ORDER NO. 06-496

ENTERED 08/24/06

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UI 251

In the Matter of	)	
	)	
UNITED TELEPHONE COMPANY OF THE	)	
NORTHWEST, dba Embarq	)	
	)	ORDER
Application for Approval of the Services	)	
Agreement with Embarq Midwest	)	
Management Services and Sprint Mid-Atlantic	)	
Telecom, affiliated interests.	)	

DISPOSITION: APPLICATION APPROVED WITH CONDITIONS

On June 9, 2006, United Telephone Company of the Northwest (Company) filed an application with the Public Utility Commission of Oregon (Commission) pursuant to ORS 759.390 and OAR 860-027-0040 for authorization of a Special Services Agreement with Embarq Midwest Management Services and Sprint Mid-Atlantic Telecom (Service Providers). The Company and the Service Providers are wholly-owned subsidiaries of Embarq. Therefore, the Company and the Service Providers are affiliated interests pursuant to ORS 759.390. Under the Special Services Agreement, the Service Providers will provide Human Resources Services, Sales and Marketing Support Services, Customer Service Support Functions, Network Support Functions, Information Services, and additional services as requested or required. A description of the filing and its procedural history is contained in the Staff Report, attached as Appendix A, and incorporated by reference.

Based on a review of the application and the Commission's records, the Commission finds that the application satisfies applicable statutes and administrative rules. At its public meeting on August 22, 2006, the Commission adopted Staff's recommendation.

OPINION

Affiliation

An affiliated interest relationship exists under ORS 759.390.

Applicable Law

ORS 759.390 requires a telecommunications utility to seek approval of contracts with affiliated interests within 90 days after execution of the contract.

ORS 759.390(4) requires the Commission to approve the contract if the Commission finds that the contract is fair and reasonable and not contrary to the public interest. However, the Commission need not determine the reasonableness of all the financial aspects of the contract for ratemaking purposes. The Commission reserves that issue for a subsequent proceeding.

CONCLUSIONS

1. An affiliated interest relationship exists.

2. The agreement is fair, reasonable, and not contrary to the public interest.

3. The application should be approved, with certain conditions.

ORDER

IT IS ORDERED that the application of United Telephone Company of the Northwest, dba Embarq, for approval of the Special Services Agreement with Embarq Midwest Management Services and Sprint Mid-Atlantic Telecom, is approved subject to the conditions stated in the Staff Report, attached as Appendix A.

Made, entered, and effective AUG 24 2006.

BY THE COMMISSION:

Becky L Beier

Becky L. Beier
Commission Secretary

A party may request rehearing or reconsideration of this order pursuant to ORS 756.561. A request for rehearing or reconsideration must be filed with the Commission within 60 days of the date of service of this order. The request must comply with the requirements in OAR 860-014-0095. A copy of any such request must also be served on each party to the proceeding as provided by OAR 860-013-0070(2). A party may appeal this order by filing a petition for review with the Court of Appeals in compliance with ORS 183.480-183.484.

ITEM NO. CA6

PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: August 22, 2006

REGULAR ____ **CONSENT** X **EFFECTIVE DATE** N/A

DATE: August 14, 2006

TO: Public Utility Commission

FROM: David Poston DP

THROUGH: Lee Sparling, Marc Hellman, and Michael Dougherty

SUBJECT: UNITED TELEPHONE COMPANY OF THE NORTHWEST: (Docket No. UI 251) Application for Approval of the Special Services Agreement with Embarq Midwest Management Services and Sprint Mid-Atlantic Telecom, which are both affiliated interests.

STAFF RECOMMENDATION:

The Commission should approve the United Telephone Company of the Northwest (Company) application to enter into a Special Services Agreement with Embarq Midwest Management Services and Sprint Mid-Atlantic Telecom (hereinafter collectively referred to as Service Providers), which are both affiliated interests, subject to the following conditions:

1. The Company shall provide the Commission access to all books of account, as well as documents, data, and records of the Company and Service Providers' affiliated interests that pertain to this transaction.

