THE CASE FOR SEPARATE SUBSIDIARIES

BY

THE HONORABLE PATRICIA M. WORTHY
CHAIRMAN, DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION

KEYNOTE ADDRESS

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RADISSON MARK PLAZA HOTEL

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I AM PLEASED TO ADDRESS YOU ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY AND UTILITY COMMISSIONERS (NARUC) AND AS CHAIRMAN OF THE NARUC COMMUNICATIONS COMMITTEE. MOREOVER, I HAVE BEEN ASKED TO DISCUSS A RECENT PUBLICATION BY THE DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION ENTITLED, "FOR WHOM DO THE BELLS TOLL? THE CASE FOR SEPARATE SUBSIDIARIES." I AM THUS WEARING A NUMBER OF HATS THIS MORNING. GIVEN THE TOPIC, HOWEVER, IT SHOULD BE MADE CLEAR THAT THE STUDY ON SEPARATE SUBSIDIARIES REPRESENTS THE VIEWS OF THE DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION AND NOT THE NARUC MEMBERSHIP. THE STUDY WAS NOT CONDUCTED UNDER THE AUSPICES OF NARUC.

IN ADDITION, ONE MORE CAVEAT MUST BE RAISED. THE DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION CURRENTLY HAS TWO PROCEEDINGS WHICH PRECLUDE ME FROM ADDRESSING SPECIFICALLY THE POTENTIAL IMPACT OF FULLY SEPARATED SUBSIDIARIES ON COMPETITION FOR PAYPHONE SERVICE. THE FIRST IS A RATE CASE WITH THE CHESAPEAKE AND POTOMAC

TELEPHONE (F.C. NO. 850). THE SECOND IS F.C. NO. 814, PHASE II, A PROCEEDING ADDRESSING THE CRITERIA FOR JUDGING COMPETITION FOR TELEPHONE SERVICES IN THE DISTRICT OF COLUMBIA. HOWEVER, OUR COMMISSION, IN FORMAL CASE NO. 829, ON NOVEMBER 13, 1985, ADOPTED A POLICY OF CUSTOMER-OWNED PAY TELEPHONES AND ESTABLISHED RULES FOR COMPETITION WHICH WOULD PROTECT CONSUMERS FROM POOR SERVICE QUALITY. I EXPECT THEREFORE, THAT THE TWO CURRENT CASES WILL INCLUDE ISSUES RELATED TO HOW WELL THE CURRENT SYSTEM HAS BEEN OPERATING AND WHAT REGULATORY CHANGES, IF ANY, MAY BE REQUIRED. AS A RESULT, I AM PRECLUDED FROM DISCUSSING THOSE ISSUES WITH YOU THIS MORNING.

I WILL, HOWEVER, GLADLY HIGHLIGHT THE FINDINGS OF THE D.C. COMMISSION STUDY ON SEPARATE SUBSIDIARIES. BUT FIRST, LET ME GIVE YOU A LITTLE BACKGROUND ON THE GENESIS OF THE STUDY.

DURING THE LAST SESSION OF CONGRESS, THE REGIONAL BELL OPERATING COMPANIES SUCCESSFULLY LOBBIED FOR THE INTRODUCTION OF SEVERAL BILLS WHICH CALLED FOR THE ELIMINATION OF THE LINE OF BUSINESS RESTRICTIONS IMPOSED IN THE MODIFIED FINAL JUDGMENT THAT CONCLUDED THE U.S. DEPARTMENT OF JUSTICE'S ANTITRUST SUIT AGAINST AT&T IN 1984. UNDER THE MFJ, AS YOU KNOW, THE REGIONAL BELL OPERATING COMPANIES (RBOCS) WERE PROHIBITED FROM (1) MANUFACTURING TELEPHONE EQUIPMENT, (2) PROVIDING INFORMATION SERVICES, AND (3) PROVIDING LONG DISTANCE SERVICE. IF THE RBOCS ARE ALLOWED TO PROVIDE INFORMATION SERVICES, THE QUESTION ARISES AS TO WHAT SAFEGUARDS ARE NECESSARY FOR MONOPOLY RATEPAYERS (AND OTHER COMPETITORS) BECAUSE OF THE ADVANTAGES THE RBOCS HAVE FROM THE

JOINT PROVISION OF MONOPOLY AND COMPETITIVE SERVICES USING THE SAME INTEGRATED NETWORK. THE D.C. COMMISSION STUDY ADDRESSES THESE CONCERNS FROM A STATE REGULATORY PERSPECTIVE.

