

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In Re Petition of

U S WEST COMMUNICATIONS, INC.,

for an Accounting Order

DOCKET NO. UT-980948

AFFIDAVIT OF PAULA M.
STRAIN

PAULA STRAIN, being first duly sworn upon oath, deposes and says:

1. I am a Regulatory Consultant employed by the Washington Utilities and Transportation Commission (Commission) and have served in that capacity since September 1996. I commenced work for the Commission in November 1992 and have been employed by the Commission since that time except for one year during which I worked for the Washington Office of the Insurance Commissioner. From October 1981 to October 1992, I worked for the Alaska Public Utilities Commission as a Utilities Financial Analyst.

2. I hold a Bachelor of Science degree in Business Administration from the University of California at Berkeley and am a Certified Public Accountant. During the course of my professional career I have become familiar with the process by which state regulatory commissions establish the rates

to be charged by utilities under the jurisdiction of such commissions. I have testified in numerous cases before both the Alaska and Washington Commissions on regulatory issues related to telecommunications, energy, cable television, water, oil pipeline, and other industries.

3. As part of my job responsibilities I was part of the Commission staff team that reviewed the accounts and practices of US West Communications, Inc., (USWC) as part of its general rate case which resulted in the order of the Commission in Docket No. UT-950200. I testified in that rate proceeding on a number of matters, including a staff proposed adjustment which imputed yellow page revenues of US West Direct (now known as US West DEX) to USWC. This adjustment involved calculating the cost plus fair return to USW Direct of its operations, and determining the amount of its revenues that exceeded the cost plus fair return. The Washington intrastate portion of this calculated amount was used to increase USWC's operating income. This adjustment resulted in no required cash transfer from USWD to USWC. The proposed staff adjustments on which I testified were all contested by USWC but were accepted by the Commission in its order, and that order was later affirmed by the King County Superior Court and the Washington Supreme Court.

4. The purpose of my testimony is to (a) set forth the rationale for regulation of transactions among affiliated companies, one of which is subject to regulation by the Washington Utilities and Transportation Commission or other similar state regulatory commission; (b) describe the method by which the Commission has regulated the transactions between other local exchange companies in Washington and their directory publishing affiliates; and (c) describe the corporate relationship among US West, Inc., US West Communications, Inc., US West DEX, Inc., US West Media Group, Inc.,

US West Communications Group, Inc., and other members of the US West group of companies. I have personal knowledge of the matters included in this testimony.

**RATIONALE FOR THE USE OF IMPUTATION AND OTHER SIMILAR RATEMAKING
ADJUSTMENTS FOR AFFILIATED INTEREST TRANSACTIONS**

5. In Washington, the Washington Utilities and Transportation Commission has authority over transactions between affiliates pursuant to chapter 80.16 RCW and pursuant to its ratemaking authority under title 80 RCW.

6. There is a strong public policy rationale for the regulatory authority over affiliated transactions of a regulated utility, such as US West Communications. The control of affiliated companies by a common owner gives the affiliates opportunities to experience savings through economies of scale and the lack of having to compete for the affiliates' business with nonaffiliates. The owner company, through its control of the affiliates, can direct them in the pricing of services and products to each other; can control their capital structures; and can control their ability to obtain services from nonaffiliates even if the cost would be lower.

This ability of the owner of an affiliated group of companies has resulted in actions being taken that shift costs to affiliates subject to rate of return regulation, and shifts profits to nonregulated affiliates in the same group. Since rate of return regulation bases rates on costs and a set return on investment, and nonregulated companies can charge prices without being limited to a set rate of return, non-arms-length behavior among members of the affiliated group can maximize the profits from the group as a whole.

7. The Commission's response when it encounters such situations is to impute (i.e., assign or attribute) revenues, profits, gains, cost savings, or capital costs, to the regulated entity. The purpose of these actions is to adjust the revenue requirement of the regulated affiliate to recognize appropriate portions of the cost savings, revenues, profits, gains on sale, or lower capital costs, that the affiliated group has experienced as a whole, or to remove excessive costs or expenses that the regulated affiliate would not incur as a non-affiliate.

