

1 **Q. Do you agree there are benefits to placing US West's cable television business in a**
2 **separate subsidiary?**

3 A. Yes. Since cable TV is not regulated, there are some benefits to providing unregulated services
4 through a separate subsidiary. It simplifies the regulatory process and reduces the likelihood
5 that the Commission will find it necessary to intrusively scrutinize activities and services which
6 are intended to be unregulated. As US West has pointed out, the proposed transfer may also
7 simplify US West's management and accounting practices. As Mrs. LaFave has alluded, in a
8 situation involving one company that has both regulated and unregulated services, there is the
9 opportunity and incentive to misallocate costs toward its regulated monopoly operations and
10 away from its more competitive, less regulated ventures. To the extent these incentives are
11 acted upon, a firm can underprice its competitors and gain market share while also enhancing its
12 overall profitability. To the extent that both regulated and unregulated operations share the same
13 or similar plant, equipment, and personnel, the firm has the incentive and opportunity to shift
14 costs to the regulated operations and away from its unregulated operations, thereby maximizing
15 its overall profitability. Establishing a separate subsidiary can potentially make it easier to
16 monitor the situation and reduce the difficulties associated with ensuring a proper accounting for
17 regulated and unregulated costs and profits.

18
19 **Q. Does setting up a separate subsidiary eliminate these incentives or otherwise solve**
20 **the problem?**

21 A. No. Even when regulated and unregulated services are provided through separate affiliates,
22 incentives and opportunities for cost shifting and manipulation remain, particularly where both
23 subsidiaries operate in the same geographic areas. Regardless of the corporate structure, the
24 ultimate stockholders remain the same, and thus the incentive remains for the firm to shift costs
25 onto its captive ratepayers and to maximize the profits earned in areas which are not subject to
26 close regulatory scrutiny. Any transactions between the subsidiaries will not represent
27 arms-length dealings. Cost allocation techniques and methods of charging affiliates must be

1 frequently reviewed and analyzed to ensure that the firm's regulated operations are not
2 burdened by the unregulated operations; while placing the unregulated operations in a separate
3 subsidiary may simplify some of the accounting problems, it does not eliminate these problems,
4 nor does it eliminate the need for close regulatory scrutiny.

5 Since US West stockholders continue to own both subsidiaries, the arm's-length
6 bargaining of a normal competitive environment is not present. Although unregulated affiliates
7 may be legally separate from the parent company, the economic incentives to place costs in the
8 regulated operations and profits in the unregulated operations remain essentially the same. Both
9 the regulated and unregulated operations are part of one corporate family with the same owners
10 and many of the employees of the separate subsidiary are likely to be former employees of the
11 regulated entity with common corporate loyalties. These facts, combined with the continued
12 interaction among the various entities, preclude any possibility of true arm's-length transactions.
13 Accordingly, there is no assurance that separation of the unregulated operations from the
14 regulated operations will automatically protect regulated ratepayers.

15 Even when the regulated and unregulated operations have been logically and
16 appropriately separated into distinct corporate entities, close scrutiny of affiliate relationships is
17 still warranted, since the parent company has a continued incentive to place as much cost as
18 possible in the regulated entity and to place as little cost as possible in the unregulated entity. A
19 similar incentive exists for the parent company to underprice services and support functions that
20 are provided by the regulated entity to the unregulated entity. As with the misallocation of costs,
21 undercharging for services and functions provided to the unregulated operations will yield higher
22 returns for the competitive ventures, and lower returns for the regulated operation. The net
23 result is that profits of the consolidated enterprise will be enhanced at the expense of captive
24 ratepayers. Furthermore, if the unregulated subsidiaries or operations pay less than fair market
25 value for the services and support functions provided by the regulated entity, they will receive
26 an unfair edge in the competitive marketplace. Another potential form of cross-subsidization is
27 the overcharging for services and functions that the unregulated entity provides to the regulated

1 company. Overcharging the regulated operations will yield high returns for the unregulated
2 operations at the expense of regulated ratepayers.

3
4 **Q. The Company claims that establishing BSI as a separate subsidiary will reduce the**
5 **number and size of affiliate transactions, thereby helping ensure that these cross-**
6 **subsidization problems do not occur. Please respond.**

7 A. There is some merit to this claim, particularly if the corporate reorganization is carefully
8 designed to comport with existing regulatory systems. For example, the Telecommunications
9 Act of 1996 (“Federal Act”) requires incumbent LECs to offer at cost-based rates
10 nondiscriminatory access to unbundled network elements. (“UNEs”). [47 U.S.C. § 251(c)(3)]. The
11 Federal Act also imposes upon the Commission the obligation of regulating the provision of
12 UNEs by ILECs to other carriers. If the separate subsidiary rents network elements from US
13 West at the same rates paid by other carriers, there will automatically be considerable
14 protection against cross-subsidization and misallocation of costs.