THE STUDY OF SEPARATE SUBSIDIARIES HAS THREE MAJOR CONCLUSIONS, EACH OF WHICH I WILL ELABORATE ON FURTHER. THEY ARE:

1. THERE IS A NEED FOR STRUCTURAL SAFEGUARDS BECAUSE OF THE INCREASING TREND TOWARD DIVERSIFICATION BY THE RBOCS SINCE DIVESTITURE AND THE ECONOMICS OF PRODUCTION OF TELEPHONE SERVICES;
2. FULLY DISTRIBUTED COSTING METHODS (SOMETIMES REFERRED TO AS NONSTRUCTURAL SAFEGUARDS) DO NOT PROVIDE ADEQUATE PROTECTIONS AGAINST CROSS-SUBSIDIZATION AND PREDATORY PRICING;
3. SEPARATE SUBSIDIARIES HAVE A NUMBER OF ADVANTAGES IN MINIMIZING CROSS-SUBSIDIZATION; AND IF SEPARATE SUBSIDIARIES ARE IMPOSED, THERE ARE A NUMBER OF NECESSARY ADDITIONAL CONDITIONS WHICH ALSO MUST BE MET.

I WILL NOW DISCUSS EACH OF THESE ISSUES IN TURN.

SINCE DIVESTITURE, THERE HAS BEEN A DRAMATIC EXPLOSION IN THE NUMBER OF NONREGULATED SUBSIDIARIES OF THE RBOCS. FOR EXAMPLE, THE BELL ATLANTIC COMPANY GREW FROM 17 NONREGULATED SUBSIDIARIES RIGHT AFTER THE BREAK-UP, TO OVER 90 IN YEAR END 1989. THESE NONREGULATED SUBSIDIARIES PROVIDE SERVICES IN A WIDE VARIETY OF MARKETS AND THEY REFLECT A CORPORATE STRATEGY TOWARDS INCREASED DIVERSIFICATION AWAY FROM THE TRADITIONAL CORE TELEPHONE BUSINESS. ADDITIONAL EMPIRICAL EVIDENCE IS REFLECTED IN THE TRIPLING, ON AVERAGE, OF THE GROWTH

OF THE RBOC'S CAPITAL EXPENDITURES ON NONTELECOMMUNICATIONS ACTIVITIES AND THE ACCOMPANYING DECLINE IN THE SHARE OF THOSE EXPENDITURES ON TRADITIONAL TELEPHONE OPERATIONS. RBOC'S REVENUES FROM NONTELECOMMUNICATIONS SERVICES HAVE ALSO RISEN OVER 50 PERCENT SINCE DIVESTITURE.

THESE TRENDS MEAN THERE IS AN EVEN GREATER OPPORTUNITY FOR AND THUS RISK OF CROSS-SUBSIDIZATION FROM MONOPOLY RATEPAYERS TO THE NONREGULATED SERVICES. IT ALSO MEANS GREATER OVERSIGHT RESPONSIBILITY FOR STATE REGULATORS WHO ARE CHARGED WITH PROTECTING THE RATEPAYERS AND THE COMPANY INTERESTS IN THE TRADITIONAL TELEPHONE LINES OF BUSINESS. THE RISK OF ANTICOMPETITIVE PRACTICES IS ALSO HEIGHTENED, GIVEN THE VAST NUMBER OF NONREGULATED MARKETS IN WHICH THE RBOCS NOW APPEAR TO BE OPERATING.