8. Examples of these types of actions, and responses by the Commission, include:

a. The funding of higher-cost equity of the regulated affiliate through the use of lower-cost debt issued by the owner company.

In the 1995-96 US West rate case, the Commission imputed a hypothetical capital structure to the company in place of the actual capital structure, stating:

The Commission's function is to set as the appropriate capital structure for ratemaking purposes that structure which best balances economy with safety. (WUTC v. Continental Telephone co. of the Northwest, Cause No. U-81-14, 2d Supp. Order (1981).)

The Commission accepts Mr. Hill's analysis and his proposed hypothetical capital structure. We find that Mr. Hill's proposal best balances safety with economy. We find that the existing capital structure is unreasonable and unwise for the company and that it so unreasonably and substantially varies from usual practice as to impose an unfair burden on the consumer.

We find it significant that US WEST Inc can set the Company's capital structure at whatever level best fits with its larger corporate objectives, rather than whatever is the best balance between debt and equity for both business and ratepayer concerns for USWC as a stand-alone company. (Docket UT-950200, Fifteenth Supplemental Order, at 76.)

b. The failure of affiliates to pass along vendor discounts they receive to regulated affiliates purchasing services or goods from them.

In a rate case involving Continental Telephone Co. of the Northwest (CTNW), the Commission ordered an adjustment to reduce the supply expenses paid to an affiliate, stating: Texocom is the supply affiliate of CTNW. It provides telecommunications products to the Continental Telecom system operating companies. The products are purchased by Texocom and resold after adding a gross profit margin in its selling price. Texocom achieves economies of scale by consolidating purchasing and supply functions of the Contel operating companies. Due to their affiliation, the transactions between Texocom and CTNW are not conducted at arms length. Thus, the normal bargaining that occurs between a seller and buyer over price and conditions of sale in a competitive environment does not exist. Consequently, there is a potential for excessive prices and excessive returns. In a regulated company, prices paid to affiliates for goods and services are passed along to the ratepayers in the form of operating expenses, depreciation and rate base. If the prices paid by CTNW are excessive, rates may well be excessive. (Cause No. U-85-32, Second Supplemental Order, at 15.)

c. A nonregulated affiliate charging a regulated company a higher price for a good or service than the regulated company would incur if it purchased the good or service on the open market.

(1) In the 1995-96 US West rate case, in regard to the company's transactions with its supply affiliate, the Commission adjusted for ratemaking purposes the cost of the services to reflect the lower costs available from nonaffiliate vendors for the same services:

In conclusion, because the transaction is with an affiliate, the Commission may look to the lower of the affiliate's costs or the market price for comparable services to establish the reasonableness of the charges. Here, the credible information as to market prices is the 1988 study and Ms. Strain's testimony. USWC contends that it is entitled to recognition of higher payments because it believes BRI provides better service than a low bidder might, but provides little evidence beyond conclusory statements that BRI knows a great deal about USWC's business. The burden of proof to justify affiliated interest transactions is higher than such bare allegations. (Docket UT-950200, Fifteenth Supplemental Order, at 55.)

(2) In a rate case involving Pacific Power and Light's payments for generation produced by using coal from an affiliate, the Commission set the price of the coal by imputing Pacific Power and Light's cost of capital to the coal company's rate base in setting its allowable profit. In the decision, the Commission said:

The Jim Bridger generating plant is located in Montana. It is owned two-thirds by Pacific and one-third by the Idaho Power Company. Coal, its fuel, is supplied by the Bridger Coal Company which, in turn, is owned through subsidiary relationships by Pacific and Idaho Power in the same proportion as they own Bridger. In effect, Pacific is selling coal to itself; through the subsidiary relationships, the consolidated financial statements of PP&L reflect the operations of Bridger Coal and the risks associated with that operation are perceived by investors evaluating Pacific's securities.

