October 9, 1992, by order of this Commission, the Staff, OPC, and SWBT filed recommendations to this Commission as to whether the plan should continue, continue with modifications, or be discontinued. At that time Staff, OPC, and SWBT filed a Joint Recommendation that the existing plan should be continued in its present form until January 1, 1994. The extension would allow all interested parties to fully consider alternative regulatory proposals and maintain the status quo with regard to the present incentive regulation experiment. This Commission adopt-

ed that Joint Recommendation, and among other things established a prehearing conference date. As a result of the prehearing conference held in Case No. TO-90-1, this Commission created a separate docket, TO-93-192 to evaluate the current plan.<sup>1</sup>

On April 15, 1993 this Commission consolidated TO-93-192 with TC-93-224. TC-93-224 is the complaint filed on January 15, 1993 by the Staff against SWBT alleging SWBT's rates produced excess earnings. The complaint requests a revenue reduction of approximately \$150 million a year. The Attorney General, Jeremiah W. (Jay) Nixon, has been granted intervention in both cases on behalf of the State of Missouri.

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<sup>1</sup>The procedural background for TO-90-1 and the substance of the existing incentive regulation experiment is contained in the Direct Testimony of Samuel Goldhammer. Ex. 93, pp. 2-3 and schedule 1, pp. 1-4 through 1-9 and 1-36 through 1-66. The Attorney General refers the Commission to the above cited portion of Mr. Goldhammer's testimony for a more detailed history of TO-90-1 than necessary to enumerate here and for the Joint Recommendation for the revised incentive regulation experiment attached to his testimony. The Attorney General will cite pertinent portions of the existing plan as appropriate for this brief rather than fully enumerate its terms here.

### III. SOUTHWESTERN BELL'S PROPOSAL

In this consolidated proceeding, Southwestern Bell Telephone Company is requesting adoption of its Telefuture 2 proposal in lieu of the \$150 million revenue reduction requested by the Staff of the Missouri Public Service Commission (Staff) based on traditional ratebase rate of return regulation.

SWBT has clearly indicated that it "cannot accept" the Staff or the OPC's incentive proposal requesting the setting of rates based on rate of return regulation before entering into any type of sharing plan (D. Robertson surrebuttal, ex. 50, p. 6). SWBT further indicates that if the Commission discontinues incentive regulation by rejecting Telefuture 2, SWBT is requesting that this Commission return to traditional regulation (Id.). Finally, it is clear that if the Commission does not accept Telefuture 2 in its entirety, SWBT will not commit the investment included in Telefuture 2 (Hearing transcript, hereinafter "tr.," 711). Therefore, SWBT is requesting this Commission to examine its proposal and accept it in its entirety or return to traditional ratebase rate of return regulation (Id. and tr. p. 838).

SWBT's Telefuture 2 proposal is outlined in the testimony of Dale Robertson, Assistant Vice President-External Affairs for the State of Missouri for SWBT. The Telefuture 2 plan is characterized as a continuation of the current experimental plan with some modifications, and provides for: (1) the continuation of an earnings sharing plan with certain modifications to the existing sharing grid; (2) the removal of Yellow Pages revenues from



the calculation of SWBT's earnings; (3) \$22 million a year rate reduction; (4) the expansion of the lifeline program; (5) a three year moratorium on rates with a provision preventing the filing of a complaint case against SWBT and preventing a rate case filed by SWBT unless its earnings fall below 9.21% ROE; (6) a one time investment of approximately \$84 million for accelerated compliance with the basic local service rule, and for a fiber optic network for Distance Learning and Telemedicine; and (7) no automatic requirement for an end to the plan (D. Robertson Direct, ex. 48, pp. 11-12 and Schedule 2). Though most of the proposals included in Telefuture 2 speak for themselves, the proposed changes to the sharing grid and monitoring procedures and the proposed investment package require further explanation.

Telefuture 2 proposes to lower the sharing thresholds contained in the current plan by 3.4% or 340 basis points except at the 17.25% ROE earnings cap. The 3.4% figure is to represent 1985 Yellow Pages earnings level. Therefore all the sharing thresholds except the 17.25% cap will be reduced to account for the 1985 earnings level of Yellow Pages. The current sharing grid is as follows:

### CURRENT PLAN

<u>Earnings Level</u>	<u>Sharing SWBT</u>	<u>Percentage Customer</u>
Up to 14.1% ROE	100%	0%
14.1% to 14.5% ROE	40%	60%
14.5% up to 17.25%* ROE	50%	50%
Above 17.25%* ROE	0%	100%

\*No SWYP imputation

The proposed sharing grid by SWBT in Telefuture 2 is as follows:

### TELEFUTURE 2 PROPOSAL

<u>Earnings Level</u>	<u>Sharing SWBT</u>	<u>Percentage Customer</u>
Up to 10.7% ROE	100%	0%
10.7% to 11.1% ROE	40%	60%
11.1% up to 17.25%* ROE	50%	50%
Above 17.25%* ROE	0%	100%

\*No SWYP imputation

The proposed sharing grid is not based on a rate of return calculated under traditional rate of return regulation but a modification of the existing grid (D. Robertson direct, ex. 48, pp. 13-14).