THE INTEGRATED NATURE OF THE NETWORK MAKES CROSS-SUBSIDIZATION DIFFICULT TO DETECT AND MONITOR. CURRENTLY, THE FCC REQUIRES THE USE OF FULLY DISTRIBUTED COSTING (FDC) METHODS TO ALLOCATE COSTS BETWEEN REGULATED AND NONREGULATED SERVICES AND TO DIVIDE THE REVENUE REQUIREMENT BETWEEN THE INTERSTATE AND INTRASTATE JURISDICTIONS. THE FDC METHODS, HOWEVER, ARE NOT AN ADEQUATE "NONSTRUCTURAL" SAFEGUARD FOR PROTECTING AGAINST CROSS-SUBSIDIZATION FOR SEVERAL REASONS.

<u>FIRST, THE FDC METHODS DO NOT ASSIGN TRUE ECONOMIC COSTS TO THE NONREGULATED SERVICES</u>; THAT IS, THE FDC-BASED COSTS WHICH ARE ALLOCATED TO A SERVICE DO NOT CORRESPOND TO THE PRICE THE SERVICE WILL COMMAND IN THE MARKETPLACE. THIS DILEMMA ARISES BECAUSE THE LOCAL EXCHANGE COMPANY (LEC) HAS A CLEAR INCENTIVE TO ALLOCATE AS

MUCH OF THE JOINT COSTS OF PRODUCING BOTH REGULATED AND NONREGULATED SERVICES TO THE REGULATED SIDE WHILE ASSIGNING AS MUCH OF ITS REVENUES AS POSSIBLE TO THE NONREGULATED SERVICES. THUS, IT WOULD BE IN THE INTEREST OF THE LEC TO OPERATE A NONREGULATED ACTIVITY AT A LOSS (FROM THE TOTAL CORPORATION PERSPECTIVE) AS LONG AS THE REVENUES ASSIGNED "BELOW THE LINE" EXCEED THE SIMILARLY ASSIGNED COSTS.

TO ITS CREDIT, THE FCC ATTEMPTED TO ADDRESS THIS CONCERN IN CC DOCKET 86-111, IN WHICH IT ADOPTED THE PRINCIPLE THAT THE COMPETITIVE, NONREGULATED ACTIVITY SHOULD BE RESPONSIBLE FOR THE ECONOMIC VALUE OF ITS SHARE OF A JOINTLY USED RESOURCE, UNLESS A PUBLISHED TARIFF PRICE EXISTED FOR A GIVEN SERVICE. AS AN EXAMPLE, IN THE CASE OF A TRANSFER OF AN ASSET, THE NONREGULATED ACTIVITY WOULD BE REQUIRED TO PAY THE GREATER OF THE EMBEDDED COST OR ECONOMIC VALUE. IN THEORY, THIS APPROACH HAS THE EFFECT OF TRANSFERRING ALL OF THE BENEFITS OF JOINT PRODUCTION TO THE REGULATED ACTIVITY. HOWEVER, IN PRACTICE, THE PRINCIPLE HAS BEEN SUBSTANTIALLY ERODED BY THE FCC AND IT HAS BEEN IGNORED BY THE LECS IN DESIGNING THEIR OWN COST ALLOCATION MANUALS AND PROCEDURES. FOR EXAMPLE, THE LECS, RATHER THAN TRANSFERRING ASSETS IN ACCORDANCE WITH THE THEORY, HAVE CIRCUMVENTED THE THEORY BY TRANSFERRING THE <u>USE</u> OF THE ASSET OWNED BY THE REGULATED ENTITY TO THE NONREGULATED ENTITY. THUS, THE NONREGULATED ACTIVITY IS PERMITTED TO ENJOY ALL OF THE BENEFITS OF JOINT PRODUCTION.

<u>SECOND, AND RELATED TO THE FIRST, THE FDC METHODS OVERALLOCATE COSTS TO REGULATED CUSTOMERS.</u> THE ALLOCATORS USED IN THE FDC

METHODS OFTEN ARE BIASED TOWARD THE TRANSFER OF COSTS TO THE REGULATED SIDE OF THE BUSINESS. THIS PHENOMENON IS ILLUSTRATED IN THE STUDY BY THE D.C. COMMISSION ON THE BASIS OF THE ALLOCATION OF AMERITECH'S CORPORATE HEADQUARTER EXPENSES. THE EXAMPLE SHOWED HOW APPROXIMATELY 95% OF THE CORPORATE HEADQUARTER EXPENSES WERE ALLOCATED TO THE REGULATED SIDE OF THE BUSINESS EVEN THOUGH THE REGULATED ACTIVITIES MAY NOT BE THE COST-CAUSERS.