Because Pacific is in effect selling coal to itself, the Commission must examine the reasonableness of the transaction. (Cause Nos. U-82-12 and U-82-35, Fourth Supplemental Order, at 14-15)

(3) In a subsequent rate case involving PacifiCorp, successor to Pacific Power and Light, the Commission reaffirmed this approach:

A public service company has a fundamental obligation to minimize its cost of service. When a company such as PacifiCorp elects to operate through affiliated interests like the Bridger Coal Company, it takes upon itself the burden of demonstrating that its decision does not increase the cost of service of its utility

operations. As pointed out in this Commission's previous order and in the United States Supreme Court decision Western Distributing Company vs. FPC, 285 U.S. 119 (1932) to avoid the possibility of excess profits, the affiliated companies must be subject to special scrutiny. (Cause No. U-84-65, Fourth Supplemental Order, at 29)

d. Charging regulated affiliates for goods or services that they would not need to purchase if they operated as a stand-alone entity.

Again, in the US West rate case, regarding charges to the company from its parent, US West, Inc., the Commission disallowed charges found to be duplicative or unnecessary:

Based on the evidence, the Commission finds that the USWI functions are not entirely duplicative of USWC functions, but that there is substantial overlap and that the challenged USWI functions are directed principally toward family-wide matters rather than USWC issues. USWC has not demonstrated that the overlapping services are reasonable charges to the regulated subsidiary or that they are charged in proportion to the benefits received by the regulated subsidiary. If USWC were a nonaffiliated company, it does appear from the credible testimony of record that those functions could be performed by USWC existing staff or would be unnecessary. (Docket UT-950200, Fifteenth Supplemental Order, at 58.)

e. Transferring property at book value from a regulated affiliate to a nonregulated affiliate before selling it at a profit to a nonaffiliate.

(1) In a rate case involving Puget Power Company, the Commission imputed to the regulated utility the fair market value over book value of land and property sales conducted by the utility's nonregulated affiliate:

The Commission accepts the position of Public Counsel that it appears to be improper, without further explanation, for the Company to record the transfer at book value of property which has been supported by ratepayers. The Commission believes that the difference between net book value and fair market value at the time of the transfer should be considered gain on the sale of the property and treated as income to the company.

....

Circumstances here are particularly sensitive because of the transactions between Puget and its subsidiary, PWI. As Puget diversifies, the temptations and the opportunities for self-dealing among subsidiaries and affiliates multiply. The proposed adjustment will reduce such temptations. (Puget Power, Docket U-85-53, Second Supplemental Order, at 30-34.)

(2) In a subsequent Puget Power Company rate case, the Commission rejected a proposed company adjustment to modify the treatment required by previous Commission orders to recognize the gains on land sales. The company proposed to determine the portion of the gain that should be apportioned to the utility by determining the appraised or assessed value of the property at the time the property is transferred to non-utility property. This appraisal would then be compared to original cost to determine the portion of the total gain at disposition that should be allocated to ratepayers. In rejecting the proposed treatment, the Commission raised the following concerns:

Evaluation of this adjustment involves determination of several sub-issues. First, how should the gain be allocated to ratepayers? The commission is concerned that the company's proposal has serious problems. Most importantly, the company's method calculates a gain on property at the time of transfer, but does not pass that gain to ratepayers until the property is actually disposed. When the company does finally dispose of the property **B** at a date which may be many years later **B** ratepayers have been deprived of the use of that money in the interim. The company has not proposed to compensate ratepayers by paying a carrying charge or by any other means.

An additional problem is reliance on appraisals taken on properties many years ago. How would these be verified? How would the company keep records? The company has not fully developed its proposals on these issues. (Puget Power, Dockets UE-920433, UE-920499 and UE-921262, Eleventh Supplemental Order, at 48-50.)

f. Transferring assets from a regulated affiliate to a nonregulated affiliate without adequate compensation

This is the basis for the use of imputation in both the 1995-96 rate case (Docket UT-950200) and the present case.