Telefuture 2 also includes a one-time \$84 million investment in network projects. Though there is strong disagreement as to the actual cost of the investment or the actual revenue requirement of the investment, this summary will provide the Commission with SWBT's proposal as they have advanced it.

In the prefiled portion of SWBT's case, SWBT committed to invest two million of the \$84 million to accelerate compliance with this Commission's basic local service rule except for partyline elimination. Partyline elimination was scheduled to be completed by the end of 1997 pursuant to the negotiated settlement of TC-89-14 (Id.). But at the hearing during cross-examination of Mr. Robertson, SWBT proposed to accelerate partyline elimination within 18 months of the adoption of Telefuture 2 (tr. 793-794). SWBT estimated that the party line acceleration will cost an additional \$11 million but will undertake the investment if the Telefuture 2 proposal is adopted Id.

The major part of the \$84 million investment included in Telefuture 2 is the deployment of a dedicated fiber network for Distance Learning Fiber Network and Telemedicine (D. Robertson, ex. 48, schedule 2, p. 2-1). According to the prefiled testimony, the Distance Learning will consist of the fiber optic cable and interoffice electronics to provide interactive video to every public school with 7th grade or higher within SWBT's rural service area. The Company is also prepared to meet any demand arising in metro areas (Id.). Telemedicine is proposed to be provided to all rural and metropolitan hospitals within its service area.

SWBT estimates that the fiber investment will account for \$82 million of the total investment package. Of that \$82 million, SWBT estimate that approximately \$37 million will be invested toward the interoffice fiber portion of the network and \$45 million be toward the fiber in the loop (tr. 759). The

interoffice fiber will consist of \$16.5 million for the cable and \$20.6 million for the electronics (W. Crossley, Direct, ex. 75, p. 13). The loop portion of the network will account for \$22.4 million of the investment for fiber cable and \$22.6 million for electronics (Id. at p. 11).

At the hearing, SWBT again offered to increase its investment to gain adoption of its incentive plan by offering to supply an expensive connecting mechanism called a CODEC to all the schools participating in the Distance Learning (tr. 855) and to extend the Distance Learning to private schools within its service area. The Company has indicated that providing the CODECS will cost approximately \$10 million (tr. 859). SWBT estimates that extension of Distance Learning to private schools could cost \$35 - \$45 million but will commit to the investment if Telefuture 2 is adopted. The total amount of added investment SWBT proposed at the hearing is \$56 million (tr. 1127). Thus the Company proposes to commit to invest \$140 to \$150 million to gain acceptance of the incentive proposal in lieu of the \$150 million revenue reduction contained in Staff's complaint.

## ARGUMENT

### A. LEGAL STANDARDS

Southwestern Bell Telephone Company is a public utility as defined in Section 386.020, RSMo Supp. 1992, and is subject to the jurisdiction of this Commission pursuant to Section 386.250(2). This Commission has jurisdiction over the complaint filed by the Missouri Public Service Commission Staff pursuant to Section 392.240, RSMo Supp. 1992.

The Public Service Commission is purely a creature of statute and its powers are limited to those conferred by its enabling statute, either expressly or by clear implication as necessary to carry out powers specifically granted. State ex rel. Utility Consumers Council of Missouri, Inc. et al. (UCCM) v. The Public Service Commission of Missouri, 585 S.W.2d 41, 49 (Mo. banc 1979) citing State ex rel. City of West Plains v. Public Service Commission, 310 S.W.2d 925, 928 (Mo. banc 1958). On appeal, an order of this Commission will be reviewed to determine if such order is authorized by law, and if so, whether it was reasonable UCCM, 585 S.W.2d at 47 citing State ex rel. Dyer v. Public Service Commission, 341 S.W.2d 795, 802 (Mo. 1960), cert. denied, 366 U.S. 924, 81 S.Ct. 1351, 6 L.Ed.2d 384 (1961), and State ex rel. Missouri Water Company v. Public Service Commission, 308 S.W.2d 704, 713 (Mo. 1957).

In determining the statutory authority of this Commission or the lawfulness of its order, a reviewing court need not defer to the Commission as it has no authority to declare or enforce

principles of law or equity. UCCM, 585 S.W.2d at 47, citing Board of Public Works of Rolla v. Sho-Me Power Corp., 244 S.W.2d 55 (Mo. banc 1952). However, in determining the reasonableness of a Commission order, the reviewing court will not substitute its judgment for that of the Commission if the order is supported by competent and substantial evidence on the record as a whole. UCCM, 585 S.W.2d at 47, citing State ex rel. National Trailer Convoy, Inc. v. Public Service Commission, 488 S.W.2d 942, 944 (Mo.App. 1972), and Missouri Water Co., 308 S.W.2d at 713.