THIRD, THE FDC METHODS IGNORE NONBOOK TRANSFERS. THE COST ALLOCATION MANUALS (CAMS) OF THE LECS DO NOT IN ANY MATERIAL SENSE ADDRESS NONBOOK TRANSACTIONS BETWEEN REGULATED AND NONREGULATED ACTIVITIES. THESE INCLUDE, BUT ARE NOT LIMITED TO, EXCHANGES OF INFORMATION, REASSIGNMENT OF PERSONNEL, ACCESS TO THE FORMIDABLE FINANCIAL RESOURCES OF THE REGULATED UTILITY, AND ACCESS TO THE TRADEMARKS, REPUTATION, ORGANIZATIONAL AND PHYSICAL UBIQUITY, GOODWILL, AND OTHER TANGIBLE AND INTANGIBLE RESOURCES OF THE REGULATED UTILITY AND ITS CORPORATE PARENT. AN EXAMPLE OF THIS PROBLEM IS THE TRANSFER OF CUSTOMER PROPRIETARY NETWORK INFORMATION (CPNI). WHEN A NEW RESIDENTIAL CUSTOMER CONTACTS THE LEC, SUCH INFORMATION AS THE CUSTOMER'S NAME AND ADDRESS CAN BE GIVEN TO THE NONREGULATED SIDE OF THE BUSINESS (UNLESS THE CUSTOMER SPECIFICALLY PROHIBITS THE TRANSFER OF SUCH INFORMATION) AND THE SAME CUSTOMER CAN THEN BE CONTACTED TO BUY A NONREGULATED SERVICE SUCH AS VOICE MAIL. YET, THERE IS NOTHING IN THE FCC'S COST ALLOCATION RULES WHICH WOULD REQUIRE ANY FINANCIAL TRANSFER OR "PAYMENT" BY THE NONREGULATED SIDE OF THE LEC'S BUSINESS FOR THIS INFORMATION.

FOURTH, THE FDC METHODS UNDERALLOCATE THE BENEFITS OF

INTEGRATION TO CONSUMERS OF REGULATED SERVICES. WHEN A LEC IS AFFORDED THE OPPORTUNITY TO ENGAGE IN A NONREGULATED BUSINESS ACTIVITY ON A FULLY INTEGRATED BASIS WITH ITS REGULATED SERVICES, IT IS ABLE TO ABSORB MOST IF NOT PERHAPS ALL OF THE JOINT COSTS OF BOTH THE REGULATED AND NONREGULATED ACTIVITIES WITHIN THE ABOVE-THE-LINE REGULATORY REVENUE REQUIREMENT. THE EXAMPLE GIVEN IS THE DEREGULATION OF INSIDE WIRE MAINTENANCE. IN THIS INSTANCE, THE COMPANY COULD OFFER ITS SUBSCRIBERS THE OPPORTUNITY TO PURCHASE AN INSIDE WIRE MAINTENANCE CONTRACT ON A NONREGULATED BASIS. THIS NONREGULATED SERVICE IS SOLD THROUGH THE REGULATED TELEPHONE COMPANY'S BUSINESS OFFICES, OFTEN DURING THE VERY SAME CUSTOMER CONTACT IN WHICH THE BASIC TELEPHONE SERVICE IS BEING ORDERED. THE BILLING AND COLLECTION OF REVENUES FOR THIS NONREGULATED SERVICE IS ALSO FULLY INTEGRATED INTO THE MONTHLY BILLING ACTIVITIES FOR THE REGULATED SERVICES. BECAUSE NO SEPARATE SUBSIDIARY IS INVOLVED, THE COSTS ASSOCIATED WITH THESE FUNCTIONS ARE ALLOCATED UNDER THE CAM, RATHER THAN BEING EXPLICITLY CHARGED FOR AS THEY WOULD BE UNDER A SEPARATE SUBSIDIARY MODEL OR AS THEY WOULD BE IF THE ENTITY PROVIDING THE SERVICE WERE AN UNAFFILIATED THIRD PARTY. UNDER THE CAM, THE INTEGRATED NONREGULATED INSIDE WIRE MAINTENANCE SERVICE BEARS A MINUSCULE SHARE OF THE AGGREGATE COST OF BILLING AND COLLECTIONS; FAR LESS THAN IT WOULD UNDER A SEPARATE SUBSIDIARY MODEL, AND CERTAINLY FAR LESS THAN WOULD BE PAID BY ANY COMPETITOR DESIRING TO OFFER ITS OWN INSIDE WIRE MAINTENANCE OPTION USING THE COMPANY'S BILLING.

