BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

SPRINT-NEXTEL MERGER

DOCKET NO. UT-051291

DIRECT TESTIMONY OF STEPHEN G. HILL (SGH-1THC)

ON BEHALF OF

PUBLIC COUNSEL

REDACTED VERSION

November 30, 2005

DIRECT TESTIMONY OF STEPHEN G. HILL (SGH-1THC)

TABLE OF CONTENTS

TABLES AND GRAPHS

HILL EXHIBIT LIST

I. INTRODUCTION / SUMMARY

Q. Please state your name, occupation and address.

A. My name is Stephen G. Hill. I am self-employed as a financial consultant, and principal of Hill Associates, a consulting firm specializing in financial and economic issues in regulated industries. My business address is P.O. Box 587, Hurricane, West Virginia, 25526 (e-mail: sghill@compuserve.com).

Q. Briefly, what is your educational background?

A. After graduating with a Bachelor of Science degree in Chemical Engineering from Auburn University in Auburn, Alabama, I was awarded a scholarship to attend Tulane Graduate School of Business Administration at Tulane University in New Orleans, Louisiana. There I received a Master's Degree in Business Administration. More recently, I have been awarded the professional designation, "Certified Rate of Return Analyst" by the Society of Utility and Regulatory Financial Analysts. This designation is based upon education, experience and the successful completion of a comprehensive examination. I have also been elected to the Board of Directors of that national organization. A more detailed account of my educational background and occupational experience appears in Exhibit No. __(SGH-2).

Q. Have you testified before this or other regulatory commissions?

A. Yes, I have previously presented testimony in this jurisdiction and have testified on cost of capital, corporate finance and capital market issues in more than 225 regulatory proceedings before the following regulatory bodies: the West Virginia Public Service Commission, the Texas Public Utilities Commission, the Oklahoma State Corporation Commission, the Public Utilities Commission of the State of California, the Public Service Commission of New Hampshire, the Georgia Public Service Commission, the Public Utilities Commission of the State of Minnesota, the Ohio Public Utilities

Commission, the Insurance Commissioner of the State of Texas, the North Carolina Insurance Commissioner, the Rhode Island Public Utilities Commission, the City Council of Austin, Texas, the State of Maine Public Service Commission, the South Carolina Public Service Commission, the Public Utilities Commission of the State of Hawaii, the New Mexico Corporation Commission, the Wisconsin Public Service Commission, the State of Texas Railroad Commission, the Public Service Commission of Utah, the Illinois Commerce Commission, the Kansas Corporation Commission, the Indiana Utility Regulatory Commission, the Virginia Corporation Commission, the Public Service Commission of Maryland, the Pennsylvania Public Utilities Commission, the Montana Public Service Commission, the Maine Public Utilities Commission, the Vermont Public Service Board, the Federal Communications Commission and the Federal Energy Regulatory Commission. I have also testified before the West Virginia Air Pollution Control Commission regarding appropriate pollution control technology and its financial impact on the company under review.

O. On behalf of whom are you testifying in this proceeding?

A. I am testifying on behalf of the Public Counsel Section of the Washington State Attorney General's Office ("Public Counsel").

Q. What is the purpose of your testimony?

A. Public Counsel has requested that I review the financial aspects of the pending transfer of the local exchange telephone assets of United Telephone of the Northwest (UTNW) from Sprint Nextel Corporation to a newly formed stand-alone company, currently referenced as LTD Holding Company (LTD). My review is designed to determine whether that transaction is in the public interest and will promote a fair balance of the interests of Sprint's investors and Washington's LTD telephone ratepayers.

In December of 2004, Sprint Corporation and Nextel Corporation entered into a definitive agreement to merge Nextel with and into a wholly owned subsidiary of Sprint. That merger received stockholder approval and was completed in August of 2005. The new corporation was named Sprint Nextel Corporation (referenced herein as Sprint). In the merger agreement, Sprint and Nextel agreed to separate the incumbent local exchange business of Sprint by means of a stock distribution of the shares of a new, separate, local exchange company to the then existing shareholders of Sprint Nextel Corporation. The new company, which will consist predominantly of local exchange telephone operations will be given a new name when and if it is separated or spun-off from Sprint. Currently that new company is referred to as LTD Holding Company (LTD).

I have reviewed the testimony and exhibits provided by the company representatives as well as the report prepared by Houlihan Lokey evaluating the projected enterprise value of LTD (referenced herein as the Sprint Report) and responses to data requests submitted by Public Counsel and other parties in the proceeding.

Q. Please provide a brief summary of your findings and recommendations?

A. With the merger of Sprint and Nextel the primary focus of that newly merged corporation is wireless communications and the interests of Sprint will diverge from those of its local exchange operations.[1] In other words, those two corporate entities (Sprint and LTD Holding Company) will compete for the same customers. Therefore, Sprint management, as a condition of the merger with Nextel, agreed to separate its incumbent local exchange business to stockholders so that they would own shares in two separate companies—one focused on national wireless communications and one focused on regional local exchange wireline telephone service.

