The Impact of Affiliate Transactions on Utility Telecommunications Ventures

A White Paper by

THE SHPIGLER GROUP

STRATEGY MANAGEMENT CONSULTING SERVICES

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On an increasing basis, utilities are seeking opportunities to enter the telecommunications arena. The business ventures created vary widely and can offer promise of significant impact over time to the parent utility's bottom line. However, regulations affecting affiliate transactions are a factor to deal with and must be considered as part of the business case. We investigate this issue and show how the impact of affiliate transactions regulations can be quantified.

1. Overview of Utility Telecommunications Businesses

Over the past several years we have seen the emergence of a new sector within the category of telecommunications carriers: utilities. A generally cautious collection of companies, utilities have sought opportunities within the more aggressive field of telecommunications due to strategic fit and market opportunity. Today, as telcos struggle for survival, many utilities have looked to increase their involvement in the market and to pursue potential growth of the communications marketplace. To be sure, not all of these ventures have proven successful; in fact, several have been noteworthy failures. Included within this category are such ventures as Telergy (regional fiber), Conectiv (CLEC), and of course, Enron (bandwidth trading). Nevertheless, many other UTelco ventures have been initiated and have found considerable levels of success.

The reason for utilities to pursue telecom business ventures comes down to the pursuit of value through synergies between the two industries. In our view, these synergies can be categorized into three groups:

- *Infrastructure* – Some of the same pieces of infrastructure needed to support a utility operation – fiber, towers, poles, ROW, etc. – are necessary in developing telecommunications businesses.
- *Capabilities* – The knowledge and ability behind constructing and maintaining networks – be it power or telecom – are already in place in all utilities.
- *Finances* – In today's uncertain economic times, utilities are among the few players that have the financial resources to capitalize on the anticipated growth that is expected within the telecom sector.

Based on our research, we have found that those UTelco ventures that have fared the best have been the ones that "stuck close to their knitting". In other words, those utilities that created businesses that sought the greatest operational links to the inherent advantages their utility operations offered tended to do well. Interestingly enough, the technology platform supported was not a dominant issue here – a listing of the more successful UTelco ventures would likely include such diverse operations as FPL FiberNet (FPL – fiber), Southern LINC (Southern Company – wireless), and Sigecom (Vectren – cable).

Following this logic, those utilities that utilize the inherent advantages available to them through ratepayer-based assets can expect to reap the rewards of a UTelco venture. However, this same logic is part of the drive by state regulators to place limits on the UTelco business operating model. We now look at some of those issues.

2. Applications of Affiliate Transactions on UTelco Ventures

Telecommunications providers are already faced with a number of regulatory requirements based on the services they offer to the market. For example, offering voice services requires a carrier to provide for interconnection, resale, number portability, dialing parity, access to rights-of-way, and reciprocal compensation. Meanwhile, operating a cable TV system requires the payment of franchise fees, control over broadcast content, and access to channel capacity[1]. Any UTelco offering these services would similarly have to account for these issues.

However, in addition to these elements of regulatory control over content, there is a set of affiliate transaction requirements that specifically apply to UTelco operations. The motivation for the establishment of these controls is based on the desire to return potential profits to ratepayers on assets they have contributed to. At the same time, many state regulators have voiced a concern over supporting a level playing field between utilities and their telco counterparts. Broadly speaking, there are three key areas of regulatory concern[2]:

