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MEMORANDUM

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AZ CORP COMMISSION
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TO: [REDACTED]
FROM: Ernest G. Johnson
Director
Utilities Division

DATE: November 29, 2001

RE: STAFF REPORT FOR TOUCH AMERICA SERVICES, INC. FOR A WAIVER OF THE PUBLIC UTILITY HOLDING COMPANIES AND AFFILIATED INTERESTS RULES (A.A.C. R-14-2-801 ET SEQ.) AND THE JOINT APPLICATION OF TOUCH AMERICA, INC. AND MONTANA POWER COMPANY FOR A WAIVER OF PUBLIC UTILITY HOLDING COMPANY AND AFFILIATED INTEREST RULES. DOCKET NOS. T-03911A-01-0448 AND T-04011A-01-0645

Attached is the Staff Report for Touch America Services, Inc. for a waiver of the Public Utility Holding Companies and Affiliated Interests Rules and the joint application of Touch America, Inc. and Montana Power Company for a waiver of the Public Utility Holding Company and Affiliated Interests Rules. Staff recommends that the matters be consolidated and that the Commission approve a limited waiver. Staff further recommends that a hearing should not be held in this matter.

EGJ:LAJ:nms

Originator: Linda A. Jaress

Attachment: Original and Ten Copies

Arizona Corporation Commission
DOCKETED

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DOCKETED BY [Signature]

Service List for: Touch America Services, Inc.
Docket Nos. T-03911A-01-0448 and T-04011A-01-0645

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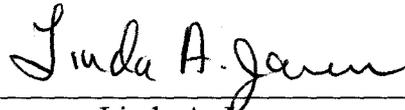
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STAFF ACKNOWLEDGMENT

The analysis of the applications of Touch America Services, Inc., Touch America, Inc. and Montana Power Company for waivers of the Public Utility Holding Companies and Affiliated Interests Rules (Docket Nos. T-03911A-01-0448 and T-04011A-01-0645)

Contributing Staff:



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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

**TOUCH AMERICA SERVICES, INC.
TOUCH AMERICA, INC. AND
MONTANA POWER COMPANY**

**DOCKET NOS.
T-03911A-01-0448 AND T-04011A-01-0645**

**APPLICATION FOR APPROVAL
OF A WAIVER OF THE
PUBLIC UTILITY HOLDING COMPANIES
AND AFFILIATED INTEREST RULES**

NOVEMBER 2001

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Introduction

On May 31, 2001, Touch America Services, Inc. ("TASI" or "the Company") filed an application for approval of a permanent general waiver of the Arizona Corporation Commission's ("the Commission") Public Utility Holding Companies and Affiliated Interests Rules, A.A.C. R14-2-801 through 805 (the Rules). In the alternative, TASI's application seeks a partial waiver of the Rules "...consistent with Touch America Services operation as an interexchange facilities-based telecommunications services provider in Arizona." This waiver request was filed to partially effectuate the merger of TASI into Touch America, Inc. On November 16, 2001, the Applicants filed a letter in the docket waiving the thirty (30) day timeline set forth in A.A.C. 14-2-806, as it pertains to the above-referenced Dockets.

On August 9, 2001, Touch America, Inc. and Montana Power Company ("Montana Power") filed a joint application for approval of a permanent general waiver of the Commission's Rules. This application also addresses the restructuring of Montana Power from an energy and telecommunications utility into a telecommunications company.

Staff requests that the two dockets be consolidated because the two filings are similar and Staff's recommendations for each would be identical.

Applicants and the Restructuring of Montana Power Company

TASI received a Certificate of Convenience and Necessity ("CC&N") to provide resold, facilities based long distance telecommunications services and alternative operator services in Arizona in Decision No. 62672 dated June 30, 2000. TASI originated as TeleDistance, Inc. TeleDistance, Inc. was formed by Qwest, Inc. to facilitate the federally mandated divestiture of Qwest Communications, Inc.'s interLATA business prior to the merger of Qwest, Inc. and U S West, Inc. Qwest transferred its interLATA customers and assets of Qwest Communications Corporation and Qwest affiliates LCI International Telecom, Inc., Phoenix Network, Inc. and USLD Communications, Inc. to TeleDistance. Qwest then changed the name of TeleDistance to TASI and sold TASI to Touch America, Inc.