WHILE I HAVE MADE IT CLEAR THAT I PREFER SEPARATE SUBSIDIARIES

TO ACCOUNTING/ALLOCATION RULES, I WANT TO STRESS THAT SEPARATE SUBSIDIARIES BY THEMSELVES ARE INSUFFICIENT FOR THE TASKS AT HAND. TO CLARIFY THIS POINT, I SHALL NOW DESCRIBE THE ADVANTAGES OF SUBSIDIARIES, AND NOTE THAT EACH ADVANTAGE MUST BE ASSOCIATED WITH ADDITIONAL SAFEGUARDS.

<u>SEPARATE SUBSIDIARIES MAKE IT EASIER TO DETECT ANY CROSS-SUBSIDIZATION WHICH MIGHT OCCUR THROUGH PROCUREMENT PRACTICES.</u>

A MAJOR BENEFIT OF THE DIVISION OF REGULATED AND DEREGULATED BUSINESSES INTO THE SEPARATE SUBSIDIARIES STRUCTURE IS THAT IT EXPOSES THE RELATIONSHIPS AMONG THE COMPONENTS OF THE HOLDING COMPANY. IF A DEREGULATED SUBSIDIARY PRODUCES A GOOD OR SERVICE THAT THE REGULATED SUBSIDIARY PURCHASES, THE OPPORTUNITY FOR CROSS-SUBSIDIZATION EXISTS. BY REQUIRING THE REGULATED SUBSIDIARY TO PURCHASE PRODUCTS FROM A DEREGULATED SUBSIDIARY, THE HOLDING COMPANY CAN SUBSIDIZE ITS DEREGULATED SUBSIDIARY AND INCREASE ITS OVERALL PROFITS.

THE ASSOCIATED SAFEGUARD IS THE RIGHT TO ESTABLISH RULES GOVERNING AFFILIATE TRANSACTIONS. SUCH RULES ARE NEEDED BECAUSE UNSUPERVISED HOLDING COMPANIES WILL DEVELOP RULES AND PROCEDURES THAT FAVOR IN-HOUSE BUYING TO THE DETRIMENT OF COMPETITION. EXAMPLES OF SUCH RULES INCLUDE THE REQUIREMENT FOR COMPETITIVE BIDDING ON ANY LARGE PURCHASE OR A LIMIT OF 50 PERCENT OF ANY EQUIPMENT TYPE PURCHASED FROM AFFILIATE VENDORS. THE PURPOSE OF THESE RULES IS NOT ONLY TO REDUCE THE COST FOR THE RATEPAYERS, BUT ALSO THROUGH THE CREATION OF A LEVEL PLAYING FIELD, SUPPORT THE MARKET MECHANISM.

