The Arizona Constitution Hangs UP on Telephone Competition

by
Randall H. Warner

JUDGING BY THE TV ADS and trenched-up streets, it appears telephone competition **is on the verge of breaking through** in Arizona. For decades, Qwest—f/k/a US West f/k/a Mountain Bell—enjoyed a state-sanctioned monopoly over local telephone service in most of the state. Now, **dozens of companies are working** to lure away your business. They offer advanced services, promise **better customer service** and will even negotiate rates.

Technology made this competition possible. Economics made it desirable. Whether the Arizona Constitution will make it legal remains to be seen.

Since statehood, the Arizona Corporation Commission has set utility rates by determining a reasonable return on the fair value of the utility's assets. This makes perfect sense where there is only a single provider in a given area. It makes no sense in a competitive market, which must allow participants to set prices in response to market conditions.

Yet the Arizona Court of Appeals has interpreted the Arizona Constitution to require exactly that. The Corporation Commission, it held, must set rates for all public service corporations—incumbent providers and competitors alike—based on the fair value of their Arizona assets.[1]

Fair value ratemaking is antithetical to competition, yet the constitution may well require it. It is a classic case of technology outpacing law. Whereas digital routers drive our telecommunications systems, our regulatory framework remains in the age of manual switchboards.

This article explores the legal and historical basis of this constitutional quandary, how it affects the regulation of competitive telecommunication providers and how it might be resolved. Although the issue remains subject to further judicial review, it may take an amendment to finally bring the constitution in step with twenty-first century technology.

Regulated Monopolies

Back in 1910, when Arizona's constitution was adopted, services like electricity, water and telephones were provided by "regulated monopolies"—public service corporations with the exclusive right to serve within a geographic area. To allow more than one provider in the same area was thought a senseless redundancy. Imagine two separate phone companies each installing a network of telephone poles and wires over the same area. Unheard of!

These public service corporations obtained certificates of convenience and necessity (CC&Ns) from the Corporation Commission that granted them monopolies in their service areas. The quid pro quo was rate regulation and a duty to serve all customers. The Corporation Commission fixes their rates, which must be reasonable to ratepayers but high enough to permit the company a fair profit.

Rate-Setting the Old-Fashioned Way

The drafters of Arizona's constitution codified this rate-setting concept in several provisions. Article 15, Sections 3 and 12 require that all rates charged by public service corporations be "just and reasonable." Section 14 takes this a step further by requiring the Corporation Commission to ascertain the value of a utility's assets in setting rates: "The Corporation Commission shall, to aid it in the proper discharge of its duties, ascertain the fair value of the property within the State of every public service corporation doing business therein."

As the courts have interpreted these provisions, the Corporation Commission must set a utility's rates based on a reasonable return on the fair value of its assets. This asset base is called "fair value rate base."[2]

Why fair value rate base? The basic assumption (which is no longer true) is that utilities invest in facilities such as telephone poles, lines, switches and so forth and serve their customers using those facilities. The shareholders who make the investment are entitled to a reasonable return, no more or less. This encourages investment in necessary facilities and precludes price-gouging. To discharge its constitutional duty to set just and reasonable rates, the Corporation Commission must determine the

value of the investment and a reasonable rate of return.

Setting rates in this manner is no easy task. It is done through massive, contested proceedings called "rate cases." The filing requirements alone for rate cases are daunting[3]: Qwest/US West's initial filing for its most recent rate case was four volumes thick. And the case took more than two years to complete.

Neither the concept of fair value ratemaking nor the means by which it is accomplished are suitable to a competitive market.

Telephone Competition

Though various forms of competition have been seeping into the telecommunications industry for decades (remember when you first were allowed to buy your own telephone?), the modern era began in the mid-1990s. In 1995, the Corporation Commission promulgated rules permitting other telecommunications providers to compete in what were previously monopoly service areas.[4] In 1996, Congress enacted the Telecommunications Act of 1996,[5] which requires states to open telecommunications markets to competition.

Several companies sought authority to compete in Arizona. Some of these are competitive local exchange carriers (CLECs), which provide the basic local phone service that Qwest/US West has always provided. Many are long-distance resellers, who merely buy long-distance service from large providers like AT&T, Sprint and MCIWorldCom and resell it to end users.[6] Today, dozens of companies have received or applied for authority as CLECs, and hundreds are authorized long-distance resellers.

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Competitive providers can be facilities-based—they provide service through their own switches, lines and other facilities—or they can resell service purchased at wholesale from another provider. Under federal law, incumbent local exchange carriers like Qwest/US West must make certain elements of their network available to other providers for resale. Although some companies only resell the service of others, most major CLECs serve customers through a combination of their own facilities and resold network elements. This is how they provide the same service without installing a completely parallel network.

Under the competition rules, competitive providers may change their rates freely, subject to maximum rates approved by the Corporation Commission.[7] These maximum rates are typically above-market, giving the carrier plenty of flexibility. The rules do not require competitive carriers to justify their rates based on fair value rate base or a reasonable return.[8]

The *U.S. West* Case

Not surprisingly, Qwest/US West challenged the Corporation Commission's rules allowing competition. It argued, among other things, that Arizona's constitution requires the Corporation Commission to set rates for all telephone carriers based on the fair value of their assets and a reasonable rate of return. Any rules to the contrary, it argued, are unconstitutional.

That argument is heresy to competitive carriers. Imagine if McDonalds, before pricing a Big Mac, had to go before regulators, open its books, discern the fair value of its assets and justify its rate of return. One would hardly expect a healthy hamburger market to develop.[9] Thus, competitive carriers argued that the constitution's fair value provisions were intended to apply only to monopoly utilities. They also argued that requiring competitive carriers to justify their rates with fair value rate base impedes competition in violation of the 1996 Telecommunications Act.