GTE/CONTEL YELLOW PAGE HISTORY

9. Commission scrutiny of telephone utilities= relationships with directory publishing companies has been a feature of numerous Commission proceedings for companies other than US West.

10. Continental Telephone Company of the Northwest, Inc. (CTNW), prior to its merger with GTE Northwest Incorporated, maintained an arrangement with an affiliated directory publishing company, Leland Mast Directory Company. From 1973 until 1985, CTNW maintained a contract with Leland Mast Directory Company for the provision of directory publishing, advertising, and distribution. Under the terms of the contract, Leland Mast sold all of the advertising space in the telephone directories of CTNW; printed the directories in the numbers requested by CTNW; and delivered them to CTNW's customers provided the postage was paid by CTNW. CTNW billed and collected for the advertising following its regular collection routine, but was not responsible for uncollectible accounts. CTNW retained a percentage of each month's advertising collection and remitted the balance to Leland Mast Directory Company. The percentage of advertising revenues retained was set at 48%. (Cause No. U-73-49, Order Conditionally Granting Application.)

11. In granting approval of the contract, the Commission placed CTNW on notice that for rate making purposes the test for determining the reasonableness of the transactions under the contract

was the cost to Leland Mast Directory Company of providing its services plus a fair return on the investment associated with said services.

12. In Docket U-81-14, a rate case concerning CTNW, the Commission rejected a staff proposed adjustment to reduce CTNW's costs for services from Leland Mast Directory Company for the level of profits deemed excessive. The Commission found that the company had sustained its burden of proof that the transactions among affiliates were not economically detrimental to Washington intrastate subscribers.

13. In Docket U-82-41, a rate case concerning CTNW, the Commission required an adjustment that imputed back to CTNW the return earned by Leland Mast Directory Company in excess of the recommended return for CTNW:

After review of the CTNW-LMDC transactions, as well as evidence and argument submitted by the parties, the Commission, in this case, accepts the Commission staff's approach to this adjustment. This provides the most equitable treatment to both the ratepayer and the company. It recognizes that the affiliate should receive a fair return while protecting the ratepayer from paying for profit levels derived through other than arms length transactions. This approach also recognizes the benefits of economies of scale and passes these benefits on to the ratepayer. (Cause No. U-82-41, Second Supplemental Order, at 11.)

14. In Docket U-84-18, a rate case concerning CTNW, the Commission concluded that the profits to Leland Mast under its contract with CTNW were higher than reasonable. It accepted a

Commission Staff adjustment in which an excess profit percentage was calculated and applied to Washington generated directory revenue.

15. On August 14, 1985, Leland Mast Directory Company (also known as Mast Advertising & Publishing Company) was sold by Continental Telecom (CTNW's parent company) to Southwestern Bell Corporation for \$120 million. Continental Telecom's pre-tax gain was \$105.6 million (Moody's Public Utility Manual). Amortization of a portion of that gain on the sale of Leland Mast Directory Company was used to reduce the revenue requirement of CTNW in subsequent rate proceedings.

16. In Cause No. U-9927, Order Conditionally Granting Application, the Commission approved a directory publishing contract between General Telephone Company of the Northwest, Inc. (now known as GTE Northwest Incorporated, or GTE-NW) and General Telephone Directory Company (Directory). Both companies were 100% owned by GTE Corporation. The contract granted Directory the exclusive right to sell advertising in and to compile, print or cause to be printed all the telephone directories for GTE-NW's exchanges. The contract required Directory to pay all expenses associated with the directories and called for GTE-NW to retain 54% of each month's directory billings, less uncollectibles and adjustments, and remit the remainder to Directory.

17. In granting approval of the contract, the Commission concluded that it appeared the settlement terms in the proposed agreement should be substantially improved for GTE-NW's benefit. It stated that a determination of the exact proportion of directory advertising that GTE-NW should retain

would be made at the discretion of the Commission wherein the reasonableness of Northwest's operating revenue and expenses were established.