SEPARATE SUBSIDIARIES FACILITATE THE MONITORING OF INTRACORPORATE TRANSACTIONS AND ELIMINATE THE NEED TO DEVELOP ACCOUNTING RULES WHICH PROHIBIT THE TRANSFER OF COSTS TO RATEPAYERS. USING ACCOUNTING RULES TO SEPARATE COSTS BETWEEN REGULATED AND DEREGULATED ACTIVITIES NECESSITATES THE DEVELOPMENT OF RULES AND THE AUDITING OF APPLICATIONS OF THE RULES. ANY PROPOSED SET OF RULES GOVERNING A PARTICULAR ACTIVITY ALWAYS APPEARS REASONABLE. HOWEVER, ALL RULES MUST BE BASED ON CERTAIN ASSUMPTIONS. FOR EXAMPLE, SHOULD USAGE BE MEASURED AT THE PEAK OR ON A 24 HOUR A DAY BASIS. THE CHOICE OF MEASUREMENT STANDARD WILL SHIFT COSTS AMONG THE SERVICES THAT USE THE SAME EQUIPMENT.

ONCE THE RULES HAVE BEEN ESTABLISHED, IT IS NECESSARY TO AUDIT THE COMPANIES TO ENSURE THAT THE RULES ARE BEING APPLIED PROPERLY. HOWEVER, THE GENERAL ACCOUNTING OFFICE, OF THE FEDERAL GOVERNMENT, IN ITS LATEST REPORT, TELEPHONE COMMUNICATIONS: CONTROLLING CROSS-SUBSIDY BETWEEN REGULATED AND COMPETITIVE SERVICES, SHARPLY CRITICIZED THE FCC FOR ITS FAILURE TO CONTROL CROSS-SUBSIDIZATION THROUGH THE USE OF ITS COST ALLOCATION METHODS. THE REPORT STATED: "THE LEVEL OF OVERSIGHT THE FCC IS PREPARED TO PROVIDE WILL NOT, IN THE GAO'S OPINION, PROVIDE TELEPHONE RATEPAYERS OR COMPETITORS POSITIVE ASSURANCE THAT FCC RULES AND PROCEDURES ARE PROPERLY CONTROLLING CROSS-SUBSIDY." MOREOVER, JUDGE GREENE, IN HIS RECONSIDERATION OF THE MFJ JUDGMENT RESTRICTIONS, ALSO RAISED QUESTIONS REGARDING THE ABILITY OF THE FCC TO CONTROL AND MONITOR ABUSES IN LIGHT OF ITS REDUCED RESOURCES. HE NOTED THAT "IN 1980, THE FCC HAD AN AUTHORIZED

CEILING OF 2,103 EMPLOYEES; THIS HAD FALLEN BY 1987 TO 1,855 EMPLOYEES AND THE COMMISSION WAS APPARENTLY SHORT BY 120 EMPLOYEES OF EVEN THAT LOWER CEILING."

THE ASSOCIATED SAFEGUARD IS THE RIGHT OF THE FCC AND STATE COMMISSIONS TO REVIEW AFFILIATE INTEREST TRANSACTIONS INCLUDING NOT ONLY THE PURCHASE AGREEMENTS AND CONTRACTS PRIOR TO EXECUTION, BUT ALSO THE BOOKS AND RECORDS OF AFFILIATES. THIS AUTHORITY IS NEEDED EVEN IN THE REGULATORY ENVIRONMENT OF SEPARATE SUBSIDIARIES BECAUSE SEPARATE SUBSIDIARIES DO NOT REDUCE THE INCENTIVE OF THE PARTIALLY REGULATED FIRM TO INCREASE ITS PROFITS THROUGH COST SHIFTING. SEPARATE SUBSIDIARIES ONLY PROVIDE A BRIGHT LINE THAT CAN BE SEEN IF THE REGULATOR HAS THE RIGHT TO LOOK.

ACCESS TO THE BOOKS AND RECORDS OF AFFILIATES IS VIRTUALLY IMPOSSIBLE TODAY WITHOUT AFFILIATE INTEREST LEGISLATION.