According to Sprint's third quarter 2005 S.E.C. Form 10-Q, that company is capitalized with approximately 54% common equity (excluding goodwill) and 45% long-

[1] Sprint Nextel Application, p. 21.

term debt and preferred stock.[2] However, Sprint plans to spin off its regulated local exchange operations with far less equity and more debt than that with which it has elected to capitalize its newly-merged wireless business.

As part of the spin-off of LTD, Sprint plans to monetize its investment in its local exchange company by having LTD issue **** Billion in new debt (bank debt ($*** Billion) and notes ($***** Billion)), and ************************ to Sprint.[3] That amount of new debt is *** times the amount of debt currently on the books of the local exchange operations.[4] As a result of issuing the new debt at the time of the spin-off, the new local exchange company (LTD) will have **************************. Because the liabilities and shareholder equity must equal the asset value in a balance sheet, the planned spin-off and the addition of $*** Billion of new debt to LTD will result in a ******** common equity value on LTD's books of account.

Sprint, as demonstrated by the analysis contained in the Sprint Report provided as an attachment to Company witness Daniel's Direct Testimony, has been careful to model the spin-off of LTD so that the resulting market-value capital structures resemble other "comparable" local exchange telephone companies. However, the companies that serve as a model for LTD in the Sprint Report have debt ratings, on average, that are well below investment grade and have correspondingly high financial risk. While two bond rating agencies (*****************) have provided *************** ************************************** one rating agency (*********** *****) expects that the LTD spin-off will cause the bond rating of LTD to ******** ****************. Standard and Poor's also projects that ******************

[2] Sprint Nextel S.E.C. Form 10-Q, September 30, 2005, p. 3. Goodwill is created by the difference between the market price paid for an asset and its accounting or book value.

[3] Data from Sprint Report, p. 12 and telephone conference with Sprint personnel on November 18, 2005.

[4] Sprint Report, p. 12.

****************** will help to improve Sprint's bond rating from **************[5]

My review of the projected separation of the local exchange operations of United Telephone from Sprint indicates that the parent company has estimated the amount of additional leverage LTD can support and still have an opportunity to maintain a ****** investment bond rating. Based on an analysis of the valuation of small local exchange companies, Sprint has estimated that additional amount of debt that LTD's operations can absorb to be approximately $*** Billion.

It is important to understand that LTD is not required to issue $*** Billion in debt in order to be spun-off from Sprint, and that the spin-off is not an arms-length transaction. The shares of LTD could be distributed to the shareholders of Sprint with no additional debt or any amount between zero and $*** Billion. For example, if LTD issued $3.6 Billion in new debt rather than the $*** projected, the new LTD Holding Company would have a ******** common equity book balance that equaled approximately ***of total capital.[6] That specific amount of debt ($*** Billion) was selected, in my view, to maximize the cash distribution to Sprint while creating a stand-alone LTD with at least an opportunity to achieve a ********* investment grade bond rating. Sprint's cash draw from the separation is being ********* while LTD's financial safety is being *********.

While Sprint's intentions seem to be well designed (*********************** have indicated in private that LTD could achieve a *************************, the more important question is whether or not the creation of a local exchange telephone company with a *************** bond rating status is in the public interest. It is clear from the documents provided by Sprint that the creation of a ********** LTD operation is in the surviving Sprint wireless company's best interest, however, I believe it is not in

---

[5] Sprint Response to Public Counsel Data Request No. 8, Attachment 8.2.
[6] Data from Sprint Report, p. 17, Pro Forma Balance Sheet of LTD.

the best interest of United Telephone of the Northwest or its customers in Washington. The transaction is modeled on telephone companies, which have ******** bond ratings. While the operating metrics of LTD are slightly better than the group of other telephone companies on which the separation is modeled (meaning that LTD is probably less risky operationally), there is little room for error and the impact of an unforeseen negative financial event could drive down the bond rating, cause emergency rate requests, lead to service quality problems, and/or restrict funds available for infrastructure development such as DSL roll-out to rural areas.

Unfortunately, this Commission and Washington ratepayers, in recent years, have been faced with too many instances in which utilities in restrictive financial positions have had to turn to ratepayers and higher rates for support. While it may be reasonable to separate the local exchange operations from Sprint, it is not reasonable to do so in a manner that creates an entity with a marginal financial position. Therefore, on the basis of the projected marginal financial position of LTD Holding Company, I recommend that the Commission reject the Company's proposal to transfer the control of the Washington local exchange assets of United Telephone from Sprint Nextel Corporation to LTD Holding Company.

Q. If the Commission determines, for other reasons, that there are advantages to moving forward with the transfer of control, are there conditions you believe should be included in an approval of that transaction?

A. Yes. Because the transfer as currently structured places LTD in a financially precarious position, the conditions included in the Commission's approval of the transfer of control should be directed to protecting the financial integrity of LTD. Also, there should be conditions that will protect the local assets of United Telephone of the Northwest from financial distress at the parent company (LTD) level.