18. In Docket U-9914, a general rate case for GTE-NW, the Commission ordered a reduction to GTE-NW's revenue requirement in the amount of profits earned by Directory in excess of its cost plus a fair rate of return. (Order Authorizing Tariff Revisions, dated December 24, 1970, Appendix A.) This decision was appealed to the Thurston County Superior Court (Case No. 44043) and was upheld by a September 16, 1974, Order of Judge Doran.

19. In Dockets U-82-45 and U-82-48, complaint cases regarding GTE-NW's general rates and late payment charges, the Commission ordered a revenue requirement reduction in the amount of excess profits of GTE Directories to reflect payments from GTE-NW to GTE Directories at a cost plus fair return.

TRANSACTIONS NOT INVOLVING AFFILIATES

20. The Commission also requires adjustments to impute revenues for ratemaking purposes that do not involve transactions with affiliates. These adjustments do not involve transactions with affiliates in any way.

21. RCW 80.36.150(3) and (4), regarding telecommunications contracts filed with the Commission, state that if the Commission finds that contracts provide for rates that are below cost, it may adjust the company's revenue requirement in a subsequent proceeding.

22. WAC 480-80-335(6), relating to special contracts for electric, water, and natural gas utilities, states that Commission approval of contract rates, terms and conditions shall not be

determinative with respect to the expenses and revenues of the utility for subsequent ratemaking considerations.

23. In a rate case involving Puget Power Company, the Commission ordered an adjustment to impute to the revenue requirement the difference between revenues collected from Puget's FERC Wholesale Firm Class, which were found to be below cost, and the revenues that would have been collected had the rates for those customers generated Puget's authorized rate of return. (Docket No. UE-921262, Eleventh Supplemental Order, at 93.)

CORPORATE STRUCTURE OF THE US WEST GROUP OF COMPANIES

24. During the course of my employment at the Commission, I have become familiar with the corporate relationships among US West, Inc., US West Communications, Inc., US West DEX, Inc., US West Media Group, Inc., US West Communications Group, Inc., and other affiliated companies.

25. According to the Corporate Disclosure Statement filed December 7, 1998 with US West's brief to the Ninth Circuit Court of Appeals in MCI Telecommunications Corp. and MCI Metro Access Transmission Services, Inc. v. US West Communications, Inc. and the Washington Util. and Transp. Commission (No. C97-01508-BJR) (Attachment A to this affidavit), US West Communications, Inc., and US West DEX are now both subsidiaries of the same parent company. On June 12, 1998, the former US West, Inc. (subsequently named MediaOne Group, Inc.) consummated a transaction whereby it was separated into two independent companies. The former US West Inc. had conducted its business through two groups, the US West Communications Group and the US West

Media Group. Pursuant to the separation, the former US West, Inc. contributed the businesses of the Communications Group and the domestic directories business of the Media Group (i.e., US West DEX) to USW-C, Inc. (which was subsequently renamed US West, Inc.). As a result of the separation, US West Inc. became an independent company conducting the businesses of the US West Communications Group, US West DEX, and other subsidiaries. MediaOne Group, Inc. continues as an independent company conducting the businesses of the US West Media Group other than US West DEX. US West, Inc. is a publicly-held corporation whose stock is traded on the New York Stock Exchange; neither US West Communications nor US West DEX are publicly traded.

26. Attached to my affidavit is an investor information item from US West's homepage on the Internet, entitled "One company, one vision, one focus, makes life better here." ([Http://www.uswest.com/com/insideusw/investorinfo/vision/htm](http://www.uswest.com/com/insideusw/investorinfo/vision/htm)) (February 1, 1999) (Attachment B to this affidavit). US West emphasizes that the new US West [US West, Inc.] is operated as a "single company" speaking with a "single voice," having a "single vision," and offering a "single strategic focus." Referring to the recent company split into two separate corporations (with Mediaone Group, Inc. now a separate corporation), US West states:

And with the split, we will bring the directory business, US West Dex, under the banner of the new US West. This will add synergy, both for customers and shareowners[.]

PAULA M. STRAIN

SUBSCRIBED AND SWORN to before me this 18th day of February, 1999.