RECENTLY, THE NEW YORK PUBLIC SERVICE COMMISSION AND THE FCC HAVE USED THEIR LEGISLATIVE AUTHORITY TO INVESTIGATE AFFILIATE TRANSACTIONS TO AUDIT THE RELATIONSHIP AMONG NYNEX'S REGULATED AND UNREGULATED SUBSIDIARIES. NYNEX HAD ESTABLISHED THE MATERIALS ENTERPRISES COMPANY (MECO) FOR THE PURPOSE OF REDUCING THE COSTS OF PURCHASING GOODS AND SERVICES FOR ITS REGULATED COMPANIES. HOWEVER, INSTEAD OF LOWERING THE COSTS, MECO RAISED THE COSTS. FOR EXAMPLE, MECO ACCEPTED A $574,000 BID TO REMOVE SWITCHES AND CHARGED NEW YORK TELEPHONE $832,000 FOR THE REMOVAL WITHOUT PROVIDING ANY OF THE SERVICE. MECO PURCHASED CIRCUIT BOARDS FOR NYNEX. THESE BOARDS COULD HAVE BEEN PURCHASED FOR APPROXIMATELY $60, BUT MECO CHARGED THE OPERATING COMPANIES $79 PLUS HANDLING.

IN ADDITION, THE GENERAL COUNSEL OF THE NEW YORK PUBLIC SERVICE COMMISSION INVESTIGATED THE COMMISSION'S PROBLEMS IN REGULATING THE RELATIONSHIP BETWEEN NYNEX AND NEW YORK TELEPHONE. IN A REPORT JUST RELEASED, THE GENERAL COUNSEL MADE SEVERAL RECOMMENDATIONS WITH REGARD TO AFFILIATE INTEREST TRANSACTIONS. FIRST, THERE IS A NEED TO ENHANCE THE AFFILIATE INTEREST LEGISLATION SO THAT THE COMMISSION AND ITS STAFF CAN OBTAIN MORE DETAILED INFORMATION. SECOND, THE REPORT NOTED THAT THERE SHOULD BE AN ADDITIONAL REGULATORY PROCEEDING WITH RESPECT TO NEW YORK TELEPHONE COMPANY BECAUSE OF THE NEED TO INVESTIGATE THE MORE COMPLICATED INTRACORPORATE TRANSACTIONS. THIRD, THE REPORT CALLS FOR AN AUDIT OF NEW YORK TELEPHONE'S INTERNAL AUDIT PROCEDURES AND THE NEED TO PROTECT WHISTLEBLOWERS. FOURTH, AND PERHAPS MOST PROVOCATIVE, THE REPORT RECOMMENDS CHANGING THE CORPORATE STRUCTURE OF NEW YORK TELEPHONE AND NYNEX IN ORDER TO PREVENT FUTURE PROBLEMS WITH AFFILIATE INTEREST TRANSACTIONS. AMONG THE POSSIBLE CORPORATE STRUCTURES THAT SHOULD BE EVALUATED, THE REPORT RECOMMENDED, THE COMPLETE DIVESTITURE OF NEW YORK TELEPHONE COMPANY FROM NYNEX.

<u>SEPARATE SUBSIDIARIES PROTECT THE MONOPOLY RATEPAYERS FROM LOSSES ASSOCIATED WITH THE RISK OF FAILURES.</u>

UTILITY COMPANIES DIVERSIFY INTO COMPETITIVE BUSINESSES IN ORDER TO OBTAIN HIGHER PROFITS. HOWEVER, THE MARKETS WHERE HIGHER PROFITS CAN BE EARNED FEATURE HIGHER LEVELS OF RISK. THE SUPPLIERS OF DEBT AND EQUITY FUNDS TO THE HOLDING COMPANY WILL REQUIRE A HIGHER RETURN IN ORDER TO BE COMPENSATED FOR ACCEPTING THE HIGHER RISK. THESE HIGHER LEVELS OF RETURN WILL BE REQUIRED FROM

ACTIVITIES THE HOLDING COMPANY IS ENGAGED IN UNLESS THE RISK ASSOCIATED WITH ONE ACTIVITY CAN BE SEPARATED FROM THE RISK ASSOCIATED WITH THE OTHER.