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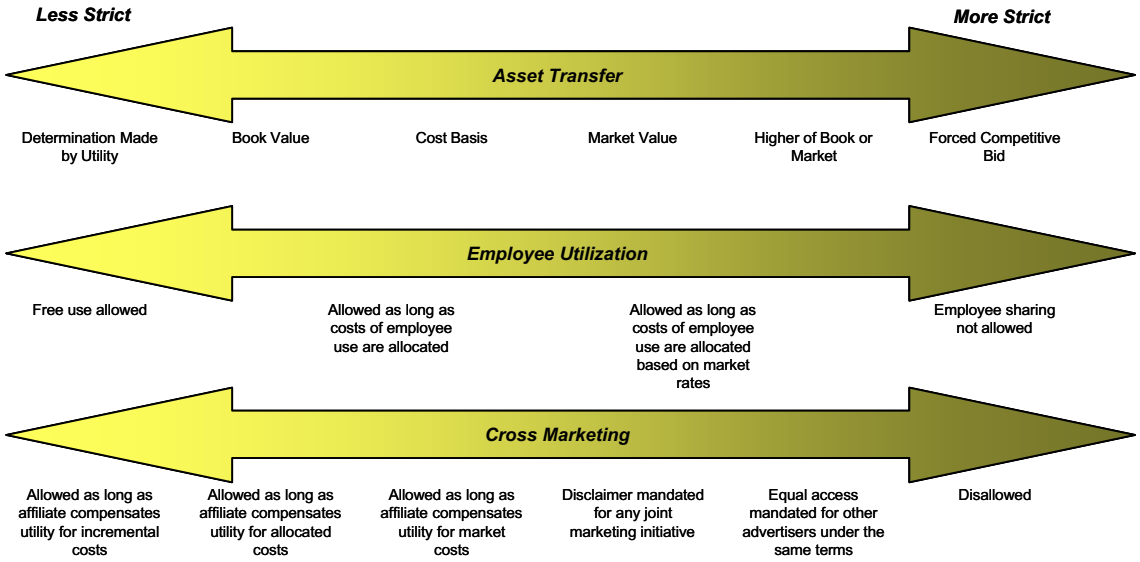
[1] United Telecom Council.
[2] Ibid.

- *Asset Transfer* – Establishment of prices at which assets or rights are transferred from the regulated utility to the unregulated telecommunications subsidiary
- *Employee Utilization* – The ability to utilize utility staff for activities that support the operations of an unregulated subsidiary
- *Cross Marketing* – The ability to promote services of an unregulated subsidiary through the ongoing operation of the regulated utility

While the motivation of regulating each of these areas is the same, the specific rulings that apply vary widely by state. Recently, we interviewed state regulators from nineteen states to understand how these regulations are applied and found that within each of these areas, there is a wide spectrum of possible rulings that can be mandated, as shown below[3]:



Differences in the types and degree of regulations can have impacts on the business case for a UTelco operation. We look at each of these factors in turn.

- Asset Transfer -

As mentioned previously, one of the key advantages of a UTelco venture is the ability to utilize already existing assets for a telecom offering. For example, if a utility has built a fiber network to each of its substations to

[3] The Shpigler Group interviews with state regulators, United Telecom Council

support internal communications, it is likely that significant excess fiber strands and/or capacity exists on the network – an excess that could easily enough be transferred to an unregulated subsidiary for a market offering. However, in transferring the asset, compensation must be paid in order to support the ratepayers that originally paid for the asset. The question, therefore, is what price to pay? Typically, the best way for a utility to transfer the asset is at book value. This value can be low if the original asset was put on the books some time ago and the accumulated depreciation has built up, leaving a small amount for actual compensation. Typically, a higher price will be required in the case of market value – although in today's environment of falling asset values, it is possible to make the argument that prices should be fairly low under this scheme. Of course, some states have followed a higher standard, forcing asset transfer pricing from the regulated utility to the unregulated sub to occur at the *higher* of book or market, and further requiring transfers going from unregulated to regulated to occur at the *lower* of book or market. A few states have gone even further, stipulating that for a utility to transfer assets, it must make the asset available to third parties and thus requiring an open bidding process where effectively a utility must bid for its own assets.

- Employee Utilization -

Another advantage of a UTelco operation is the ability to leverage the internal skill set that already exists in house. Utilities know how to build networks, how to maintain networks, and how to operate networks. Therefore, it only makes sense that a utility would create value by utilizing its own internal human resources in support of UTelco operation. Again, the question comes down to compensation – at what rate does the UTelco pay for these services? The most liberal state regulators require that the UTelco pay the regulated utility based on incremental costs; that is, any extra cost created by this support is borne by the unregulated sub. However, a more typical arrangement is one of cost allocation. Under this arrangement, hours spent by employees are recorded and the fully loaded costs for each employee are charged back to the UTelco on a pro-rata hourly basis. Some other states hold to a stricter standard – one in which market rates for comparable labor in the industry in question is charged back. In any of these scenarios, however, it is likely that expense associated with network operations can be reduced through the use of utility employee labor. In states where this practice is disallowed altogether, the potential benefit is lost.