First, the Company should be required to maintain an investment grade bond rating from at least two of the three major bond rating agencies (Standard & Poor's, Moody's and Fitch). If LTD Holding Company looses its investment grade bond rating (i.e., was rated "BB+" or below by at least two of the three major rating agencies), it should commit to restrict dividend payments to one third of net income in order that the Company's retained earnings and common equity ratio can be improved. That dividend restriction should stay in place until an investment grade bond rating with two of the three major rating agencies is restored.

Second, the Company should agree not to seek any rate increase in Washington for a period of five years for reasons related to the financial health of the parent company, LTD Holding Company, or alleged lack of access to the capital markets on reasonable terms.

Third, none of the assets of United Telephone of the Northwest should be used to secure any debt issued by LTD Holding Company. Neither should United Telephone of the Northwest participate in any inter-corporate money pool arrangement.

Fourth, if LTD should declare bankruptcy, the parent company and United Telephone of the Northwest should sign a definitive agreement with this Commission that would prohibit the payment of any dividends or cash transfers of any kind to LTD Holding Company during the time period in which the bankruptcy is pending.

While the conditions noted above will not prevent Washington ratepayers from being the ultimate "deep pocket" and facing rate increase requests if the LTD financial structure is not strong enough to withstand the difficulties pending in the wireline telephone industry, they will work to shore up LTD's financial strength in the event of the loss of an investment grade bond rating and retard any rate impact due to financial difficulties at the parent level by restricting the flow of cash from United Telephone of the Northwest to its parent company.

Q. Can you explain why a sound financial position is important for companies that have public service obligations, like local exchange telephone utilities?

A. Incumbent local exchange telephone service is a fundamental service that is integral to the manner in which our society operates and maintaining that service and the quality of that service is a primary goal of regulation. The provision of utility service such as local exchange and long-distance telephone operations is capital intensive in nature. That is, with respect to the revenues generated, the capital expenditures necessary to build or buy the equipment to provide telephone utility service is relatively high, compared to other types of firms. Due to that capital-intensive nature of utility operations, in concert with the objective of providing a necessary public service at the lowest cost, it is important to maintain the ability to access capital on reasonable terms in order to fund, on an on-going basis, the additional plant necessary to provide the services required by customers.

If a firm elects to carry too much financial risk (i.e., is capitalized with too much debt capital), even if it has a relatively stable revenue stream like a utility operation, that firm will have difficulty in raising the capital necessary to provide the service required by customers. Or, in the event that it is possible to raise capital, the cost of that capital would be significantly higher than it would be if the firm is capitalized with less debt. In that way, an undercapitalized firm (a firm with too little equity/too much debt capital) would not be operating in the public interest because a firm that is more appropriately capitalized would be able to provide the same service at a lower cost.

It has been my experience that regulated utility operations (and their regulators) strive to maintain bond ratings that are at least “investment grade.” While that standard is not met in every instance, it remains a reasonable goal. Investment grade bond ratings are those that are "BBB-" (Standard and Poor's) or "Baa3" (Moody's), or above.[7] Because some large investors (pension funds, insurance companies) are prohibited from investing in bonds that are below investment grade level, the market for lower-rated bonds is more restricted and the returns demanded by investors for those riskier bonds are substantially higher. For example, the current Reuters yield differential for BBB and BBB- utility bonds (the lowest bond rating differential in the investment grade category) for 5-year notes is 7 basis points. The yield differential for the same 5-year notes between "BBB-" (the lowest investment grade bond rating) and "BB+" (the highest below-investment-grade or "junk" rating) is 114 basis points.[8] Of course, that debt cost rate differential expands dramatically as the bond rating drops. Debt that is below investment grade is substantially more costly than debt that is rated at "BBB-"or higher. Therefore, it is important that a firm that offers regulated utility services that are essential like telephone service maintain a capital structure that will promote a sound financial position—one that is "investment grade."

Q. Is there evidence in the documents provided by the Company that it expects the cost of debt of LTD to be higher following the spin-off?

A. Yes. Exhibit No.___RGP-2 and Exhibit No.___RGP-3, attached to the Direct Testimony of Company witness Richard Pfiefer, show a total debt load for United Telephone of the Northwest of approximately $60 Million and an interest expense of approximately $3 Million. Those data imply a debt cost rate of 5.4%. At page 11 of Mr. Pfeifer's testimony he indicates that the cost rate of the new LTD Holding Company debt will be about *****%. Those data indicate the Company expects that its debt cost rate in the future will be substantially ********** than it has been in the past.

[7] The following bond ratings are all "investment grade": BBB-, BBB, BBB+, A-, A, A+, AA-, AA, AA+, AAA-, AAA, AAA+.

[8] http://www.bondsonline.com/asp/corp/spreadbank.html.