The Arizona Court of Appeals agreed with US West. In *U.S. West Communications v. Arizona Corporation Commission*,[10] Division One held that the Commission's rules are unconstitutional because they fail to provide for rate-setting based on fair value rate base. The court recognized that this method of fixing rates may be anachronistic in a competitive market but is nonetheless required by the Arizona Constitution:

> We hold that the Arizona Constitution requires the Commission to determine a fair value rate base for all public service corporations before setting rates, unless and until the fair value determination requirement contained in article 15, section 14, is amended by the people of this state.[11]

The court then rejected the argument that applying a fair value requirement to competitive carriers violates federal law.[12]

A Nineteenth Century Concept in a Twenty-First Century Market

At the extreme, the *U.S. West* case could mean that competitive carriers must justify their rates in the same manner and to the same extent as Qwest/US West. This is a nightmarish prospect, not just for competitors but also for already time-strapped regulators. A more moderate reading of the case is that competitive carriers must make some sort of fair value demonstration that is less than a full-blown rate case but enough to provide reasonable grounds on which to allow the Commission to fix rates. Even that, however, would severely dampen competition for various reasons.

For one, there are very real logistic hurdles. Many competitive carriers would not know how to begin justifying their rates on a fair value basis. Even more problematic are the resellers who have no Arizona facilities. For those companies, there is simply no meaningful way to link assets with rates.

There is also the time and expense of fair value ratemaking. Regulatory approval can take months. Rate proceedings are costly to prepare, and even more so when

rates are contested. This effectively eliminates the ability of competitive companies to roll out new rate plans in response to changing market conditions.

Most daunting, however, is simply the idea that competitive rates would be reviewed to determine their reasonableness in relation to a company's assets. Rate decisions might even be appealable,[13] raising the specter of legal challenges by competitors to prevent a new rate plan. What is worse, companies would be subject to the burden of rate regulation without the reciprocal benefit of a guaranteed return.

All this would make Arizona extremely undesirable for telecommunications competitors. Instead of trying to justify their rates based on fair value and reasonable return, many companies would simply pick up their marbles and take them to more friendly markets.

The Fallout

Within weeks of the *U.S. West* decision, the Commission started acting on it. Each competitive carrier with a pending CC&N application received an order requiring it to provide extensive fair value rate base information.

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The order dictated that each company file a description of all its plant and equipment used to provide service in Arizona and demonstrate how the value of those assets justified its rates. If the company's maximum rates are higher than Qwest's for the same services, the order required the company to show that the rates are reasonable and constitute a fair rate of return.

Competitive carriers were confounded. Although some tried to comply with these orders, others found it almost impossible. In the meantime, the competitors appealed the *U.S. West* decision to the Arizona Supreme Court.

Since then, the Corporation Commission has softened its stance pending the Supreme Court's resolution of the issue. Its standard orders now require some fair value justification, but not nearly to the extent originally required. This is clearly a temporary measure—what its orders ultimately will look like depends entirely on how the Supreme Court rules.

Something's Got To Give

The Supreme Court heard arguments in the *U.S. West* case in May. Although no one knows how the issue ultimately will pan out, one thing is clear: Telephone competition and fair value ratemaking will have a hard time peacefully coexisting. Robust competition will likely never occur if competitors have to justify their rates like regulated incumbent utilities.

The Supreme Court may resolve this problem by interpreting the fair value rate base requirement to apply only to monopoly utilities or by deeming it a barrier to competition inconsistent with the 1996 Telecommunications Act. A federal court or the Federal Communications Commission might reach the same result on the federal issue.

In the end, however, Arizona's constitution may well have to be amended. Ironically, the recently failed Proposition 108 would have eliminated the fair value requirement for telephone carriers, but it was so riddled with other problems that competitive providers opposed it. It failed by a margin of 80 percent to 20 percent.

Amending the constitution will require a delicate balance. We should not throw away its ratemaking provisions completely. Even though competition is starting to bud, Qwest/US West and other incumbent local exchange carriers still dominate in their service areas, and it would be foolish to think consumers no longer require protection. At the same time, the constitution should not force our telecommunications market to remain in the last century.

Postscript—Electric Competition

Concurrent with the Corporation Commission's attempt to introduce telephone competition has been an effort to bring competition to the electric industry. Although there are significant differences between the two industries—for example, no federal law mandates electric competition—the constitution's fair value provision applies to both. Indeed, Judge Colin Campbell of Maricopa County Superior Court has held the Corporation Commission's electric competition rules invalid based on the fair value requirement, and that ruling is being appealed. Any resolution of the fair value issue, whether judicial or by constitutional amendment, must take into account the effect on both industries.

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1. *U.S. West Communications v. Arizona Corporation Commission*, 8 P.3d 396 (Ariz. Ct. App. 2000).
2. *Simms v. Round Valley Light & Power Co.*, 294 P.2d 378, 383 (Ariz. 1956); *Scates v. Arizona Corporation Commission*, 578 P.2d 612, 615 (Ariz. Ct. App. 1978).
3. *See* A.A.C. R14-2-103.
4. A.A.C. R14-2-1101 *et seq.*
5. Pub. L. No. 104-104, 110 Stat. 56 (1996).
6. The Corporation Commission has jurisdiction over long-distance within Arizona. The Federal Communications Commission regulates interstate long-distance.
7. A.A.C. R14-2-1109.
8. A.A.C. R14-2-1109, R14-2-1110.
9. A healthy market, that is. The McLean Deluxe taught us that there is no market for a healthy hamburger.
10. 8 P.3d 396 (Ariz. Ct. App. 2000).
11. *Id.* at 405.
12. *Id.* at 405-406.
13. *See* A.R.S. § 40-254.01.