- Cross Marketing -

Another benefit of operating a UTelco venture is through the potential for cross marketing. A utility already has relationships with customers in the service territory. If a new service offering developed by a UTelco venture could be marketed to the existing ratepayers cost effectively, it can result in a higher market penetration than might otherwise be expected. Of course, it should be noted that the real benefit of this is found in retail telecom offerings targeted to the residential and SMB market. Every month, each utility customer receives correspondence from the utility in the form of a bill. If bill stuffers promoting the new offering could be included with the bill, customers could become aware of the availability of the service. Likewise, people who move into the area and call the utility to have electric service turned on could be directed to another call center that could handle other services like cable, Internet, and telephony. Also, it is possible to the leverage the generally favorable impression customers have of their electric utility relative to telco and cable providers by branding the product as being affiliated with the utility and allowing the joint use of logos. All of these are theoretically possible ways to increase market reach, but again the issue comes down to what regulators will allow. If a utility is allowed use of these avenues of marketing by paying some cost, there is a real potential for improved sales rates. Many states will allow some or all of these activities but mandate that a disclaimer is made either stating that the new business is not regulated or that ratepayers do not have to subscribe to the new service offering. Stricter regulatory bodies mandate that equal access under the same terms offered to the unregulated sub be made available to other carriers. At the far end of the spectrum are those states that disallow any joint marketing initiatives altogether, thus eliminating the potential for value creation through improved market penetration.

3. Quantifying the Impact of Regulations

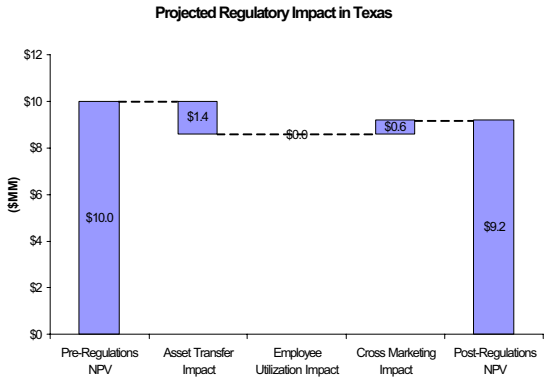
Given the options above, utilities are always interested in understanding completely the economic impacts of regulatory controls and the results felt in the business case. Roughly speaking, there are two ways to impact the business – through revenue effects or through cost effects. Determinations on how assets are transferred from the regulated utility to the unregulated sub involve the introduction of new cost while sharing of utility employees' labor efforts feature potential cost savings. Meanwhile, the opportunity to market new service offerings to ratepayers offers a revenue enhancement potential.

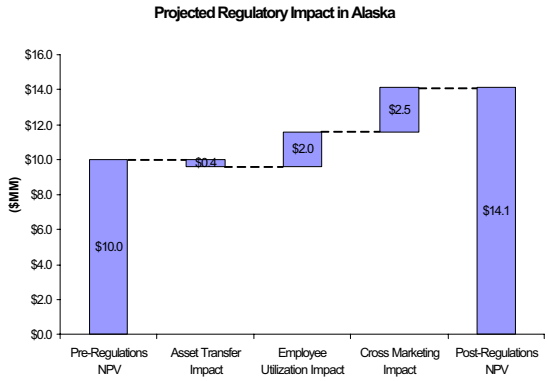
To understand the financial impact of regulations, we can build the business case without incorporating these limiting factors and potential opportunities and then re-run the model with regulations taken into account. To illustrate this issue, we look at the impact of regulations of a UTelco business in two states. Let's say a utility wants to establish a broadband offering in the marketplace through an HFC deployment. The parent utility already has significant fiber throughout the market and will build coaxial cable to homes and businesses. Let's assume the business case shows that without regulations, a broadband provider establishing this network would see a positive NPV of the business of $10 million. The question then is, how much would the UTelco facing regulations make on the venture?