In examining Chapters 386 and 392, RSMo, and the supporting case law construing these statutes, it is readily apparent that this Commission lacks the statutory authority to order the adoption of SWBT's Telefuture 2 proposal. Implementation of alternative regulation portion of Telefuture 2 is beyond this Commission's statutory authority because it (1) constitutes retroactive ratemaking, (2) contains an unlawful moratorium provision, (3) creates a variable rate scheme in violation of § 392.240, RSMo Supp. 1992, and (4) constitutes "one issue" ratemaking in violation of § 392.240, RSMo Supp. 1992.

The modernization portion of Telefuture 2 also raises serious legal concerns regarding this Commission's statutory authority. If ratepayers are forced to forgo a valid rate reduction to fund the investment package contained in Telefuture 2, this would constitute contributions in aid of construction and the amount of the contribution would legally be required to be de-

ducted from rate base and SWBT would be unable to ever earn a return on that investment.

Even if this Commission has the statutory authority to order the implementation of Telefuture 2, the reasonableness of its adoption is not supported by competent and substantial evidence. Therefore Telefuture 2 should be rejected in its entirety and this Commission should set just and reasonable rates according to traditional ratebase rate of return regulation.

B. THIS COMMISSION LACKS STATUTORY AUTHORITY TO ORDER THE IMPLEMENTATION OF TELEFUTURE 2.

1. This Commission lacks statutory authority to order the implementation of the alternative regulation portion of Telefuture 2.

An examination of Chapter 392 indicates that this Commission lacks the statutory authority to order the implementation of the alternative regulation portion of Telefuture 2 as it constitutes retroactive rate making. "Retroactive rate making" has been defined as "the setting of rates which permit a utility to recover past losses or which require it to refund past excess profits collected under a rate that did not perfectly match expenses plus rate-of-return with the rate actually established." UCCM, 585 S.W.2d at 59. Section 392.240.1, RSMo Supp. 1992, gives the Commission the authority to determine the rate "to be charged." This requires that the Commission set a fixed rate to be effective prospectively and prevents this Commission from redetermining the rate already set. UCCM, 585 S.W.2d at 58-59.

It is clear that the earnings sharing plan adopted by this Commission in TO-90-1 and any continuation of it through adoption of Telefuture 2 constitutes retroactive rate making. The refund provision of the earnings sharing plans clearly requires the company to refund excess profits under a rate previously established. Thus, any order implementing the earnings sharing plan constitutes retroactive rate making and is beyond this Commission's statutory authority. Section 392.240.1, RSMo Supp. 1992, UCCM, 585 S.W.2d at 58-59.



The next portion of the incentive plan which causes serious legal concerns is the provision for a moratorium on the reevaluation of the plan or monopoly rates. SWBT is requesting that the proposed alternative regulation plan "have no automatic sunset" as existed in the current plan which provided for a reevaluation of the plan after 3 years. (D. Robertson Direct Ex. 48, p. 11 & Schedule 2). Though SWBT indicates that at some point a reevaluation of monopoly rates may be required to determine if they are still reasonable, the Company prefers that no reevaluation of reasonableness of rates occur based on cost based regulation for the foreseeable future -- at least for the next 3 years. (tr. 723).

The regulation of utilities by the PSC is a continuing statutory responsibility. One of the primary purposes of the public utility law in Missouri is to provide a mechanism for continuous regulation as changes in conditions require. State ex rel. Jackson County v. Public Service Commission, 532 S.W.2d 20, 29 (Mo. banc 1975). The inability of this Commission to alter its orders and directives with regard to the regulation of a utility "potentially could prevent alteration of rates confiscatory to the company or unreasonable to the consumers." Jackson County, 532 S.W.2d at 30.

The Telefuture 2 proposal prevents anyone from filing a general rate or complaint case against SWBT for the life of the plan. (D. Robertson Direct, Ex. 48, p. 35). Though SWBT agrees that adjustments to the plan can occur, it is not anticipated that rates will be reevaluated for reasonableness based on

traditional rate base rate of return regulation within the life of the plan. Conversely, the Company is free under the plan to file general rate case before January 1, 1997 if SWBT's earnings fall below 9.21 ROE. Therefore, there is no possibility that the Commission would be unable to alter rates that are confiscatory. Because of the inability to file a complaint against SWBT, there is no safeguard to prevent unreasonable rates to consumers. SWBT will not agree to the Telefuture 2 plan if there is a possibility that a complaint could be filed against them within the next 3 years. (D. Robertson Direct, Ex. 48, p. 35). This provision of the plan raises serious constitutional concerns and violates the spirit of the Missouri utility regulation and an order for such a moratorium as proposed by Telefuture 2 would be unlawful.

Next, an order adopting the incentive plan would be beyond this Commission's authority in that the sharing provision provides for variable rates in contravention of the fixed rate system provided for in § 392.240, RSMo Supp. 1992.

