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1 **Testimony of Charles E. Peterson**

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3 **INTRODUCTION:**

4 **Q: Please state your name, business address and title.**

5 A: My name is Charles E. Peterson; my business address is 160 East 300 South, Salt Lake City,
6 Utah 84114; I am a Utility Analyst in the Division of Public Utilities.

7 **Q: On whose behalf are you testifying?**

8 A: The Division of Public Utilities (“Division”).

9 **Q: Please summarize your educational and professional experience.**

10 A: I attended the University of Utah and earned a B.A. in mathematics in 1978 and a Master in
11 Statistics (M.Stat.) through the Graduate School of Business in 1980. In 1990 I earned an
12 M.S. in economics, also at the University of Utah.

13

14 Between 1980 and 1991 I worked as an economic and financial consultant and business
15 appraiser for several local firms or local offices of national firms. My work frequently
16 involved litigation support consulting and I have testified as an expert witness in both Federal
17 and state courts.

18

19 In 1991 I was employed by the Property Tax Division of the Utah State Tax Commission as
20 an analyst in the Centrally Assessed Utility Section performing annual appraisals of utility,
21 transportation and communications property. In 1992 I was promoted to manager over that
22 section and became responsible for the annual assessment of over 100 centrally assessed
23 companies and the section’s audit program. I was also heavily involved in settlement

24 negotiation and the litigation of appeals. I have provided expert testimony numerous times,
25 both in deposition and formal hearing, before the Utah State Tax Commission.

26

27 I joined the Division of Public Utilities at the first of January 2005 as a utility analyst and
28 since then I have worked primarily in the energy section of the Division.

29 **Q: Please outline the projects you have worked on since coming to the Division.**

30 A: I was involved in evaluating cost of capital issues in the most recent rate case with
31 PacifiCorp; and I subsequently co-authored a paper regarding the Capital Asset Pricing
32 Model (CAPM). I have worked on DSM, service quality, and customer guarantees involving
33 PacifiCorp. I am the Division lead on the forecasting task force, and have participated in
34 other task forces. I am the Division lead on two internal research projects involving Ring-
35 Fencing and Fuel Issues for Electric Generation. The Ring-Fencing research project was
36 done at the specific request of the Public Service Commission. Additionally, I have been
37 assigned to be the lead of an economics and finance group within the Division to evaluate the
38 proposed acquisition of PacifiCorp by MidAmerican Energy Holdings Company.

39 **Q: Have you worked on telephone issues at the Division?**

40 A: Yes, but to date, besides my testimony in this matter, it has been limited mostly to some
41 preliminary cost of capital work and internal consulting on a dispute between two rural
42 telephone companies.

43 **Q: Please summarize your experience with telecommunications companies as a result of**
44 **your work at the Utah State Tax Commission.**

45 A: As manager I oversaw the assessment and audit program of approximately 35
46 telecommunications companies. These companies ranged from Qwest, AT&T and Sprint, to

47 rural telephones, CLECs, and wireless companies such as AT&T Wireless/Cingular and
48 Sprint Wireless.

49 **Q: Did you ever testify as an expert witness before the Utah State Tax Commission**
50 **regarding a telecommunications company?**

51 A: Yes.

52 **Q: Please describe the testimony you have given.**

53 A: Over the last three years I have testified in major hearings involving Qwest, Verizon
54 Wireless, and T-Mobile. The Utah State Tax Commission assesses these companies based
55 on what is known as the “unitary method.” This means that the operating system as a whole
56 is viewed as the unit of property, rather than the individual poles, towers, switches, lines, etc.
57 The unitary appraisal is generally similar to business appraisal work and often includes an
58 evaluation of the cash flows of the company, capital structure, cost of capital, and the
59 valuation of securities in the securities markets.

60

61 My testimony included an evaluation of the economic setting these companies operated in as
62 well as the financial strength and future expectations of these companies. Besides the final
63 valuation issues, other issues included cost of capital, capital structure, and the nature and
64 organization of the subsidiaries of the parent holding companies. The latter was an issue
65 because there were major questions raised regarding “what-the-unit-of-property” should be.

