

**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON**

UI 252

In the Matter of)	
)	
UNITED TELEPHONE COMPANY OF THE)	
NORTHWEST, dba Embarq)	ORDER
)	
Application for Approval of the Services)	
Agreement with Embarq Management)	
Company, an affiliated interest.)	

DISPOSITION: APPLICATION APPROVED WITH CONDITIONS

On June 9, 2006, United Telephone Company of the Northwest, dba Embarq (Company), filed an application with the Public Utility Commission of Oregon (Commission) pursuant to ORS 759.390 and OAR 860-027-0040, and an amended application on August 9, 2006. The application requests authorization of a Services Agreement with Embarq Management Company (EMC). The Company and EMC are wholly-owned subsidiaries of Embarq Corporation and are therefore affiliated interests pursuant to ORS 759.390. Under the Services Agreement, EMC will provide the following services: Human Resource, Finance, Communications, Legal, Planning, General Support, Tax (advice and assistance), Information (production data processing, programming, inserting and mailing, and archival), Supply Chain Management, Regulatory, and Company Operations, as well as 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 Management Company, 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.

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: *LS* Lee Sparling, *MH* Marc Hellman, and *MD* Michael Dougherty

SUBJECT: UNITED TELEPHONE COMPANY OF THE NORTHWEST:
(Docket No. UI 252) Application for Approval of the Services Agreement with Embarq Management Company, which is an affiliated interest.

STAFF RECOMMENDATION:

The Commission should approve the United Telephone Company of the Northwest (Company) application to enter into a Services Agreement with Embarq Management Company (EMC), which is an affiliated interest, 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 EMC's 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.

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DISCUSSION:

The Company filed an amended application on August 7, 2006, pursuant to Oregon Revised Statute (ORS) 759.390 and Oregon Administrative Rule (OAR) 860-027-0040. The Company and EMC are wholly owned subsidiaries of Embarq Corporation. Therefore, the Company and EMC are affiliated interests under ORS 759.390.

The Company requests authorization from the Commission for EMC to provide management services, including: Human Resource Services, Finance Services, Communications Services, Legal Services, Planning, General Support Services, Tax (advice and assistance), Information Services (Production Data Processing Services, Programming Services, Inserting and Mailing Services, and Archival Services), Supply Chain Management Services, additional services (as requested or required), Regulatory Services, and Company Operations.

This is not a fixed-rate contract, and estimated annual costs for the services provided to the Company are \$11 million. This estimated annual cost compares to approximately \$9 million in charges for similar services the Company incurred in 2004 and \$11 million incurred in 2005. All fees will be subject to Staff review in any future rate case or audit to ensure they are limited to necessary services supporting the Company's Oregon-regulated operations.

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. EMC represents a relatively small part of Embarq's overall operations.

Issues

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

Terms and Conditions of the Agreement

Based upon Staff's analysis of the contract, there appears to be no unusual or restrictive terms that will harm customers.

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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 Applicant and EMC must conform to FCC Docket Nos. 86-111 and 96-150.¹

Transfer Pricing

Services provided by EMC are priced at fully distributed cost. Expenses generated by certain departments of EMC 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 EMC shall be determined by EMC 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 EMC on an equitable basis among all

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. These safeguards require an annual audit performed by an independent auditor to ensure the carrier's accuracy and conformity to their Commission-approved cost allocation manual and methodologies used in preparing reports to the Commission. FCC Docket 96-150 modifies the affiliate transactions rules to provide greater protection against subsidization of competitive activities by subscribers to regulated telecommunications services.

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- the user companies for which the services are rendered and in accordance with applicable laws and regulations.
- c. Costs associated with the general administration of EMC's 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. If the parties have not resolved the charges within one hundred days of the dispute, either party may invoke arbitration.

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 EMC 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 the Service Provider. The Company states that they are better and more economically assisted by the centralized group of specialists available from EMC, 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 EMC 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 EMC 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.

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The Company provides, through their Oregon operations, the greatest proportion of the services that are supplemented by EMC under the terms of the 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 Human Resources and Information Services provided by this Services Agreement (UI 252) and the Special Services Agreement filed through UI 251.

- Human Resources: Although Human Resources functions will be handled by EMC, Human Resource expense allocated from EMC to Service Providers under the UI 251 filing 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 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.

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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 United Telephone Company of the Northwest application for approval of the Services Agreement with Embarq Management Company, be approved subject to the three recommended conditions.

UI 252 Public Meeting Memo