Touch America, Inc., TASI's parent is a Montana Corporation wholly owned by Entech, Inc. a wholly owned subsidiary of Montana Power. Montana Power is currently divesting all of its energy business, including its electric and gas utility and will invest the proceeds in Touch America, Inc. It has completed the sales of its oil and gas business to a Canadian company for \$475.0 million, its independent power business to CES Acquisition Corp. for \$84.5 million and its coal business to Westmoreland Coal Co. for \$138.0 million. The sale of the electric and gas utility operations to NorthWestern Corp. for \$602 million in cash and the assumption of up to \$488 million in debt are expected to close by year-end.

Touch America, Inc. owns an 18,000-mile fiber-optic network and provides long distance service, Internet access, and frame relay/ATM services and provides other services such as the design, installation and maintenance of PBX and key systems, and construction management oversight. TASI was formed primarily to effectuate the divestiture of the interLATA business of Qwest. The network has been operated by Touch America, Inc. since the divestiture.

The Waiver Requests

The Applicants request a permanent general waiver of the Commission's application of the Rules. In the alternative, the Applicants seek a partial waiver of the Rules that would result in public benefit outweighing the "burden of partial compliance". They also note that they are not waiving any federal constitutional arguments concerning the applicability of the Rules to particular transactions or operations.

The Applicants believe they should have a permanent general waiver from the Rules for several reasons. First, they believe that due to market forces in effect in Arizona, Touch America, Inc. will have no incentive or ability to charge unduly high or above market prices that could be used to fund or subsidize unregulated affiliates. Neither would it be motivated to commingle utility and non-utility funds in a manner that is harmful to Arizona customers when customers have easy access to a different provider. They also argue that the rates of AT&T, Sprint and MCI WORLDCOM set limits on the rates Touch America, Inc. could charge.

The Applicants maintain that when a public utility participates in a competitive market and holds non-monopoly power, application of the Rules is unnecessary and that because Touch America, Inc. is not a monopoly it does not have the ability to improperly capitalize or subsidize the businesses of its non-regulated affiliates.

Depending upon the interpretation of the Rules, without a waiver, TASI, Touch America, Inc., Montana Power and all of their affiliates would fall under the purview of R14-2-803 requiring notice to the Commission every time each of them "reorganized". The Applicants believe that the filing requirements would be unnecessarily burdensome. Because Touch America, Inc.'s revenues and investment in Arizona will comprise only a small portion of its total corporate family revenues and investment and that the majority of affiliate transactions will be national or pertain exclusively to interests in other states, the Applicants believe that application of the Rules is unnecessary.

Because TASI may have become a Class A public utility either before or during the processing of this case, the Applicants requested that the Commission's decision on these applications be issued *nunc pro tunc*, if necessary, retroactive to the date on which the Rules became applicable to TASI.

The Purpose of the Public Utility Holding Companies and Affiliated Interests Rules

Prior to and during 1990, Arizona Public Service Company ("APS") formed a holding company, Pinnacle West Capital Corporation, and acquired MeraBank. Huge losses were experienced by MeraBank resulting in downgrades of APS's bond rating and increases in APS's cost of capital. Southwest Gas Corporation had also recently purchased a savings bank, PriMerit and Tucson Electric Power Company ("TEP") had diversified into several non-utility related activities both with unfortunate financial outcomes.

Decision No. 56844, dated March 14, 1990 first adopted the Public Utility Holding Companies and Affiliated Interests Rules found in Article 8 of the Commission's Rules. Attachment B to the Decision was a Concise Explanatory Statement that described and explained 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. "

Staff believes that utilities that are participants in a competitive market, such as the market for long distance service, have no motivation to cause the harm to customers that the Rules were written to prevent. Ratepayers do not need protection from costs of a utility's affiliates when the ratepayers generally have the option to secure service from another company. Any competitor currently entering the competitive local exchange carrier market would not be motivated to raise rates to subsidize non-utility operations when raising rates puts them at a competitive disadvantage.