66 **Q: Could you elaborate on the issues surrounding the “what-[is]-the-unit-of-property”?**

67 A: Yes. In each of the above cases, the parent company operated through a number of
68 subsidiaries. In the case of Verizon Wireless, there were essentially seven subsidiaries that
69 covered the state of Utah. Verizon’s position was that those subsidiaries, individually,

70 should be the unit of property for assessment purposes. In the case of T-Mobile, the
71 company operated through several subsidiaries in Utah, but constructed an artificial unit
72 covering exactly to the borders of Utah as its unit, even though no collection of actual
73 operating subsidiaries covered exactly the state of Utah. The position I argued for was that
74 the national operating system of each of these two wireless companies was the proper unit.
75 This was based upon an evaluation of how the system was managed and operated, the
76 accounting systems, the deployment of employees, marketing and capital and the financing
77 of the systems. I was able to show that these subsidiaries had no employees of their own, had
78 no separate accounting system, that management, marketing and financing was done on a
79 nationwide basis and that national operations (including Utah) were controlled from a couple
80 of central locations. The Tax Commission found that the proper unit for Verizon Wireless
81 was its national unit. The Tax Commission has not yet issued its decision in the T-Mobile
82 case, but based upon Verizon, it is expected that the national unit will be accepted.

83 **Q: What about the Qwest matter?**

84 A. Qwest was a more complex case in that it was operating in the wireless, long-distance, and
85 local exchange sub-sectors through different subsidiaries. I believed that the evidence clearly
86 showed that the intent of the parent holding company was to operate these subsidiaries in
87 concert with one another through significant direct, hands-on management, deployment of
88 capital, and marketing. There was also considerable cross-subsidization using employees of
89 the various subsidiaries to do work for other subsidiaries. In my view, the individual
90 subsidiaries were being managed together to maximize profit of the parent, but that any one
91 subsidiary was not an independent, profit-maximizing entity. However, the subsidiaries did
92 have some of their own employees, accounting systems, and nominal top management.

93 Further, the regulated local exchange carrier had regulatory conditions that separated it
94 further from the non-regulated entities (although most of these conditions were expected to
95 expire in a couple of years). The Tax Commission determined that the local exchange carrier
96 was sufficiently separated within the holding company to leave it as a separate unit of
97 property.

98 **Q: So you have had previous experience analyzing and testifying about holding company**
99 **organization and the relationships between subsidiaries and between a subsidiary and**
100 **its parent?**

101 A: Yes.

102

103 **RING-FENCING:**

104 **Q: Earlier you indicated that you prepared a study on ring-fencing. What is ring-fencing?**

105 A: In this context ring-fencing can be defined as structural and operational practices and
106 concepts imposed on a utility operating company, such that the utility operating company is
107 insulated from the operations and financial results of affiliates or a parent holding company.
108 That is, the utility can be said to be “fenced-off” from unregulated or other regulated
109 businesses of a company. Usually ring-fencing procedures and practices are put in place to
110 protect the utility and its customers from bearing any burdens resulting from financial or
111 other distress in affiliates or a parent company. Of key concern to regulators is often the
112 protection of the utility’s credit standing in the market place, but other issues, including
113 going-concern/bankruptcy issues may be among the reasons for ring-fencing.

114 **Q: Who imposes ring-fencing on a company?**

115 A: Parent holding companies have imposed ring-fencing on subsidiaries for their own corporate
116 purposes; usually to protect the credit rating of the subsidiary, but could be used to protect
117 the parent from the subsidiary. Regulatory authorities have imposed ring-fencing either
118 through exercise of specific statutory authority, or as part of a regulatory action filed by the
119 company: usually for a merger or re-organization approval.