2. The Commission reserves the right to review, for reasonableness, all financial aspects of this arrangement in any rate proceeding or earnings review under an alternative form of regulation.

3. The Company shall notify the Commission in advance of any substantive changes to the agreement, including any material change in price. Any such change shall be submitted in an application for a supplemental order (or other appropriate format) in this docket.

DISCUSSION:

The Company filed this application on June 9, 2006, pursuant to Oregon Revised Statute (ORS) 759.390 and Oregon Administrative Rule (OAR) 860-027-0040. The Company and the Service Providers are wholly owned subsidiaries of Embarq Corporation. Therefore, the Company and the Service Providers are affiliated interests under ORS 759.390.

The Company requests authorization from the Commission for Service Providers to provide management services, including: Human Resource Services, Sales and Marketing Support Services, Customer Service Support Functions, Network Support Functions, Information Services, and additional services as requested or required.

This is not a fixed-rate contract, and estimated annual costs for the services provided to the Company are $3 million. This charge compares to approximately $2.5 million in charges for similar services the Company incurred in 2004 and $2 million incurred in 2005. The Company has indicated that the amount of $3 million estimated in the official filing included both regulated and non-regulated expenses. During any future general rate proceeding, Staff would remove from customer rates all non-regulated expenses that occur from the contract. As a result, the $2 million cost incurred in 2005 is an accurate estimation of regulated expense.

Overall, the Company's Oregon-regulated operations are currently serving approximately 55,500 customers in Oregon, and represent 0.84 percent of the parent company, Embarq's, total revenue. Embarq is a large company with about 55 affiliates and subsidiaries. The Service Providers, Embarq Midwest Management Services and Sprint Mid-Atlantic Company (soon to change its name to Embarq Mid-Atlantic), represent a relatively small part of Embarq's overall operations.

<u>Issues</u>
Staff investigated the following issues:

1. Terms and Conditions of the Agreement
2. Transfer Pricing
3. Public Interest Compliance
4. Records Availability, Audit Provisions, and Reporting Requirements

<u>Terms and Conditions of the Agreement</u>
Based upon Staff's analysis of the contract, there appears to be no unusual or restrictive terms that will harm customers.

As stated in recommended condition No. 2, the Commission reserves the right to review, for reasonableness, all financial aspects of this arrangement in any rate proceeding or earnings review under an alternative form of regulation. Additionally, all transactions between the Company and the Service Providers must conform to FCC Docket Nos. 86-111 and 96-150.[1]

Transfer Pricing

Services provided by the Service Providers are priced at fully distributed cost. Expenses generated by certain Service Providers' departments in providing services are allocated based upon a review of time and resources spent by the individual departments in various activities related to the provision of necessary services. The expenses of other departments are allocated based on statistically derived factors related to the activities performed by the department.

Costs that are charged to the Company and other telephone subsidiaries are allocated based on factors related to the activities of each department. As an example, costs of Human Resources departments are allocated on the basis of the number of employees of each telephone subsidiary compared to the total number of employees of all telephone subsidiaries. Other departments are allocated based on net property, plant and equipment investment. In each case, the allocation basis relates to the nature of the work performed. Each basis used is designed to provide a reasonable relationship to the expected benefit of the service to the companies.

Fees for services provided by the Service Providers shall be determined by the Service Providers in accordance with the following:

a. Fees for services rendered for any single user company will be charged to, and paid, by that company.

b. Fees for services rendered for more than one user company, but not all user companies, will be considered in the management fee calculation for amounts charged to and paid by the user companies for which the services are rendered. The fees for the services that cannot be separately ascertained for each user company will be allocated by the Service Providers on an equitable basis among all the user companies for which the services are rendered and in accordance with applicable laws and regulations.