THE SEPARATE SUBSIDIARY STRUCTURE IS THE VEHICLE THAT CAN SEPARATE THE RISK OF THE UTILITY FROM THE RISK OF THE COMPETITIVE SERVICES. IN ORDER TO FULFILL THIS RESPONSIBILITY, THE SEPARATE SUBSIDIARY VEHICLE MUST BE AUGMENTED BY A SAFEGUARD REQUIREMENT THAT EACH SUBSIDIARY MAINTAIN A SEPARATE CAPITAL STRUCTURE, THAT IS, EACH SUBSIDIARY MUST RAISE ITS OWN FUNDS IN CAPITAL MARKETS. THESE FUNDS CONSIST OF BOTH DEBT AND EQUITY.

TWO REASONS FAVOR A SEPARATE CAPITAL STRUCTURE: (1) TO ENSURE THAT THE UTILITY'S RATES ARE NOT AFFECTED BY THE DIVERSIFICATION AND (2) TO PROTECT THE INVESTMENT OF THE UTILITY FROM THE FAILURES OF OTHER SUBSIDIARIES OF THE HOLDING COMPANY.

IF THE HOLDING COMPANY WERE ALLOWED TO CONSOLIDATE ITS CAPITAL STRUCTURE, IT COULD TAKE ADVANTAGE OF THE GOOD CREDIT OF THE UTILITY TO FINANCE RISKY VENTURES. THE EFFECT OF THIS ACTION WOULD BE TO RAISE THE COST OF DEBT TO THE UTILITY AND LOWER THE COST OF DEBT TO THE OTHER SUBSIDIARY. THE HIGHER COST OF DEBT WOULD INCREASE THE RATES TO TELEPHONE CUSTOMERS.

WHEN DIVERSIFICATION LEADS TO FAILURE, THE EFFECT ON THE UTILITY CAN BE CATASTROPHIC. THE EXAMPLE OF ARIZONA PUBLIC SERVICE AND ITS PARENT HOLDING COMPANY, PINNACLE WEST CAPITAL CORPORATION, CLEARLY DEMONSTRATES THIS PROBLEM. PINNACLE WEST PURCHASED MERABANK, WHICH NEEDED AN IMMEDIATE CASH INFUSION OF $507 MILLION DUE TO SUSTAINED REAL ESTATE LOSSES. BECAUSE OF THESE PROBLEMS,

PINNACLE WEST'S STOCK WAS GIVEN THE LOWEST POSSIBLE SAFETY RATING BY VALUE LINE, AND ARIZONA PUBLIC SERVICE'S ACCESS TO THE CAPITAL MARKETS WAS SERIOUSLY IMPAIRED.

IN CONCLUSION, IT IS THE POSITION OF THE DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION THAT THE TRENDS TOWARD COMPETITION AND INCREASED DIVERSIFICATION IN THE TELECOMMUNICATIONS INDUSTRY CONTRIBUTE TO AN EVEN GREATER NEED FOR THE LECS TO USE STRUCTURAL SEPARATIONS SUCH AS SEPARATE SUBSIDIARIES TO MINIMIZE CROSS-SUBSIDIZATION BETWEEN REGULATED AND UNREGULATED SERVICES. MOREOVER, ACCOUNTING METHODS AS PROFFERED BY THE FCC ARE CLEARLY INADEQUATE IN DETECTING UNLAWFUL CONDUCT AND HENCE INHIBIT THE DEVELOPMENT OF SUSTAINABLE MARKET COMPETITION. IN CONTRAST, THE SEPARATE SUBSIDIARY REQUIREMENT, IN CONJUNCTION WITH REGULATORY AGENCIES' RIGHT TO ACCESS THE BOOKS AND RECORDS OF AFFILIATES AND THE OTHER SAFEGUARDS I HAVE MENTIONED TODAY, CAN FACILITATE COMPETITION AND THEREBY INCREASE THE AVAILABILITY OF SERVICES TO CUSTOMERS AT LOWER PRICES. ANYTHING LESS, AND I EMPHASIZE "ANYTHING" WILL CLEARLY <u>NOT</u> BE IN THE PUBLIC INTEREST, AND THEREFORE, IS CLEARLY UNACCEPTABLE.

THANK YOU FOR YOUR ATTENTION AND THE OPPORTUNITY TO BE WITH YOU THIS MORNING.