120 **Q: What are some of the principal ring-fencing procedures and practices?**

121 A: The following is a list of “best practices” that can be gleaned from Standard & Poor’s and
122 Fitch rating services. These “best practices” are not exhaustive of the items that could be
123 included by regulators for their purposes in a ring-fence, such as extending conditions on
124 transactions with affiliates.¹

- 125 1. The regulated utility is a corporate subsidiary in a holding structure.
- 126 2. The regulated utility is placed in a Special Purpose Entity, which is legally
127 separate from the non-regulated affiliates of the parent.
- 128 3. The provision of so-called “nonpetition” (bankruptcy) language by the parent.
- 129 4. The utility is managed separately and has a separate board of directors.
- 130 5. The utility’s books and records are kept separate from any affiliates.
- 131 6. The utility has its own bank accounts and credit facilities, its own separate debt
132 and has its own separate credit rating.
- 133 7. Limits imposed on capital structure, e.g. setting a minimum common equity
134 percentage in the capital structure.
- 135 8. Limits on inter-company guarantees and loans—including loans to money pools.
- 136 9. Limits on dividends (or, Patronage refunds).
- 137 10. A written Affiliate Code of Conduct is in place.

¹ See Exhibit 10.1, pp. 19-20.

138 11. Finally, violations of these practices are supported by clear penalties from
139 regulatory authorities.

140

141 A paper prepared by NARUC's Subcommittee on Accounting and Finance outlined five
142 areas of possible ring-fencing measures:

- 143 1. Commission authority to restrict and mandate use and terms of sale of utility
144 assets. This includes restriction against using utility assets as collateral or
145 guarantee for any non utility business.
- 146 2. Commission authority to restrict dividend payments to a parent company in order
147 to maintain financial viability of the utility. This may include, but is not limited
148 to, maintenance of a minimum equity balance.
- 149 3. Commission authority to authorize loans, loan guarantees, engagement in money
150 pools and large supply contracts between the utility and affiliate companies.
- 151 4. Commission authority over establishment of a holding company structure
152 involving a regulated utility.
- 153 5. Expand commission authority over security applications to include the ability to
154 restrict type and use of financing.

155

156 **UBTA and UBET:**

157 **Q: Are you familiar with the testimony in this matter submitted by Wesley Huntsman,**
158 **Mary Cleveland, Bruce Moio, David Thomson, and John Gothard, Jr.?**

159 A: Yes. I am also familiar with the original filing documents filed by UBTA/UBET in this
160 docket.

161 **Q: Based upon this testimony, does it appear to you that the regulated utilities of Uintah**
162 **Basin Telecommunications Association, Inc. (UBTA) are ring-fenced?**

163 A: No.

164 **Q: Could you explain why you have reached this conclusion?**

165 A: Yes. UBTA is both a regulated utility and the parent holding company of regulated (UBET)
166 and non-regulated subsidiaries and affiliates.² This in and of itself is not considered a good
167 basis for ring-fencing. The literature on ring-fencing clearly advocates that any regulated
168 utility be a separate subsidiary within a holding company structure. The accounting system of
169 UBTA is a single system controlled by UBTA employees.³ The various subsidiaries are
170 treated merely as divisions of the whole. Mr. Thomson also testifies that with regard to
171 income tax treatments, UBTA's structure and accounting fails the "benefits/burdens
172 standard" meaning that assignment of income tax liability cannot be accurately allocated
173 among the various entities.⁴

174 Beyond corporate structure and the complete intertwining of the accounting system, other
175 items support the contention that there is a complete lack of ring-fencing procedures at
176 UBTA. The subsidiaries essentially do not have their own separate employees, business plan
177 or distinguishing corporate identity.⁵ UBTA's Application includes as part of its rate base
178 items of equipment that are actually part of non-regulated operations.⁶ UBTA's proposed
179 revenue requirement includes expenses that should be allocated to non-regulated entities.⁷

² see, for example the Testimony of David Thomson, page 8, beginning at line 14.