Section 386.330, RSMo Supp. 1992, allows this Commission to investigate matters about which a complaint could be made, or to investigate to ascertain facts necessary to the exercise of its powers. Section 392.240, RSMo Supp. 1992, allows this Commission after a hearing based upon its own motion or upon a complaint to determine just and reasonable rates and set the "maximum" to be charged for telecommunication services upon consideration of all relevant factors. This provision specifically states that the Commission shall:

"with due regard, among other things, to a reasonable average return upon the value of the property actually used in the public service . . . determine just and reasonable rates . . . to be thereafter observed and in force as the maximum to be charged . . . for the performance or rendering of the service specified and shall fix the same by ordering to be served on all telecommunications companies . . . and thereafter no increase in any rate, charge or rental so fixed shall be made without consent of the Commission." (emphasis added)

This provision clearly establishes a fixed rate system providing for rates to remain in effect until a new rate is approved or permitted to take effect after the Commission has considered all factors relevant to set a proper maximum charge. UCCM, 585 S.W.2d at 56.

The earnings sharing plan on the other hand creates a variable rate system because customers' rates will change throughout the life of the plan depending on the amount of refunds based on fluctuating earnings. The plan establishes a range of earnings that trigger sharing and possibly refunds. The rate paid by a customer minus any refunds truly reflects the rate paid by the customer for phone service. In other words a customer won't truly know what rate he paid for phone service until the end of the year when refunds are calculated. Thus his rates will change from year to year depending on SWBT's earnings year to year. This type of variable rate system is prohibited by the fixed rate regulatory scheme contained in § 392.240, RSMo Supp. 1992, and beyond the Commission's authority to implement.

Finally, order of the incentive plan would be beyond this Commission's authority as it constitutes "one issue"

ratemaking in violation of § 392.240, RSMo Supp. 1992. Section 392.240, RSMo Supp. 1992, requires that when this Commission sets rates, it must consider all relevant factors including all operating expenses and the utility's rate of return. UCCM, 585 S.W.2d at 49. The refund provision of the earnings sharing plan requires the Company to refund earnings at a certain level according to the sharing grid. This is tantamount to a determination that the rates producing those earnings are too high. This determination to change rates based solely on fluctuating earnings constitutes one issue ratemaking in violation of § 392.240, RSMo Supp. 1992.

2. This Commission lacks statutory authority to order implementation of the modernization portion of Telefuture 2.

The modernization proposal in Telefuture 2 raises some equally serious legal concerns with regard to this Commission's authority. If rate payers are forced to forgo a valid rate reduction in order to fund the proposed Telefuture 2 investments, this constitutes a contribution in aid of construction which should be deducted from rate base and SWBT should not be able to earn a return of or on that investment.

"[T]he quintessence of a just and reasonable utility rate is that it be just and reasonable to both the utility and its customers." State ex rel. Valley Sewage Co. v. Public Service Commission, 515 S.W.2d 845, 851 (Mo.App. 1974). Additionally,

"[t]o force the customers and users of a utility to pay for rates predicated upon the value of a facility which they themselves substantially paid for, as is the case here, is the antithesis of a just and reasonable rate. Conversely, where the customers and

users of a utility have substantially paid for the facilities employed in the public service, the antithesis of a just and reasonable rate is one that would permit a utility's stockholders to recover a return on money which they, in fact, never invested."

Id.

In this case the Staff estimates that SWBT's rates produce \$150 million in excess revenues. In lieu of setting just and reasonable rates according to traditional ratebase rate of return regulation, SWBT is proposing to reduce rates by \$22 million and invest in infrastructure. If ratepayers are forced to forgo a rate reduction to allow SWBT to modernize, then in essence the ratepayers will be funding the modernization.

In order to set just and reasonable rates, this Commission must deduct these forgone reductions to fund the investment, from SWBT's ratebase as a contribution in aid of construction and prevent SWBT's stockholders from recovering a return on that investment. Id. Nowhere in SWBT's proposal do they agree that the excess revenues produced by their rates to fund the modernization portion of Telefuture 2 should be excluded from rate base. To allow SWBT to use excess earnings to fund the investment in Telefuture 2 without removing that contribution in aid of construction from ratebase would be an abdication this Commission's duty to set just and reasonable rates and would be beyond this Commission's authority.

C. ADOPTION OF TELEFUTURE 2 IS NOT SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE.

Even were this Commission to find that it has the statutory authority to order the implementation of Telefuture 2, there is no competent and substantial evidence in the record to justify its adoption.

In support of its case against the adoption of Telefuture 2, the State of Missouri has offered the rebuttal and cross-sur-rebuttal testimony of Dr. Mark Cooper, Ph.D. (Exs. 82 & 83), a national expert in the area of telecommunications regulation. Dr. Cooper has testified on various aspect of telephone ratemaking before the Public Service commissions of 16 states, the Federal Communications Commission and the Canadian Radio-Telephone Commission (CRTC) and a number of state legislatures. Additionally, in the past several years he has participated in network modernization and regulatory reform inquiries of 9 states and the FCC and the CRTC. (Dr. Cooper Rebuttal, Ex. 82, p. 2).