The Commission has already recognized the limitations of the Rules in a competitive environment by approving settlement agreements relating to electric restructuring. These agreements significantly reduced the notice and filing requirements and applied the Rules primarily to the utility distribution company and not to the affiliates. The filing of affiliate's plans for diversification and other reporting requirements were waived.

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." Staff believes it was never the intent of the Rule to require foreign corporations to undergo a hearing in Arizona for reorganizations (such as Montana Power selling its electric operations) which have no effect on Arizona utility customers.

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.

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.

Because TASI, soon to be Touch America, Inc., represents a very small portion of a much larger corporate structure, it may share facilities, billing systems, employees, etc. with affiliates and transfer funds to affiliates on a daily basis. It is likely tracking and reporting these transactions, as the Rules require, would be burdensome.

Discussion

Staff believes that in the current competitive environment, the Rules may be unnecessarily restrictive and expensive to comply with and that the telecommunications services market may replace the historical need for the Rules for some companies. However, Staff also realizes that the Commission may desire to continue its current policy of granting limited waivers to telecommunications companies to prevent harm in the event the market contracts.

The most recent limited waiver of the Rules granted by the Commission was granted to Cox Arizona in Decision No. 62582, dated May 17, 2000. In that Decision, the Commission rejected Staff's recommendation to grant a complete waiver of the Rules for four years but accepted Staff's recommended option of a partial waiver. Staff believes that the form of the partial waiver granted to Cox Arizona, a competitive local exchange carrier, is also reasonable for the Applicants.

Consistent with the Cox Arizona Decision No. 62582, Staff recommends that Touch America, Inc. and its affiliates should be required to file a notice of intent to enter into the transactions listed in R14-2-803 when a transaction is likely to result in significant increased capital costs of the Arizona operations; significant additional costs allocated or charged directly to the Arizona jurisdiction or a significant reduction of net income to the Arizona operations. This partial waiver would limit the Commission's involvement in the transactions that the Applicants and their affiliates routinely make to those transactions that negatively affect Arizona.

For R14-2-804, which requires Commission approval before a utility obtains a financial interest in, or guarantees, or assumes the liabilities of an unregulated affiliate, a limited waiver should also be granted. This limited waiver should require Touch America, Inc. and its affiliates to seek approval only for transactions that are likely to have a material adverse effect on Arizona operations.

Staff also believes that the 30-month complete waiver of R14-2-805 granted to Cox Arizona would also be reasonable for Touch America, Inc. Finally, Staff believes that the Commission should apply the proposed limited waivers retroactively to the time that TASI became a Class A Arizona utility.

Conclusions and Recommendations

Staff believes that the competitive nature of the services provided by the Applicants and the lack of incentives for them to engage in the activities that the Rules are designed to prevent reduce the need for Commission oversight over their relationships with affiliates. Staff recommends that the Commission grant the Applicants a partial waiver of the Rules. Staff also recommends that the partial waiver be granted retroactively to the time when TASI became a Class A public utility in Arizona.

Staff further recommends that Touch America, Inc. and its affiliates should be required to file a notice of intent to enter into the transactions listed in R14-2-803 when a transaction is likely to result in significant increased capital costs of the Arizona operations; significant additional costs allocated or charged directly to the Arizona jurisdiction; or significant reduction of net income to the Arizona operations.

Staff further recommends that for R14-2-804, that the Commission should require Touch America, Inc. and its affiliates to seek approval only for transactions that are likely to have a material adverse effect on Arizona operations.

Staff further recommends that a complete waiver of R14-2-805 be granted to Touch America, Inc. and its affiliates for 30 months.

Staff further recommends that the Commission approve the partial waiver of the Rules without a hearing.