Q. What are the factors that influence the selection of a particular capital structure for a firm?

A. The manner in which a firm is most economically capitalized is a function of the volatility of the income stream generated by the assets of the firm or, in other words, the firm's operating (business) risk. For example, if a firm has an income stream that is not volatile and which can be predicted with near certainty, then a capital structure consisting of even 100% debt would not be problematic or risky. In fact, it would be the most cost-effective capital structure in that instance because debt is the least expensive form of investor-supplied capital for a firm and, without the possibility of operating income being insufficient to meet the debt service requirements, a 100% debt capital structure would be the prudent choice.

As the revenue stream of a firm becomes more volatile (more risky), financial theory holds that the amount of debt used should decline in order to avoid a default event (the failure to meet the required debt service costs). Although the reduction of lower-cost debt and the addition of higher-cost common equity will raise the firm's overall cost of capital, all else equal, that increase is appropriate and economically efficient because it more appropriately matches the firm's financial risk with the increase in business risk. In that way, given an increased level of business risk, the cost of capital is minimized and the financial health of the firm is better assured.

An example of how the amount of debt in the capital structure varies with the operational or business risk of a firm is found in a recent publication by Standard & Poor's regarding utility business risk. A June 2004 publication by Standard & Poor's, in which that bond rating agency re-aligned its business risk profile scores for utility companies, indicates that the companies with higher business risk are required to have a lower debt ratio (less debt, more equity) in order to earn the same bond rating as a firm with lower business risk.[9]

Also, The Value Line Investment Survey reports that for a composite of industrial firms the average common equity ratio in 2003 was 59.6% of total capital.[10] In contrast, the average common equity ratio for the large telephone companies reported in the October 2005 AUS Utility Reports is 43% of total capital. AUS also reports that the average common equity ratio of gas and electric firms ranges from 42% to 47% of total capital. Those data indicate that capital intensive firms that have some utility-type operations generally have more stable income streams than purely competitive firms and, therefore, are able to be capitalized most effectively with more debt and less equity than industrial firms.

In addition, the energy and telecommunications firms in the AUS Utility Report samples, with the common equity ratios cited above, have maintained investment-grade bond ratings, on average. As I noted above, bonds that are investment grade (i.e., rated above "BBB-" or "Baa3") are considered to have lower investment risk that non-investment grade debt. As such, those securities are more widely marketable and are far more cost-effective for the issuer.

Q. How does the newly-merged Sprint Nextel Corporations' capital structure compare to others in the telecom and energy industries?

A. The same October 2005 AUS Utility Reports cited above indicates that Sprint's common equity ratio, as a percentage of total capital is 47% on a book basis. Those data are as of June 30, 2004 prior to the closing of the merger. Sprint Nextel's September 30, 2005 S.E.C. Form 10-Q indicates that, with the addition of Nextel, the merged corporations

---

[9] Standard & Poor's Ratings Direct, New Business Profile Scores Assigned for U.S. Utility and Power Companies: Financial Guidelines Revised, June 2, 2004.

[10] The Value Line Investment Survey, *Selection & Opinion*, April 8, 2005, p. 1782. Value Line's Industrial Composite consists of 673 industrial, rail and transportation companies.

common equity ratio has improved to about 55% of total capital, with goodwill (the amount of the market price in excess of the book value of Nextel's assets) removed.

SPRINT NEXTEL CORPORATION

9/30/05 Capital Structure

	Amount (Mill.)	Percent of Total
Common Equity	$30,520	54.44%
Debt and Preferred	$25,545	45.56%
Total Capital	$56,065	100.00%

Data from S.E.C. Form 10-Q, September 30, 2005, p. 3.

Therefore, the newly-merged Sprint's capital structure is similar to but contains less debt and more equity than that of other regulated telecommunications and energy firms. Sprint has lower-than-average financial risk for that reason.

Q. According to the Sprint Report, how will LTD Holding Company be capitalized?

A. The Sprint Report is an analysis of the expected valuation of LTD Holding Company by the consulting firm of Houlihan, Lokey, Howard & Zulkin and is attached to the Direct Testimony of Company witness Glenn Daniel as Exhibit No.__(GRD-3C). All the material in that report is deemed "highly confidential." Mr. Daniel is a managing director at the firm that prepared the Sprint Report.

At page 17 of that report the analysts present their estimate of LTD Holding Company's initial balance sheet following the spin-off. At mid-year 2006, the anticipated time of the spin-off and following the issuance of $****Billion of additional debt, LTD is estimated to be capitalized with $**** Billion of debt and ********* Billion of common equity capital. The capital structure appearing on the books of the new company as it begins operations will consist of *********.

Company witness Pfeifer also presents an estimated capital structure for LTD Holding Company, although he assumes that the spin-off took place at year-end 2004.

His capital structure also shows ********************** for LTD following the separation. (Exhibit No. __RGP-6C).

Q. Mr. Pfiefer, at page 5 of his direct testimony, indicates that all of the accounting changes that arise from the separation will take place at the Holding Company (LTD) level and will not affect the books of United Telephone of the Northwest. So why are the capital structure estimates you cite of concern?