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[1]FCC Docket No. 86-111, establishes accounting safeguards which govern the allocation of telecommunications common carriers' costs between their regulated and non-regulated activities and the treatment of transactions between these carriers and their affiliates. FCC Docket 96-150 modifies the affiliate transactions rules to provide greater protection against subsidization of competitive activities by subscribers to regulated telecommunications services.

c. Costs associated with the general administration of the Service Providers' services, and costs incurred for all service performed for, or furnished to all user companies generally, or all other costs not described in (a) or (b) above, will be allocated in management fees among all user companies on an equitable basis and in accordance with applicable laws and regulations.

d. Fees payable by the Company for services rendered will be handled between the parties through inter-company cost allocations. The Company will retain the right to contest the Fees for one hundred twenty (120) calendar days following the cost allocation.

The Company provided Staff with an extensive allocation list that identifies the basis for allocation of centralized management services to various segments of the Embarq operation. As a result of responses to Staff's data requests, Staff believes that the fees charged to the Company from the Service Providers appear to be reasonable in terms of the percentage of the affiliate's total operating expenses.

Public Interest Compliance

The Company did not utilize a competitive bid process in the selection of Service Providers. The Company states that they are better and more economically assisted by the centralized group of specialists available from the Service Providers, and that centralization creates real opportunities to achieve economics of scope and scale in the provision of specialized skills and services.

According to the Company, many of the services performed by the Service Providers require special skills and/or educational backgrounds, and it is not cost effective or practical to have such specialization at the Company and at each of the operating group locations to perform similar functions. The centralization philosophy enables each entity to share only a portion of the cost of the corporate expertise as opposed to bearing the total cost on a stand-alone basis.

The Company also states that they believe the services provided by the Service Providers are beneficial and necessary and enhance the Company's ability to provide quality service to its customers. The Company further believes the costs incurred in the provision of these services represent legitimate business expenses and are prudently incurred and fairly allocated.

The Company provides, through their Oregon operations, the greatest proportion of the services that are supplemented by the Service Providers under the terms of the Special Services Agreement. As a percentage of the Company's total cost for these services (provided both through the UI 251 and the UI 252 service agreements), the proportion appears to be reasonable and the new Services Agreement does not significantly change the historical usage or costs of these services.

In response to Staff's data requests, the Company explained what appears to be an overlap of the Human Resources and Information Services provided by this Services Agreement (UI 251) and the Special Services Agreement filed through UI 252.

- Human Resources: Although the Human Resources functions will be handled by EMC (UI 252), Human Resource expense allocated to Service Providers from EMC will, in turn, follow the employee expenses that Service Providers charge to its affiliates.

- Information Services: Due to the distribution of employees and equipment, services to affiliates are currently provided through more than one subsidiary.

In essence, this contract represents changes that resulted from a spin-off of Sprint's local telephone division and North Supply operations to Embarq – the new parent company of United Telephone Company of the Northwest dba Embarq. However, the services that are provided under this contract are essentially the same as those provided over the past several years.

Based on responses to Staff's data requests, this change in the provision of the management services contract is not expected to have a negative effect on the Company's Oregon-regulated operations. It should be noted that the Company's customer base has been declining over the past several years, due, in part, to the proliferation of wireless services, VOIP, and telecom services offered by competitors such as cable companies and CLECs.

The company has reviewed the Staff proposal and does not disagree with the commitments contained therein.

Records Availability, Audit Provisions and Reporting Requirements
Order Condition Number 1, listed above in the Staff recommendation, affords the necessary Commission examination of the Company's records concerning this application.

Based on the review of this application, Staff concludes the following:

1. The application involves an affiliated interest transaction that is fair and reasonable and not contrary to the public interest, with the inclusion of the proposed ordering conditions.
2. Necessary records are available.

PROPOSED COMMISSION MOTION:

The Company's application for approval of the Special Services Agreement with Embarq Midwest Management Services and Sprint Mid-Atlantic Telecom, be approved subject to the three recommended conditions.