15 The UNE rental rates are regulated by this Commission, pursuant to federal rules.
16 Because of their importance, more time and effort is expended on developing these rates than
17 would normally be available for the regulation of affiliated transactions. By establishing BSI as a
18 separate subsidiary and requiring it to pay the standard UNE rental rates, the Commission can
19 ensure that the regulated operations are fairly compensated for services and functions provided
20 to the unregulated video operations, without devoting much, if any, resources to the task of
21 monitoring these affiliated transactions.

22 Furthermore, the UNE rates are developed in an arms-length process, in which US
23 West’s incentives are distinctly different than the incentives that apply to affiliated relationships.
24 While US West has a strong incentive to undercharge its unregulated video operations for the
25 use of equipment and services, it has no such incentive to undercharge competitive carriers with
26 whom it deals in arms-length transactions. For example, if US West were to negotiate a price
27 with MCI Worldcom for the use of copper cable for xDSL services, US West has no incentive

1 to set an excessively low price. To the contrary, a price which is freely negotiated between US
2 West and MCIWorldcom is likely to provide a good benchmark for what BSI should pay for
3 use of analogous portions of US West's copper cable in providing BSI's video services.

4 As I mentioned, US West has no incentive to undercharge arms length competitors for
5 the use of its equipment, services and network elements. If anything, it may have an incentive to
6 set UNE rates at relatively high levels, in an effort to maximize the profits it generates from
7 UNE rentals, and make it more difficult for competitors to gain a toehold in the market. The key
8 point in this context, however, is that UNE rates are regulated by this Commission pursuant to
9 federal rules, and these rates are available to all carriers on a non discriminatory basis. Hence,
10 it is preferable to rely upon UNE rental prices as much as possible in monitoring and controlling
11 the financial relationship between US West's regulated and unregulated operations. To the
12 extent US West retains ownership of various equipment and network facilities, and rents these
13 network elements to BSI at standard UNE rates, there is less opportunity for cross
14 subsidization. The same UNE rates will apply regardless of whether the elements are provided
15 to BSI, or to a competitor, thereby automatically ensuring that these transactions take place on
16 terms that are established through an arms-length negotiating process.

17 The potential risk of having the regulated operations subsidize the unregulated activities
18 of BSI is greatly reduced if BSI relies upon unbundled elements provided at standard UNE
19 rates. The potential for cross subsidization and other regulatory problems is greatly reduced in a
20 UNE rental environment, compared to other scenarios, because competitors will be given the
21 opportunity to rent the same UNEs from US West at the same rates.

22
23 **Q. Mrs. LaFave claims that setting up a separate subsidiary will ensure that "unregulated**
24 **non telephone" investment is kept out of the Company's regulated rate base. Please**
25 **respond.**

26 A. This could be beneficial, if the assets in question are truly distinct from the type of plant and
27 equipment which is used by US West in providing regulated telecommunications services.

1 However, if the assets are largely interchangeable with, or similar to, assets which are used in
2 providing regulated telecommunications services, an ownership transfer may be
3 counterproductive. In any event, moving assets to an unregulated subsidiary is not the only
4 means of ensuring a proper accounting for the investments associated with unregulated
5 operations. Even if the assets used in providing an unregulated service are owned by US West,
6 it is feasible to remove the impact of these assets from the Company's regulated rate base. For
7 example, incumbent LECs routinely provide unregulated voice mail and pay phone services
8 using assets which they own. The FCC has established cost allocation rules which help ensure
9 that the investment associated with these unregulated operations is removed from the regulated
10 rate base.

11
12 **Q. Has the Commission previously had to address affiliate transaction problems involving**
13 **US West?**

14 **A.** Yes. I am aware of at least one instance in which the Commission was confronted with
15 potential problems relating to transactions between US West and its affiliates. During the mid to
16 late 1980's US West Communications, Inc. rented several buildings from its parent, US West,
17 Inc. US West, Inc. later sold the buildings to a third party at above-market prices which
18 reflected the fact that US West Communications, Inc. was obligated to long term leases at
19 relatively high rental rates. In Docket No. E-105 1-93-183, the Commission concluded that US
20 West was "imprudent for not renegotiating leases prior to the sales/leasebacks". [Decision
21 58927, p. 55] The core problem was that the transactions were driven by the overall corporate
22 goals of the parent company, and they were not necessarily consistent with the best interests of
23 the Company's regulated operations. The net result was that regulated costs were increased
24 above the minimum necessary level, in an effort to accommodate the interests of the parent
25 company. As the Commission noted, "the fact that there is the lack of an arms length
26 transaction merits additional scrutiny." As a result of that scrutiny, the Commission disallowed a
27 portion of the rental expenses for rate making purposes, concluding that the rent paid pursuant