³ Testimony of David Thomson, pp. 11-16. and Mary Cleveland

⁴ Testimony of David Thomson, pp. 5-8.

⁵ Testimony of David Thomson and Wesley Huntsman.

⁶ Testimony of Bruce Moio.

⁷ Testimony of Mary Cleveland.

180 There is common management.⁸ And perhaps most telling is the financial transactions
181 detailed by Messrs. Huntsman, Thomson and Gothard.

182 **Q: Could give examples of such transactions?**

183 A: Yes. Mr. Huntsman discusses debt attributable to non-regulated entities that are secured by
184 the assets of regulated entities.⁹ John Gothard discusses the conversion of a loan UBTA
185 made to UBET Wireless to equity that benefits the non-regulated entity at the expense of the
186 regulated entity. Mr. Gothard also analyzes and critiques the payment of patronage refunds at
187 a time when UBTA is searching for cash flow.¹⁰ Ms. Cleveland discusses UBTA's
188 departures from its own Cost Allocation Manual.¹¹

189 **Q: Based on the testimony you have cited, how would you characterize UBTA?**

190 A: As a diversified telecommunications company operating as a unit through multiple
191 subsidiaries.

192 **Q: Do you believe the patrons of UBTA and the customers of UBET would benefit from
193 ring-fencing the regulated operating companies?**

194 A: Yes.

195 **Q: Please explain.**

196 A: Successful ring-fencing could alleviate concerns for downgrades of credit standing and
197 default due to losses incurred by unregulated operations. Improved credit standing of the
198 regulated utilities would lower costs, both the direct cost in interest expense and, since
199 separate management should be in place, the indirect cost of management time and possible
200 legal expense dealing with issues surrounding any default conditions. There should be no

⁸ Testimony of David Thomson, pp. 11-12.

⁹ Testimony of Wesley Huntsman, p 22, beginning with line 12.

¹⁰ Testimony of John Gothard, Jr.

¹¹ Testimony of Mary Cleveland.

201 costs allowed for rate-making which are associated with subsidizing any non-regulated
202 affiliates in any way, at least not without the express approval of the Utah Public Service
203 Commission. In this particular case the patrons and customers of the regulated utilities would
204 be protected from the burdens that have resulted and may result from a failing subsidiary of
205 the parent.

206 **Q: Are there possible detriments to a successful ring-fencing of the regulated utilities?**

207 A: Yes, there are at least two possibilities. First, a tight ring-fence could eliminate subsidies
208 flowing from profitable non-regulated operations to the regulated companies. Second, in a
209 tight ring-fence the regulated utilities may find that they are not able participate in economies
210 of scale that the total parent holding company might enjoy resulting from larger purchases, or
211 holding company-wide services such as human resources, legal, and accounting.

212 **Q: Could a middle ground be obtained where the benefits of ring-fencing could be enjoyed,
213 but loss of some of the economies you mention could be mitigated?**

214 A: Yes. For example, the parent holding company or a subsidiary might provide “staff”
215 functions such as human resources, legal, and accounting and possibly financing and
216 purchasing, but accounting needs to be strict and the extent of the services should be
217 conditioned by regulation.

218

219 **RECOMMENDATIONS:**

220 **Q: Given your understanding of the circumstances of UBTA and UBET, what are your
221 recommendations in this matter?**

222 A: I believe that the application of ring-fencing provisions outlined in my testimony would
223 serve well the customers and patrons of UBTA/UBET. Specific ring-fencing related

224 recommendations are found in the testimonies in this matter by other members of the
225 Division of Public Utilities, see, for example, the recommendations of Wesley Huntsman and
226 John Gothard, Jr. I would endorse the recommendation that restrictions be made on the
227 refund of patronage capital until a minimal equity balance in the capital structure be attained.
228 I also would endorse the restriction of capital flows to unregulated affiliates.
229 Actions by the Division subsequent to this docket may include filing for rule making or filing
230 a complaint.

231 **Q: Does this complete your testimony?**

232 A: Yes.