The purpose of his testimony is to present to the Commission a broad range of issues raised by the introduction of Telefuture 2 that deeply effect the state's telephone bills and services and broader economic development issues raised by the modernization proposal.

Dr. Cooper's testimony raises some serious concerns with the alternative regulation and modernization proposals in Telefuture 2. He is able to give a national perspective on the performance of rate of return regulation versus alternative regulation and has offered some broad policy concerns that will

aid this Commission in determining the appropriate form of regulation for SWBT at this time. Additionally, his testimony contrasts the Company's modernization proposal with what he sees as the next logical step in the technological development of the telecommunications network - narrow band ISDN. His testimony will help broaden the Commission's perspective on the options available for technological development of the telecommunication network. (Ex. 82, p. 3).

For purposes of this brief, the Telefuture 2 proposal will be divided into two separate issues: (1) the propriety of the alternative regulation scheme proposed by Bell and (2) the modernization proposal. This division of issues reflects Dr. Cooper's first major concern about Telefuture 2, namely that the issue of alternative regulation is being improperly tied to the issue of network modernization. (Ex. 82, p. 16-17).

The Company has stated that it will commit to the modernization proposal only in exchange for its specific form of regulation (tr. 711). This ultimatum raises two very serious concerns (Ex. 82, p. 16-17). First, the company should not be able to hold technological improvements hostage in order to obtain a certain form of regulation. Every technological investment should be made with economic justification or the investment "by definition [is] at a higher price than could be achieved through some other means" (Ex. 82, p. 58). All capital investments should be tested for economic efficiency rather than determining whether it should support alternative regulation. The second major concern is that under Telefuture 2, SWBT's modernization

proposal will be funded from excess profits that belong to rate-payers and in essence is no different from a tax (Ex. 82, p. 16-17). As stated above, this arrangement would constitute an unlawful exercise of authority by this Commission and would be unfair to ratepayers.

Finally, these issues should be handled separately because there is no evidence of a correlation between alternative regulation and modernization (Ex. 82, p. 29-33) and S. Goldhammer Direct, Ex. 93, p. 4). Under traditional rate of return regulation, telecommunications companies have always made technological improvements when economically efficient in order to fulfill its obligation for providing the best service possible (S. Goldhammer Direct, Ex. 93, p 4 and Ex. 82, p. 29-33). Additionally, when it is necessary to provide adequate service this Commission has the statutory power to require companies to improve the network. For instance, the Commission has exercised this power by passing the basic local service rule. § 392.250, RSMo Supp. 1992 and 4 CSR 240-32.100. Therefore a specific form of regulation is not necessary to achieve modernization and the two issues should be discussed separately.

1. Adoption of the alternative regulation portion of Telefuture 2 is not supported by competent and substantial evidence.

SWBT has proffered that "'traditional rate base, rate of return regulation' which would be the result of Staff's January 15, 1993, complaint (TC-93-224) is the wrong path for the Commission to pursue in terms of regulatory policy for this state, and . . . such a proposal is contradictory to the regula-



tory accord put in place by the Commission at the inception of the current plan" (D. Robertson, Direct, Ex. 48, p. 1-2). SWBT is asking this Commission to abandon traditional rate of return regulation and adopt TF2 because it requires further incentives to invest in Missouri and because increased risks of competition justify adopting alternative regulation (D. Robertson Direct, Ex. 48, p. 1, 5 & 10). Yet there is no competent and substantial evidence that abandoning rate of return regulation is the proper course for this Commission to take. In fact, the record of rate of return regulation has been very successful in (1) keeping the real prices of phone service down, (2) increasing penetration rates, (3) providing incentives for efficiencies and investment whereas alternative regulation has not enjoyed the same success. Abandoning rate of return regulation at this juncture would effectively remove all protection for ratepayers against monopoly abuse without providing the incentives the Company purports to gain with alternative regulation.

Rate of Return regulation has been very effective in driving the real price of telephone service down (Ex. 82, p. 10-11). In the half century of extensive regulation of telephone companies, the rate of increase in the price for telephone service was about half of the rate of increases for all consumer items (Ex. 82, p. 10-11 and Schedule MNC-4). This declining real price of service has in turn been instrumental in increasing penetration rates for telephone service (Ex. 82, p. 11).

Conversely alternative regulation's performance with regard to real price for service and penetration rates has not been as

positive (Ex. 82, p. 11-12). Generally rates have been higher and rate increases have been larger in states which have adopted alternative forms of regulation (Ex. 82, pp. 11-12 and Schedule MNC-5). As can be expected, higher telephone rates have slowed the growth in penetration rates under alternative regulation. (Id.)

