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MEMORANDUM

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TO: Docket Control
FROM: Ernest G. Johnson
Director
Utilities Division

DATE: December 26, 2001

RE: STAFF REPORT FOR THE MATTER OF THE APPLICATION OF QWEST COMMUNICATIONS CORPORATION FOR ITS APPROVAL OF TRANSFER OF CERTIFICATES OF AUTHORITY IN ASSOCIATION WITH INTERNAL CORPORATE RESTRUCTURING (DOCKET NO. T-02811B-01-0456)

Attached is the Staff Report ordered by the Commission in Decision No. 64249 to address whether the limited waiver of A.A.C. R14-2-803 granted in Decision No. 58087 to US WEST Communications, Inc. is appropriate for Qwest Communications International, Inc. and its affiliates in light of the fact that Qwest Communications Corporation intends to commence provision of competitive interLATA services. Staff recommends that the partial waiver granted by Decision No. 58087 stand as filed and that it continues to apply to Qwest Communications Corporation and its affiliates.

EGJ:LAJ:nms

Originator: Linda A. Jaress

Attachment: Original and Ten Copies

Arizona Corporation Commission
DOCKETED

JAN 3 2002

DOCKETED BY

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Docket No. T-02811B-01-0456

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**STAFF REPORT
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ARIZONA CORPORATION COMMISSION**

QWEST COMMUNICATIONS CORPORATION

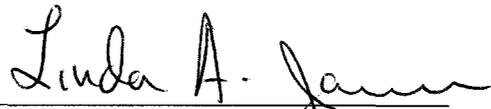
DOCKET NO. T-02811B-01-0456

**APPLICATION FOR APPROVAL TO TRANSFER
OF CERTIFICATES OF AUTHORITY IN ASSOCIATION WITH
INTERNAL CORPORATE RESTRUCTURING**

DECEMBER, 2001

STAFF ACKNOWLEDGMENT

The Staff Report for Qwest Communications Corporation, Docket No. T-02811B-01-0456, was the responsibility of Linda A. Jaress.

A handwritten signature in cursive script that reads "Linda A. Jaress". The signature is written in black ink and is positioned above a horizontal line.

Linda A. Jaress
Executive Consultant III

EXECUTIVE SUMMARY
QWEST COMMUNICATION CORPORATION
DOCKET NO. T-02811B-01-0456

On June 4, 2001 Qwest Communications Corporation filed an application for approval of several transactions and requested that the Commission affirm the continued application of the limited waiver of the Commission's Holding Companies and Affiliated Interests Rules to Qwest Communication Corporation previously granted by the Commission. Decision No. 64249, issued December 4, 2001, neither affirmed nor denied the request of Qwest Communications Corporation for affirmation of the limited waiver. However, the Decision ordered Staff to:

"Review and analyze the purpose of and requirements of the limited waiver granted in Decision No. 58087 and provide the Commission with an analysis regarding whether the limited waiver is appropriate for Qwest Communication International, Inc. and its affiliates in light of the fact that Qwest Corporation intends to commence provision of competitive interLATA services through its affiliate Qwest Communications Corporation at such time that Qwest Communications International, Inc. and its affiliates receive authorization to provide interLATA services pursuant to Section 271 of the Telecommunications Act of 1996."

The purpose of this Staff Report is to comply with the Commission's Decision No. 64249. Staff believes that the previous waiver granted to U S West Communications, Inc. has provided adequate protection of Arizona ratepayers from costs related to affiliates. Staff also believes that in the event Qwest receives approval to provide in-region interLATA service in Arizona, Section 272 of the Telecommunications Act of 1996 will provide additional protection.

Staff recommends that Decision No. 58087 be upheld and applied to Qwest Communications Corporation and its affiliates in its entirety.

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Background

On June 4, 2001, Qwest Communications Corporation ("QWEST") and three affiliates filed an application for approval of transactions necessary to effectuate a corporate restructuring. The purpose of the restructuring was to create the entity that would hold the assets necessary to provide interLATA service in Arizona and to provide the service. The application also requested that the Commission reaffirm the limited waiver of the Commission's Public Utility Holding Companies and Affiliated Interests Rules, A.C.C. R14-2-801 - 805, ("the Rules") previously granted by the Commission.

Decision No. 64249, dated December 4, 2001 neither affirmed nor denied the continued application of the limited waiver previously granted by the Commission. However, the Decision ordered Staff to:

"Review and analyze the purpose of and requirements of the limited waiver granted in Decision No. 58087 and provide the Commission with an analysis regarding whether the limited waiver...is appropriate for Qwest Communication International, Inc. and its affiliates in light of the fact that Qwest Corporation intends to commence provision of competitive interLATA services through its affiliate Qwest Communications Corporation at such time that Qwest Communications International, Inc. and its affiliates receive authorization to provide interLATA services pursuant to Section 271 of the Telecommunications Act of 1996."

The purpose of this Staff Report is to comply with the Commission's Decision No. 64249.

Decision Nos. 56844 and 58087

Decision No. 56844, dated March 14, 1990 first adopted the Rules at issue. Attachment B to the Decision was a Concise Explanatory Statement that explained the purpose of the Rules. The Statement explained that "Its {Article 8's} singular purpose is to ensure that ratepayers do not pay rates for utility service that include costs associated with the holding company structure, financially beleaguered affiliates, or sweetheart deals with affiliates intended to extract capital from the utility to subsidize non-utility operations. "

Decision No. 58087, dated November 23, 1992 granted U S West Communications, Inc. ("USWCI") a partial waiver of the Rules. The Decision said that the purpose of the partial waiver was "to ensure that notices of intent regarding occurrences which have little or no relevance to Arizona operations will not be required, yet will provide protection to Arizona ratepayers from unreasonable costs."