A. United Telephone of the Northwest does not issue securities—debt or equity. All debt and equity is issued at the parent company level. Also, the only way to invest in the local telephone operations of United Telephone of the Northwest is to buy a share of LTD Holding Company. Therefore it is LTD’s capital structure that will determine the cost of capital and impact the ability of the operating company to raise capital to meet its public service obligations. Capital structures, balance sheets and cash flow statements at the operating company (United Telephone of the Northwest) level are kept for regulatory purposes but do not represent the manner in which the parent company has actually capitalized the telephone operations it owns. Therefore, while the books of account at the local level may not change to any substantial degree as a result of the separation of LTD from Sprint, the financial risk of the entity that provides capital to the local company will change dramatically because the debt load supported by those assets will ************ ****. Not only will there be ******************, the cost rate of that additional debt will also ******** because of the ********************.

A. Portions of the Sprint Report indicate that the new LTD Holding Company will have an “equity cushion” of about **%. Why is that different from the projected book value of equity?

A. The difference in the reported common equity ratio is due to the difference between the projected market value and book value of equity. The “enterprise valuation” or market value of LTD Holding Company estimated by Houlihan Lokey in the Sprint Report is approximately $*****************************. That estimate is based primarily on the valuation of other local exchange telephone companies. The difference between the projected market value (enterprise value) of LTD ($**B) and the projected value of the debt used to finance the operation ($*B) is about $** Billion. That difference between the market value of LTD and its debt is termed an "equity cushion" in the Sprint Report, although it does not represent actual equity capital on the books of LTD. As I noted above, the books of LTD are expected to show that its operations are capitalized with an equity capital balance of *********** Billion.

While the difference between market value and the amount of debt assumed by a firm (the "equity cushion" noted above) would be important in the event of a default on debt payments and the eventual liquidation of assets in a bankruptcy, the goal in regulation is to facilitate solid, on-going local exchange telephone operations that are likely to avoid financial distress or bankruptcy. For that purpose, the financial risk indicated by the capital structure that appears on the books of the parent company and reported to the investment community is an important determining factor. The book value, then, does matter in regulation's attempt to balance the interests of ratepayers and investors.

In addition, Mr. Daniels claims at page 7 of his Direct Testimony that book value is not a relevant indicator of the fair value of the assets of LTD Holding Company. While that is certainly true in the task of estimating the market value of an on-going enterprise it is not the case in determining the on-going relative financial risk of a particular capitalization nor is it necessarily relevant in the task of setting reasonable rates based on the depreciated original cost (book value) of regulated telephone company assets.

Q. Both Messers, Pfeifer and Daniel claim that the projected capital structure of LTD Holding Company will provide for an investment grade bond rating. Do you agree?

A. The answer to that question is not clear at the present time. One bond rating agency, Standard & Poor's, has spoken publicly about the separation and indicates that LTD will, most probably, not have an investment grade rating.

> The CreditWatch implications on the debt of Sprint's local telephone division were revised to negative from developing. This action is based on industry-wide business-risk concerns about rising cable telephony and wireless competition that will make it difficult for this unit to obtain an investment grade rating as a standalone entity, regardless of the resulting capitalization.

(Standard & Poor's, Ratings Direct, Research Update: Sprint Corp Ratings Remain on CreditWatch Positive, With Those of Nextel, Pending Merger Close, August 4, 2005, Sprint Response to PC DR-8, Attachment 8.2. p.2).

While Standard & Poor's indicates that LTD's bond ratings may decline as a result of the separation, Sprint tends to discount that opinion because they assert S&P "has adopted a negative outlook" toward the local exchange industry (Sprint Response to Public Counsel's Data Request No. 8b). While that may be true, bond ratings, whether one agrees with the rating agency or not, have an impact on investors' perceptions of risk and the resultant yield that investors require for a given debt instrument.

Sprint sought private letter ratings assessments for LTD Holding Company from Fitch and Moody's. Fitch provided a bond rating estimate of "****", and Moody's provided an estimate of "****." Both estimates are the ************ investment grade rating and are *********************************** bond status. In its private letter assessment Moody's expressed concerns regarding ***************************** ** *******************************

> ***
> **
> ***
> **
> **
> ***
> ***
> **
> **
> **
> **
> **
> **
> **
> *****, Sprint Response to PC DR-8, Attachments 8.0, p. WA002960)

Moody's also notes that **
****
*************************** than the more urban local exchange operations owned by the former Bell companies. However, Moody's indicates that its projected bond rating could **
****
****
*************.

In sum, the highest bond rating that LTD can expect from the separation is the ****************** grade rating. That rating is contingent on having everything go as projected ***. However, things rarely occur as planned and if they do not, LTD could be in ********* ********************* bond rating. It is precisely because of that fact that I believe the separation of LTD from Sprint, as currently structured, is not in the public interest.

Q. The Sprint Report uses several small local exchange companies as "comparables" in estimating the separation valuation metrics for LTD Holding Company. Do those companies have investment grade bond ratings?