The central theoretical charge against rate of return regulation is that it fails to provide proper incentives for technological progress (Ex. 82, p. 27). Yet there is no empirical studies to show that rate of return regulation produces a lack of incentive to innovate (Ex. 82, p. 28). Conversely, telecommunication infrastructure development under rate of return has proven to be very successful (Ex. 82, p. 30). "Prior to the 1980's, telecommunications companies made capital expenditures at a much faster rate than companies comprising Standard and Poors 400 over the last three decades" (Ex. 82, p. 30 and Schedule MNC 8). Since World War II the growth in productivity for the telecommunications industry has been almost three times greater than the average for all non-residential businesses (Ex. 82, p. 30).

On the other hand, alternative regulation has not lead to increased investment in the network (Ex. 82, p. 31). Capital expenditures as a percentage of cash flow for the Regional Bell Operating Companies has declined since the movement to alternative regulation (Ex. 82, p. 31 & Schedule MNC 10). Additionally, ". . . the more jurisdictions in which an RBOC operates which have shifted to alternative regulation, the larger the

decline in capital expenditure as a percentage of cash flow (Ex. 82, p. 31-32 & Schedule MNC-11). Dr. Cooper has testified that this cash has been thrown off to dividends to stockholders and to unregulated assets (Ex. 82, p. 32-32 & Schedules MNC-11 & 12).

Southwestern Bell has followed this national RBOC pattern of cash flow diversion. Schedule MNC-13 shows there has been a decline in the percentage of cash flow SWB has devoted to capital expenditures (Ex. 82, p. 32-33). Especially with regard to 1990 and 1991 where virtually none of the SWB's increases in cash flow have been devoted to capital expenditures.

SWBT has indicated that one of the reasons the current alternative experiment has been so successful is that "investment in the telephone network has been made at a record rate." (D. Robertson Direct Ex. 48, p. 3). The Company has also indicated that as the Company earns better returns it will have more reason to invest those returns in Missouri (Id. at 10). Yet their own witness admits that SBIRE has failed to produce investment at a record rate. Also direct evidence totally refutes any claim that increased earnings will increase investment.

The actual level of capital expenditures made in Missouri for the period of 1985 - 1992 was explored during the cross-examination of Mr. Robertson. Mr. Robertson admitted that the level of capital expenditures in 1985 while SWBT-MO was operating under traditional rate of return regulation, were higher than the levels for both 1990 and 1992 while SWBT-MO was operating under the alternative regulation experiment. (tr. 705). For

the period 1985-1987 under traditional rate of return regulation, SWBT capital expenditures totalled \$754 million (Id.) Capital expenditures for 1990-1992 under alternative regulation totalled \$799 million (Id.). Adjusted for 3 percent inflation, the capital expenditures for these two periods were roughly equal (tr. 706). So its clear that incentive regulation provided no more incentive to increase real capital expenditures than traditional rate of return regulation. By giving SWBT more earnings under alternative regulation, Missouri has received roughly the same amount of capital investment as it received in the 1985-1987 period under traditional rate of return regulation.

SWBT indicated that they were not concerned with the real amount of capital expenditures, but the point that incentive regulation caused them to invest more than they would have otherwise (tr. 707). Yet as recognized by Staff, SWBT's construction funding is "not influenced by the type of regulation which an operating state is subject to." (G. Meyer Rebuttal Ex. 3, pp. 5-7).

The percentage of construction funding devoted to SWBT-Mo. has not significantly increased under the current alternative regulation experiment. This fact led the Staff to conclude

SWBT, through several of its witnesses' testimony claims that Missouri benefitted in network modernization through adoption of SBIRE. However, as we demonstrated through the Staff's analysis, these statements are very misleading. SWBT-MO operations did not receive any greater percentage of total construction funding as a result of SBIRE. The Staff contends instead that SWBT-MO merely prioritized its construction funding

from other projects to meet its commitment that resulted from the settlement of Case No. TC-89-14. Increased construction funding in the 1990-1992 time frame was the direct result of greater total Company funding and not the result of SBIRE. Also, the increased construction expenditures incurred by SWBT in the 1990-1992 period have been achieved by SWBT in earlier years when the Company operated under traditional regulation. From the Staff's perspective, SWBT is demanding incentive regulation in this proceeding as the price to maintain a status quo construction program, and the Staff has seen no evidence to support the Company's claim that they will go beyond the ordinary construction funding in relative terms for Missouri if the TF2 proposal is adopted.

Not only is there no support for the proposition that TF2 will provide more incentives to invest in Missouri, but further there is specific evidence in the Staff's case that earnings have been diverted from capital expenditures in Missouri to unregulated activities and shareholder dividends (R. Schallenberg Rebuttal Ex. 30, p. 15-18). This conclusion by Staff, which is also echoed by Dr. Cooper, totally refutes SWBT's assertions that their level of earnings directly impacts their network expenditures. What is truly impacted by earnings is the profits siphoned to SBC for unregulated activities.

From the foregoing it is clear for the record that alternative regulation has not created the incentives to invest in the past nor will it increase incentives in the future. Therefore, there is no competent and substantial evidence to support the conclusion that alternative regulation is necessary to provide SWBT the incentive to invest.