1 to these leases was excessive. [Id., p. 57]

2 Given this past precedent, the Commission has every reason to be concerned about
3 transactions involving US West affiliates such as BSI. It cannot assume that the proposed
4 transfer of assets is in the best interests of ratepayers, nor can it assume that future transactions
5 between US West and BSI will be in the best interests of ratepayers. All transactions between
6 these affiliates need to be carefully scrutinized. Moreover, to the maximum extent possible, the
7 Commission should encourage such transactions to be structured on the same basis as ones that
8 US West enters into with its competitors (e.g. UNE rentals), so that they can be directly
9 compared to the terms and conditions which are available to competitors on an arms-length
10 basis.

11
12 **Q. Isn't it necessary to transfer all of the assets used by BSI to ensure that ratepayers**
13 **are shielded from the risks associated with the video business, particularly the risk**
14 **that this relatively new technology may not prove to be successful?**

15 A. No. The Company claims that it wants to shield ratepayers from the "risk" associated with the
16 video technology. However, much of this risk has already occurred, and has already been
17 borne by US West and its ratepayers. The Company claims that "it is not clear whether
18 [VDSL technology] will be accepted by consumers". [Response to Staff 01-017]. From this
19 statement, one might gain the impression that this is a brand-new technology which may not
20 function properly or provide video signals which are not of acceptable quality. Yet, US West
21 began deploying VDSL technology in Arizona in 1997, and began marketing video services in
22 1998. [Responses to RUCO 03-11, 03-12]. The service has been growing rapidly, and by the
23 end of 1999, US West had approximately 16,000 cable service subscribers in Arizona.
24 [Response to RUCO 03-14]. While there may have been some technology risks when the
25 VDSL was first selected, by now these risks have largely passed. The asset transfer is being
26 proposed after the video technology has already been successfully tested and implemented, at a
27 time when many thousands of customers are using the service. Moreover, many of the assets

1 which would be transferred (e.g. fiber cable and electronics) involve proven technologies which
2 do not involve unusual risks.

3
4 **Q. Finally, would you address the Company's claim that transferring these assets will**
5 **foster competition in the cable TV industry?**

6 A. Ms. LaFave states that "competition between BSI and Cox will help bring to cable service
7 customers all of the benefits that flow from competition...". [LaFave Direct, p. 7]. Ms. LaFave
8 concedes that approval of the transfer by itself will not foster competition, since US West is
9 currently operating and offering cable service in competition with Cox. [Id.]. However, she
10 claims that approval of the transfer is "significant", because it recognizes BSI "as a separate
11 business with assets and a work force whose function is to provide cable services". [Id.]. While
12 the proposed transfer is certainly significant, Ms. LaFave fails to show how a change in the
13 asset ownership within the US West corporate family or a change in the specific employer-
14 employee relationships will enhance competition in the cable TV market. To the extent a spin-
15 off of US West's cable operations would enhance its competitive position, this can be
16 accomplished without necessarily transferring the underlying assets. Even if the Commission
17 decides that it would be helpful to transfer some of the cable-related assets, whatever
18 competitive benefits might arise from such a transfer can undoubtedly be achieved through the
19 transfer of a more limited set of assets, as I will discuss later in my testimony.

20
21 **Q. Can you summarize your response to the Company's claimed benefits?**

22 A. The Company's proposal to place its unregulated video business in a separate corporate entity
23 has merit, because it could enhance the Commission's ability to protect against cross subsidies
24 flowing from the Company's regulated operations to its unregulated operations. However, the
25 Company has not made a convincing case that the transfer should occur exactly as proposed.
26 In particular, I am not persuaded that all of the proposed asset transfers are necessary or
27 desirable. The video business can be separated from the regulated operations, without having

1 to transfer all of the assets which are used in that business. If the video business is to be placed
2 in a separate subsidiary, it would be preferable to rely more heavily upon standard UNE rental
3 arrangements, rather than a bulk transfer of network assets. US West has not shown that all of
4 the asset transfers are in the public interest.

5 The majority of the assets US West proposes to transfer involve cable and equipment
6 which is identical to, or similar to, the types of cable and equipment which US West uses to
7 provide regulated telecommunications services, including basic local exchange service, special
8 access services, and various advanced services, including ADSL. Further, the Company is
9 proposing to transfer these assets after ratepayers have already been exposed to the initial risks
10 associated with rolling out a new service. Finally, the Company has not provided any evidence
11 which suggests that the proposed asset transfers will enhance competition in the cable TV
12 industry.