A. No. The Sprint Report looks at six comparable companies in order to determine operating, valuation and credit statistics that are appropriate for the new LTD Holding Company. They are: ** ** ***, has an investment grade bond rating and, according to the October 2005 edition of AUS Utility Reports (p. 15), that company had an actual, book value common equity ratio of 55% of total capital. The other companies in the sample group selected as “comparables” by Houlihan Lokey for the Sprint Report have bond ratings that are ********************************** ***. Also the Sprint Report indicates that ** *********. Therefore, while LTD will have some attributes that mitigate its operating risk compared to the selected “comparables” and has obtained private letter opinions from bond rating agencies that its debt ****************************, its valuation and credit statistics have been based on a group of companies that ****************** *************.

Q. The Sprint Report also refers to a recent buy-out of Verizon’s local exchange business in Hawaii by the Carlyle Group as a “case study.” Has that company maintained it’s bond rating?

A. No. The Sprint Report, Appendix B, cites **************as a “case study” of a leveraged buy-out of a local exchange telephone company (*************) by a private equity firm (****************). Prior to the buy-out last year, that company’s bond rating was “****” (the same as Sprint’s current rating). The most recent data available on Standard & Poor’s website is that the bond rating of Hawaiian Telecom now is “B+”, with negative implications—four bond rating levels below investment grade.[11]

[11] http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/Page/FixedIncomeBrowsePg&r=1&l=EN&b=2&s=19&f=1.

Q. Does the Company make any representations in its filing or testimony regarding an improvement in its financial position in the future?

A. Although the Company witnesses do not discuss improvement in the book value common equity ratio because they maintain it is unimportant, they do present information regarding the expected book value of common equity in the future. The Sprint Report (p. 73) indicates that under its assumed "base case"(******************************* *******************), LTD's *******common equity position improves by 2010, *** ***************************. In the "downside" case, the Company's balance sheet **************** and, by 2010, the amount of common equity on the books ******* ************* Billion. The "downside" case assumes revenue ***************** % annually. In sum, returning LTD Holding Company to a ****** common equity position does not appear on the projection horizon assumed in the analysis and documents provided by the Company in this proceeding.

Q. Are there other concerns associated with a highly leveraged capital structure other than the additional cost of debt if the bond ratings fall below investment grade?

A. Yes. Access to capital (both equity and debt capital) can be restricted by a highly leveraged capital structure. Debt investors would be unwilling to lend additional monies to a firm that was barely able to cover its current debt costs. If additional debt were available it would have to carry a very high yield to entice conservative yield-oriented investors to commit additional capital. Moreover, because equity is junior to debt in legal claim to the assets of a firm in case of bankruptcy, common equity holders would be even more reluctant to commit additional funds to the enterprise. If the access to capital is constrained, the ability of the company to meet its infrastructure construction needs or provide sufficient staffing levels for service personnel may be diminished and, with it, a decline in service quality could occur. Therefore, a heavily-leveraged capitalization doesn't have to result in a catastrophic event like bankruptcy to be detrimental to the public interest. A firm with a limited access to capital due to a heavy debt load could see a decline in service quality which would also have a negative impact on public interest as a direct result of financing with too much debt capital.

Q. Have there been service quality problems with some of the companies included in the "comparable" local exchange companies in the sprint report?

A. Yes. One of the companies used in the Sprint Report as comparable to LTD is ***** **************, originally a private equity firm that purchased Verizon's rural local exchange operations in *****. Following the purchase of Verizon's rural ***** exchanges, the company began to experience service quality problems. In a November 28, 2001 Open Meeting Summary Report (Project No 23686) regarding telephone company service quality, the ************************ reported that, with regard to ten service quality standards imposed by that commission, *********************** had not met the standard in eight out of ten of those categories.

******* service quality problems persisted to the point where, on March 7, 2003 the ***** PUC initiated Project No. 27474, an official investigation into the service quality of ************. On July 18, the ***** PUC Staff filed an investigation report that concluded: "The customer service complaints voiced at the public meeting and the results of the recent telephone survey of ***** customers indicate there are many areas of opportunity for ***** to concentrate on for improvement. Quality of service and customer service issues continues to be a significant portion of the complaints filed with the PUC by ***** customers." (***** PUC Staff Investigation Report On Service Related Issues of *************, Docket No. 27474, p. 28) Ultimately, Valor entered into a stipulated settlement with the ***** PUC in which the company agreed to certain specified infrastructure upgrades (***** PUC Docket No. 29567, pp. 3, 4).