The second justification SWBT offers to justify adoption of TF2 and abandon traditional rate of return regulation is

that SWBT is faced by "increased risks of competition." (tr. 970). The assertion that SWBT is faced with competition for the services that produce the vast majority of its revenues or the assertion that traditional rate of return regulation is unable to effectively deal with competition is not supported by competent and substantial evidence.

The vast majority of SWBT's revenues are produced by basic local service, and they are an insulated monopoly by law with regard to that service (tr. 988). There are essentially no real alternatives to basic local services. Mr. Orozco admitted that the only possible competition for local exchange service is cellular phone service (tr. 1020). Yet he also states that cellular really isn't a viable economic alternative for residential local exchange customers (tr. 1010). Additionally, there is no evidence that SWBT has lost revenues or faced disconnects as a result of cellular phone service in any sector of the market (tr. 1021). Therefore, in reality, the vast majority of Southwestern Bell's revenues are not at risk due to competition at the present time.

Though there is no competition in the local exchange arena, it can be argued that there is some level of competition for various other SWB services (i.e., message toll, operator services, WATS and 800 service, private line and special access) (C. Orozco Direct, Ex. 65, p. 2). There is no evidence that traditional rate of return regulation is not equipped to deal with competition if and when it arrives.

First, HB360 gives this Commission the authority to grant telecommunications companies pricing and promotional flexibility for competitive and transitionally competitive services. SWBT has utilized this statutory scheme and filed cases for only 5 services all of which were granted (tr. 814). If SWBT were really concerned with competition it would be more aggressive in securing rate bands to effectively compete. This statutory scheme was passed by the legislature in order to aid this Commission in dealing with competition. It would be improvident to abandon the protections afforded monopoly ratepayers by traditional rate of return regulation by relaxing regulation for all of SWBT services when the present regulatory scheme can effectively deal with competitive services.

Second, as Dr. Cooper testifies, the rate of return authorized includes a very large risk premium (Ex. 82, p. 5). He testified that increasing the risk premium included in the allowed rate of return can effectively deal with competition (Ex. 82, p. 10).

It is clear that the largest revenue producing service SWBT offers is not subject to real competition at the present time. Should competition ever enter the local exchange market Dr. Cooper's surrebuttal testimony offers some very specific guidelines to allow this Commission to evaluate that competition (Ex. 83, p. 1-7). To relax regulation for all of SWBT services, when the vast majority of its revenues are produced by monopoly rates would put ratepayer protection in jeopardy (Ex. 83, p. 6-7). The only effective way to simulate competition in a monop-

oly environment is to restrict earnings to reasonable levels (Ex. 82, p. 46). The only way to effectively restrict earnings is to remain within the realm of cost based regulation (Ex. 82, p. 45).

SWBT has argued that this Commission need not look at costs in determining just and reasonable rates but should focus on the service price (D. Robertson Direct, Ex. 48, p. 9). Mr. Wilk on behalf of Southwestern Bell has indicated that as long as rates are set so as to not be confiscatory to the Company or cause widespread political concern to the consumer that this satisfies this Commission's duty to set just and reasonable rates (tr. 911). Additionally, Mr. Robertson testified that as long as customers are satisfied with the price of their telephone services that the Commission would still be setting just and reasonable rates (tr. 716). It is unrealistic to believe that monopoly ratepayers are in a sufficient position to judge whether their rates are reasonable. To accept this view of how to set monopoly rates would be an abdication of this Commission's duty to set just and reasonable rates.

2. Adoption of the modernization portion of Telefuture 2 is not supported by competent and substantial evidence.

The modernization portion of Telefuture 2 raises some serious public policy issues that warrant close scrutiny by this Commission. Though its clear that everyone supports technological improvements for education and health care, there are numerous issues that should be addressed before the type of social investment proposed by SWBT is accepted (Ex. 82, p. 14). Dr.



Cooper's rebuttal testimony outlines some of the major concerns with TF2's modernization proposal and contrasts it with what he sees as the next logical stage in the technological and economic development of the telecommunications network (Ex. 82, p. 3).

The first major concern is that the program involves a direct subsidy from ratepayers to educational institutions and possibly medical institutions (Ex. 82, p. 14). As discussed above, this raises serious legal concerns but the issue here is the unfairness to the ratepayers. Ratepayers are being asked to forgo a valid rate reduction of 150 million a year to fund a 127-137 million dollar investment in this "fiber optic superhighway" (82 million in prefilled testimony and 10 for the CODEC SWBT has agreed to provide schools and 35-45 million to extend Distance Learning to private schools) that SWBT will get a return on. Ratepayers are essentially investing on behalf of SWBT.

Though Mr. Bailey on behalf of SWBT indicates that they expect a "less than zero" return on the 82 million investment (tr. 1222), this does not take into account the future SWBT services that will benefit from the fiber deployed as a result of TF2. The incremental cost for future users to tap into the fiber network will be somewhat less. Therefore, ratepayers funding TF2 will essentially be subsidizing those future services (tr. 1225-1227). Additionally any new services using the fiber placed in TF2 would be provided at tariffed rates (tr. 1224) and those services would see a significant return (tr.