The answer to this question depends heavily on where the UTelco is located. If the service territory in question is in Texas, we can expect fairly strict regulatory controls to be put in place. The state will seek to ensure maximum value through the sale of the assets, and as such would require that a competitive bidding process for the assets in question be established if the value of the sale exceeds $1 million or if the value of each unit is over $75,000. Assuming that the UTelco can acquire the assets from the utility parent, we can expect the cost to be rather high. Making some assumptions about a reasonable scenario for the amount transferred and the rate paid, we estimate a net cost of $1.4 million from the venture. In Texas, utility employees are disallowed from involvement with the unregulated subsidiary, so there is no cost saving that can be expected here. Joint marketing is, however, allowed as long as a disclaimer is used in any promotional materials. The incremental benefit based on expected market penetration increase is $600,000. So, in total we can expect that the venture's NPV post-regulations will come to $9.2 million. Regulations in these three areas have cost the venture 8% of the overall profitability.

If the utility is located in Alaska instead, the story is very different. There are not any well-defined rules regarding how the assets must be transferred to the unregulated sub and in the past, deals have been made utilizing both book and market value. As long as there was logic articulated as to the methodology used, the utility could make a case for how it recommended proceeding. Using our business model with this more lenient approach, we estimate the total cost of the asset transfer to be only $400,000. Furthermore, significant gains can be made through joint use of employees and cross-marketing efforts. Alaska allows for sharing of employees across multiple business lines as long as a log of hours is kept and appropriate consideration is paid to the parent and allows for the promotion of a UTelco's products to ratepayers. We

calculate the operational savings of using utility employees to total $2.0 million and increased penetration based on cross marketing to increase profitability another $2.5 million. In total, this Alaskan UTelco would expect to see a total NPV of $14.1 million, or an increase of 41%.





4. Conclusion

As mentioned previously, utilities are increasingly looking to telecommunications as a potential avenue of operations. If a carefully designed plan that properly leverages the strategic advantage available to the utility is pursued, the ultimate results can be quite attractive. However, we have seen all too clearly what happens in the telecom sector when the business model is not well crafted. As a result, utilities need to carefully design the business case to identify the true economic potential of any venture. In doing so, the costs – and the opportunities – associated with regulations must be accounted for.

Regulations vary by state and can also vary by the type of business venture entered into. Utility executives seeking opportunities in the telecom sector must clearly identify the regulations that apply to their market situation and account for them in their operating plans. However, caution must be given that these regulations can change, typically in states where little attention has been paid to the UTelco field in the past. As a result, contingency plans should be developed in case regulatory controls shift over time.

With these wide differences in regulations, the shape of the business model should be designed in such a way as to take advantage of the rules that apply and to avoid those that put the UTelco in a disadvantaged position. For example, in those states where cross marketing is disallowed or severely

restricted, there will exist very little in the way of synergy for revenue generation. In those areas, a wholesale fiber model may make more sense than a residential broadband strategy. Conversely, where these practices are allowed, a utility can take advantage of the situation by offering services to the end customer, either directly or through strategic relationships.

While many of the rulings are fairly firm, utilities should nevertheless explore opportunities to negotiate alternative arrangements that offer opportunities to leverage utility-telecom synergies. For example, SoCal Edison operates a fiber network in California, a very highly regulated state. The utility has negotiated an arrangement to compensate ratepayers through an attractive revenue sharing arrangement that allows them to successfully build their business. Our advice – again, build the business case carefully, and explore alternative arrangements to see how they can affect the operating model.

One final note – this time directed at the regulators themselves. Numerous discussions with utilities have revealed to us a desire to fairly compensate ratepayers and to ensure a level competitive playing field. Regulations that support this effort can make sense to all those involved. However, overly strict regulatory controls will not help consumers if they ultimately drive utilities out of the telecom business. Fair but reasonable controls should be enforced so as to invite utilities to enter this field – and offer consumers and enterprises greater telecommunications choices in the long run.

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The Shpigler Group is a leading strategy management consulting firm focused on the telecommunications and technology sector. The Shpigler Group works with utilities, municipalities, telecom service providers, and infrastructure and technology developers in solving complex issues involving strategic assessment, market analysis, business case development, economic evaluation of network design, and competitive and partnership assessment. For inquiries, please refer to the contact information below:

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