******** made a commitment in ******* to shore up its telephone plant to meet service quality requirements, and due to that company's high debt load, it elected to undertake a public issuance of common stock. Prior to issuing that stock, ********* filed with the Securities and Exchange Commission, a Form S-1 registration statement in which the company announced its intent to issue stock, and in that SEC report, ********* advised potential investors of the following risks:

> Risks Relating to Our Common Stock and Our New Credit Facility
>
> - You may not receive any dividends.
> - Our dividend policy may limit our ability to pursue growth opportunities.
> - Our substantial indebtedness could restrict our ability to pay dividends and impact our financing options and liquidity position.
> - We are subject to restrictive debt covenants that impose operating and financial restrictions on our operations and could limit our ability to grow our business.
> - If we fail to comply with the restrictive covenants in our new credit facility, our senior lenders may accelerate the payment of indebtedness outstanding under our new credit facility.
> - We are a holding company with no operations, and unless we receive dividends and other payments or distributions, advances and transfers of funds from our subsidiaries, we will be unable to meet out debt service and other obligations.
> - If you purchase shares of our stock, you will experience immediate and substantial dilution.
> - Our interest expense may increase significantly and could cause our net income and distributable cash to decline significantly.
> - Before this offering there was no public market for our common stock. This may cause volatility in the trading price of the common stock, which could negatively affect the value of your investment.
> - Future sales or the possibility of future sales of a substantial amount of our common stock may

> depress the price of the shares of our common stock.
>
> - Limitations on the use of our net operating losses may negatively affect our ability to pay dividends to you.
>
> **********************************, S.E.C. Form S-1/A, February 3, 2005, pp. 11-14; Note: the bullet points provided are headings, the details under each heading have been omitted.)

Q. Have there been instances where the "comparable" companies have had to request rate increases to shore up a weak financial position?

A. Yes. Another telephone company cited by the Sprint Report as a company comparable to LTD Holding Company, ************, provides a cautionary tale. Following the purchase of 295 GTE exchanges in ****************** found that its financial projections were not met, faced a near-bankruptcy situation, and turned to its ratepayers with a rate increase request as high as 112% in some exchanges (****************** Docket No. RPU-02-4).

In April 2000, the ****************** approved the purchase of 295 GTE rural local telephone exchanges by **************************** (ITS), a firm owned by a private investor group (**). The rationale offered for approving the transaction in that proceeding echoed many of the same reasons offered by Sprint for the transfer of its local exchange assets in the instant proceeding. The ********** noted that, following the purchase, ITS would be a local company with a rural focus and would hire up to 100 new employees (Order in Docket No. SPU-99-20, p. 13). The Board also noted that if it were:

> Only looking at the initial financial position of ITS, there would be a serious question whether ITS will be able to attract capital on reasonable terms if additional capital is required in the near future. However, the Board will also consider ITS's financial projections, which indicate ITS is unlikely to need additional capital in the near future and that ITS's capital structure will improve each year.

(Order in Docket No., SPU-99-29, p. 7)

However, ************ did not achieve its revenue projections and, unable to raise additional funds from the capital markets and (apparently) unable to obtain additional monies from private equity investors, the Company turned to ratepayers for the funds necessary to stabilize operations. In ******************* Docket No. RPU-02-4, ************ requested rate increases ranging from 14.6% to 112.4%. In requesting higher rates, ************ provided the following reasons for the differences between their financial forecasts and their actual experience:

- ************ lost a substantial number of access lines in its 33 competitive exchanges (loss of market share exceeded 80% in some exchanges).
- The general economic downturn caused a decrease in access lines.
- Wireless providers have acquired landline customers.
- Higher than anticipated costs for personnel and operations support resulted from problems encountered with the migration of GTE data into ************ applications and systems.
- Higher than anticipated calls to its customer contact centers required an additional 70 employees. (******************* Order in Docket No. RPU-02-4, p. 10)

The **** Board noted that ************ had indicated that additional equity funds from investors would be available if its financial forecasts turned out to be inaccurate. However, even though ************ representatives had indicated that in the event of financial shortfall, one option "would be for the equity investors to provide additional capital or find a third party to put in additional capital." the **** Board stated, "the Company [************] has offered no evidence that it even <u>sought</u> additional common equity financing."(**************** Order in Docket No. RPU-02-4, p. 10).

The **** Board ultimately determined that "************ is attempting, with this [rate increase] proposal, to shift the burden of its financial problems from its investors to its customers," and denied its rate increase request (******************** Order in Docket No. RPU-02-4, p. 20). In sum, that company's financial projections were not realized for many reasons, but its heavy leverage prohibited capital market access, the equity investors were not willing to provide the additional monies necessary to support its finances and ************ turned to its ratepayers for those funds.

Q. Mr. Hill, aren't there differences between Iowa Telecom, Valor, Hawaiian Tel and LTD Holdings Company that bode well for the latter?

A. While there are certainly differences between the smaller companies like ************ and the proposed LTD Holding Company (e.g., the former is smaller and privately-held and LTD will be a larger, geographically diversified publicly-held company), and those differences point to somewhat lower operating risk for LTD, the spin-off of LTD is modeled on firms like ************ as well as other below-investment grade local exchange companies like *****. Even the best projections are unlikely to exactly mirror future events, as evidenced by the actual results of ************************* ************. The operational dangers inherent in the inability to forecast the future is exacerbated when the financial position of the firm is strained to begin with. The higher the financial risk, the more constricted and expensive the supply of capital and the greater the eventuality that the utility will turn to ratepayers for higher rates—not for increased operating costs but for increased capital costs brought on by *****************. When there is no other place to turn for capital to operate the business, the utility must turn to its ratepayers for those monies. That is the essence of my concern with Sprint Nextel's request to have this Commission approve the creation of a heavily-levered entity that owns United Tel's local exchange operations in Washington and why I believe it is not in the public interest to do so.