1225). *Once ratepayers fund the deployment of this fiber backbone SWBT will see the return on it for all future services.*

Secondly, though there are far more economic alternatives available, if it is determined that a dedicated broad band network is the right choice, it still must be determined that SWBT is the proper entity to deploy it (Ex. 82, p. 15). In order to prevent inefficiency and wasting of resources it is necessary to determine which entity could provide the best service at the lowest possible cost (Ex. 82, p. 16). Virtually every institution is passed by a broad band cable network (Ex. 82, p. 16). Instead of having ratepayers subsidize the telephone company in deploying a duplicate broad band network, maybe Missouri citizens would be better off in subsidizing the cable companies.

Dr. Cooper has presented a specific proposal of what he sees as the next logical step in the development of the telecommunications network - narrowband ISDN. This proposal is outlined in detail in Attachments 2 and 3 and warrant this Commission's consideration. This proposal will aid in broadening this Commission's perspective on options available for the development of the telecommunications network. Though his proposal is far too detailed to enumerate here, there are some important policy issues with regard to his proposal that warrant pointing out (Ex. 82, pp. 14-26).

The key to the narrow band ISDN proposal of Dr. Cooper's is that it can deliver the information age in a more ubiquitous

manner and in a more economically efficient way than dedicated fiber network contained in TF2 (Ex. 82, p. 18).

First, the necessary technological infrastructure necessary to deploy ISDN (e.g., digital switches, SS7, and copper wire) are largely deployed and those costs have been or soon will be included in ratebase (Ex. 82, p. 18). TF2 will require deploying all the interoffice fiber and fiber in the loop at a cost of \$82 million dollars. Next, the equipment necessary to use ISDN is widely available. There are well over 100 million communications platforms waiting to hook into the information age (e.g., computers, E-mail) (Ex. 82, p. 18-19). Whereas Telefuture 2 will require the schools and hospitals to purchase expensive equipment to utilize the service. For example for Distance Learning the cost per classroom will be \$40,000 (tr. 1097). Though SWBT has agreed to provide the \$17,000 connecting mechanism the CODEC, it still will require \$23,000 investment in equipment per classroom (Id.) That cost does not include necessary classroom modifications or specialized personnel (tr. 1097-1098).

Next, ISDN is an affordable option, and has a reasonably identifiable market and is provided on a pay as you go basis (Ex. 82, p. 22). On the other hand, there is serious concern whether there is truly a demand for the interactive video project contained in TF2. There is no firm commitment from any of the schools, and all that is required before the deployment of fiber is a nonbinding document indicating an interest (tr. 1095). SWBT has indicated that if the anticipated demand

doesn't materialize then the PSC and OPC can agree on how the money should otherwise be spent (tr. 1096). The fact that SWBT has provided for this contingency indicates how speculative demand really is for this network. There is no dispute that the fiber investment proposed in TF2 is uneconomic or SWBT would invest in it on its own. SWBT has indicated that without alternative regulation that this investment would not be economic and would not be made for years.

Narrowband ISDN is an excellent interim solution to technological development until broadband is economically viable. This proposal is meant to offer this Commission a possible alternative. But realistically until all possible proposals can be effectively evaluated to determine the most economic way to achieve the best results, it would be premature to order this type of investment especially in light of HB 566.

HB 566 was recently signed into law and creates the "Commission on Informational Technology." The Commission is to develop a statewide strategy

by using technology and facilities available to all residents to enhance and equalize educational opportunities for all Missouri students by providing greater access to information, to enhance the state's delivery of health care and to enhance economic development opportunities in a cost-effective manner.


In developing this statewide strategy on informational technology, the Commission will be addressing such issues as efficiency and duplication of resources, coordination of efforts, economic and cultural development, financing equipment and personnel. The Commission will also work in cooperation with business,

consumers, and the telecommunications industry to among other things take inventory of existing programs and assess the effectiveness of those programs. There are many options that have not been fully explored within the limited confines of the present case. These issues need to be resolved before embarking on the dedicated fiber optic network proposed by SWBT in TF2. Adoption of the modernization portion of TF2 at this time is not supported by competent and substantial evidence and should be rejected by this Commission.

WHEREFORE, the Attorney General respectfully requests this Commission to reject Telefuture 2 in its entirety and set just and reasonable rates according to traditional ratebase rate of return regulation.

Respectfully submitted,

JEREMIAH W. (JAY) NIXON  
Attorney General

  
JANE E. EILERMANN  
Assistant Attorney General  
Missouri Bar No. 43156

Broadway State Office Building  
221 West High Street, 8th Floor  
Post Office Box 899  
Jefferson City, Missouri 65102  
(314) 751-8825

Attorneys for State of Missouri

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was mailed, postage prepaid, by United States mail, to all counsel of record.

  
JANE E. EILERMANN