The Qwest Organization

Qwest Communications International, Inc. ("QCII") is the holding company and ultimate parent of several entities including Qwest Communications Corporation ("Qwest"), the entity that provides local exchange service to over 3.0 million access lines in Arizona. QCII, as the holding company, is the counterpart of the former US West, Inc. while Qwest, as the certificated utility, is the counterpart of the former US West Communications, Inc. On September 30, 2001, QCII's organization was comprised of over 50 subsidiaries and partnerships. QCII entities are divested and formed to suit the QCII organizational goals. These "organizations and reorganizations" can be a common occurrence. The former U S West, Inc. organization was similar to the organization of QCII in that it consisted of many affiliates and the creation and divestiture of its affiliates occurred on a regular basis.

Partial Waiver of R14-2-803

R14-2-803 requires a utility or the utility's affiliate to give advance written notice of intent to organize or reorganize a public utility holding company to the Commission. R14-2-801 broadly defines reorganization as "the acquisition or divestiture of a financial interest in an affiliate or a utility, or reconfiguration of an existing affiliate or utility's position in the corporate structure or the merger or consolidation of an affiliate or a utility."

At the time Decision No. 58087 was issued, USWCI held investments in 24 affiliates and U S West, Inc. controlled over 70 affiliates of its own. The Decision granted a partial waiver of R14-2-803 by allowing that USWCI and its affiliates file a notice of intent to organize or reorganize a public utility holding company only for those organizations or reorganizations which were likely to: (1) result in increased capital costs to USWCI; (2) result in additional costs allocated to the Arizona jurisdiction; or (3) result in a reduction of USWCI's net operating income.

The partial waiver of R14-2-803 has served as a safety net through which transactions inconsequential to Arizona have passed, while larger transactions with more significant consequences to the Arizona jurisdiction have been processed. Specifically, the U S West, Inc. acquisition of a partnership interest in Time Warner Entertainment, L.P., the divestiture of USWCI's interest in Bell Communications Research, Inc. (Bellcore), and the separation of the U S WEST Communications Group from U S WEST Media Group all required Commission approval although the waiver was in place.

No Waiver of R14-2-804

R14-2-804 requires prior Commission approval for certain transactions undertaken by the utility including obtaining an initial financial interest in an affiliate, guaranteeing or assuming liabilities of affiliates or increasing or decreasing a financial interest in an affiliate. Staff did not recommend, nor did the Commission order, a waiver from this Rule. Thus, the Commission has not waived oversight of any of the future financial transactions between Qwest's local exchange service utility and the proposed interLATA utility.

No Waiver of R14-2-805

This Rule requires all public utility holding companies and Class A public utilities in Arizona to file their diversification plans annually. Along with these plans, the utilities must file other information including, but not limited to, financial statements for each subsidiary, a description of the plans for the utilities' subsidiaries to change business activities, an assessment of the effect of planned affiliated activities on the utility's capital structure, the bases upon which the holding company allocates costs, the dollar amount transferred between the utility and each affiliate, and most contracts between affiliates and the utility. Decision No. 58087 ordered that no waiver of R14-2-805 is granted.

Implementation of the Telecommunications Act of 1996

The Telecommunications Act of 1996 ("the Act") set in place certain restrictions and compliance requirements concerning Bell Operating Companies ("BOC"), including Qwest, and their transactions with affiliates that provide competitive services. Some of these restrictions and requirements a layer of oversight in addition to the Arizona Commission's Rules. Section 272 of the Act permits a Bell Operating Company (including Qwest) that has previously received certain approvals, to originate in-region interLATA telecommunications services and provide certain competitive services only if it does so through one or more separate affiliates.

According to Section 272, each of those affiliates must maintain separate books, records, and accounts in the manner prescribed by the Federal Communications Commission. All transactions between the BOC and affiliates must be on an arms-length basis. The Section further requires that the BOCs and their Section 272 affiliates are restricted from joint ownership of switching and transmission facilities and the land upon which they are located, and are restricted from providing operations, installation and maintenance services to each other. Also, books, records and accounts of the BOC and its Section 272 affiliates must be separate and the entities must have separate officers, directors and employees.

A Section 272 affiliate may not obtain credit under any arrangement that would permit a creditor to have recourse to the assets of the BOC. A Company with 272 affiliates is required to obtain and pay for a joint Federal/State audit every two years conducted by an independent auditor to determine whether it has complied with the section and the accounting requirements. The results of the audit will be submitted to the FCC and the State commission of each state in which the company provides service.

The FCC also adopted accounting safeguards related to the Act in a Report and Order ("the Order") released on December 24, 1996. The Order prescribed how incumbent local exchange carriers must account for transactions with affiliates involving costs and allocation of costs incurred in the provision of both regulated telecommunications services and nonregulated services.

The purpose of the Order was to seek to protect regulated service ratepayers from bearing the risks and costs of carriers' nonregulated ventures and to promote competition by preventing carriers from using their market power in local exchange service to obtain an anti-competitive advantage in the markets that they seek to enter. Staff believes that Qwest's compliance with Section 272 will provide the Commission and Staff another means to review Qwest's transactions with affiliates. The biannual audits, especially, will allow oversight that exceeds that contemplated by the Rules.

Conclusions and Recommendations

Staff believes that the previous waiver granted to U S West Communications, Inc. has provided adequate protection of Arizona ratepayers from costs related to affiliates. Staff also believes that in the event Qwest receives approval to provide in-region interLATA service in Arizona, that Section 272 of the Telecommunications Act of 1996 will provide additional protection.

Staff recommends that Decision No. 58087 be upheld and applied to Qwest Communications Corporation and its affiliates in its entirety.