Q. What is your recommendation to the Commission in this proceeding?

A. I recommend that the Commission reject the approval of the transfer of United Telephone of the Northwest assets from Sprint to LTD Holding Company as it is currently structured. The transfer, as it is currently structured, creates an entity that has too much financial risk to ensure the continued long-term provision of quality telephone utility service in United Telephone's Washington service territories.

Q. Your review of the proposed transfer is limited to financial considerations, correct?

A. Yes.

Q. If the Commission, for reasons other than financial, finds that approval of the transfer is ultimately in the public interest, are there conditions that you would recommend be included in any such approval?

A. Yes. My concern with the pending transfer of United Telephone assets from Sprint to LTD Holding Company is that the new holding company will have a ************* financial structure. The conditions I recommend will help to provide incentive for LTD management to maintain an investment-grade bond rating and, in the event of extreme financial difficulty at the parent level, prevent the parent company from extracting financial support from the local exchange operations. In order for the Washington Utilities and Transportation Commission to approve the transfer of assets as requested by Sprint in this proceeding the following conditions should apply:

- LTD Holding Company should maintain at least a minimum-level investment grade bond rating ("BBB-" or "Baa3") from two of the three major bond rating agencies. If that bond rating is not maintained (i.e., if LTD has a below-investment-grade bond rating from two of the three major bond rating agencies), it agrees to limit dividend payout to one-third of net income. Retaining more of the parent company's income, rather than paying it out to investors as dividends, will help to restore the Company's common equity balances, reduce leverage, and shore up its financial position. This dividend restriction should remain in place until the parent company's bond rating is restored to investment-grade.

- LTD Holding Company will, in the event of Commission approval of the transfer of control, not to seek any rate increase in Washington for reasons related to the financial health of the parent company (LTD Holding Company) or to lack of access to the capital markets. Public Counsel has identified its concerns with the financial position of the to-be-formed holding company, LTD, and out concern is that the weak financial position of LTD could harm ratepayers. Therefore, if the transfer of control is approved, Public Counsel recommends that the Company agree to a five-year stay-out provision for parent company financial-distress-related rate increases.
- While it is not normal procedure for telephone companies to issue mortgage debt, in the event of Commission approval of the requested control transfer, LTD should agree not to pledge the assets of United Telephone of the Northwest to secure any borrowing undertaken at the parent company level.
- United Telephone of the Northwest should not be allowed to participate in any inter-corporate short-term money pool arrangement. Such arrangements effectively allow cash-rich regulated operations like United Telephone of the Northwest to subsidize any unregulated operations also held by the parent company through money-pool lending. The United Telephone operations comprise a substantial portion of LTD Holding Company operations and any cost rate advantage gained through the use of an LTD money-pool credit arrangement versus short-term debt or commercial paper issued directly by United Telephone would be minimal.

- In the event of a bankruptcy filing by LTD Holding Company, both the parent company and United Telephone of the Northwest should sign a definitive agreement with this Commission that prohibits the payment of any dividends or cash transfers of any kind to LTD Holding Company from United Telephone of the Northwest during the period when the bankruptcy is pending. A definitive agreement (e.g., a separate signed document) between the companies and the Commission which would come into force in the event of bankruptcy would provide stronger support for the cessation of dividends than would an order by the Commission or a compliance promise by United Telephone.

Q. Will the conditions recommended by Public Counsel preclude the possibility that ratepayers could be negatively affected by the requested transfer of control?

A. No. The ultimate source of funds for a utility is its ratepayers. No matter what regulatory restrictions are in place, if utility firms are unable to raise capital—for whatever reason—the only place to which they can turn for additional monies is to raising rates for their customers. If those customers continue to require that particular utility service, they will have to pay higher rates to get it.

Those negative financial conditions can happen for many reasons that are beyond the control of any company or any regulatory body. They can happen to a company that is well capitalized and one that is weakly capitalized, depending on the severity of the negative financial events. One can say with certainty, however, that a negative financial event severe enough to prevent access to capital markets and require rate increases is more likely to happen to a utility operation that is weakly capitalized, i.e., one that has too much debt and too little equity capital.

In the opinion of Public Counsel, the creation of LTD Holding Company with ************ common equity balances on its books is not in the public interest and makes more likely the possibility that a negative financial event could unnecessarily impact and harm UTNW telephone ratepayers in Washington. While the conditions recommended above to support the finances of the local exchange operations will not prevent that occurrence, it will make less likely the event that UTNW ratepayers in Washington will see their bills increase because of the financial status of LTD Holding Company.

Q. Does this conclude your direct testimony, Mr. Hill?

A. Yes, it does.