BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

SPRINT-NEXTEL MERGER

DOCKET NO. UT-051291

DIRECT TESTIMONY OF MICHAEL L. BROSCH (MLB-1THC)

ON BEHALF OF

PUBLIC COUNSEL

REDACTED VERSION

November 30, 2005

DIRECT TESTIMONY OF MICHAEL L. BROSCH (MLB-1THC)

TABLE OF CONTENTS

BROSCH EXHIBIT LIST

Exhibit No. ___ (MLB-2)	Summary of Qualifications of Michael L. Brosch
Exhibit No. ___ (MLB-3)	R. H. Donnelley, SEC Form 10-K
Exhibit No. ___ (MLB-4)	Dex Media, Inc., SEC Form S-4
Exhibit No. ___ (MLB-5HC)	Sprint Publishing & Advertising Gain on Sale Allocation to Washington

I. INTRODUCTION AND QUALIFICATIONS

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 Northwest Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. By who are you employed?

A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in utility rate and regulation work. The firm's business and my responsibilities are related to special services work for utility regulatory clients. These services include rate case reviews, cost of service analyses, jurisdictional and class cost allocations, financial studies, rate design analyses, utility reorganization reviews and focused investigations related to utility operations and ratemaking issues.

Q. On whose behalf are you appearing in this proceeding?

A. I am appearing on behalf of the Washington Attorney General's Office, Public Counsel Section ("Public Counsel"). Utilitech entered into a contract with Public Counsel to review and respond to certain issues raised by the Application of Sprint Nextel Corporation ("Sprint") to transfer control of United Telephone Company of the Northwest ("UTNW") and Sprint Long Distance, Inc.

Q. Will you summarize your educational background and professional experience in the field of utility regulation?

A. Exhibit No. ___ MLB-2 is a summary of my education and professional qualifications. I have testified before utility regulatory agencies in Arizona, Arkansas, California, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, New Mexico, Ohio, Oklahoma, Utah, Washington and Wisconsin in regulatory proceedings involving electric, gas, telephone, water, sewer, transit, and steam utilities. Exhibit No. ___ MLB-2 also contains a listing of the testimony I have submitted since 1981.

Q. Have you previously participated in telecommunications regulatory proceedings?

A. Yes. I have participated in Sprint (then United Telephone Company) rate cases in Florida, Indiana, Kansas and Missouri on several prior occasions. In those cases, I addressed Sprint's affiliated interest arrangements and directory imputation issues, as well as other ratemaking accounting issues.

With respect to Verizon, I have participated in rate cases, earnings reviews, alternative regulation proceedings and merger/acquisition proceedings in California, Hawaii, Indiana, Oklahoma and the most recent rate case in Washington.[1]

With regard to Qwest, my firm has represented various clients in a number of prior Qwest/US West Communications ("USWC") proceedings in several states, including Arizona, New Mexico, Utah and Washington. In Washington, I assisted the Washington Attorney General's Office, Public Counsel Section, in negotiation and subsequent review of this State's first Alternative Form of Regulation (AFOR) plan.[2] I was also a witness in the two subsequent Washington general rate cases involving USWC, the 1998 Dex proceeding dealing exclusively with directory imputation issues and the 2003 proceeding involving the sale of Dex.[3] In Arizona, Utilitech has assisted the Commission Staff in a

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[1] *WUTC v. Verizon*, Order No. 15; Order Approving and Adopting Proposed Settlement; Rejecting Filed Rates; Accepting Proposed Rates, Docket Nos. UT-040788 and UT-040520 (April 12, 2005).

[2] *WUTC v. Pacific Northwest Bell Telephone Company d/b/a US West Communications,* Twenty-First Supplemental Order Distributing Undisputed 1992 Excess Revenues Under the Alternative Form of Regulation, Docket No. U-89-2698-F and U-89-3245-P (November 15, 1993).

[3] *WUTC v. US West Communications, Inc.*, Fifteenth Supplemental Order; Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling. Docket No. UT-950200; *WUTC v. US West Communications, Inc., Tenth Supplemental Order Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling;* Docket

total of five revenue requirement proceedings, including the pending review of the Qwest Price Cap Plan in that state, as well as the recent Dex sale proceeding in that state.[4] In New Mexico, I served as a witness for the Commission Staff in the most recent USWC rate case.[5] In Utah, I served as witness for the Utah Committee of Consumer Services in USWC's last general rate case, Docket No. 97-049-08 and sponsored the directory imputation amount approved by the Commission in that Docket. I also assisted the Utah Committee in analysis of the Dex sale and negotiation of the Dex settlement approved in Utah. I also represented consumer advocate clients in Washington and two other states (Iowa and Utah) in the regulatory proceedings associated with the acquisition of USWC by Qwest.[6]

I have also been involved in numerous regulatory proceedings involving BellSouth and SBC local exchange operating companies in several states, as described in Exhibit No. ____MLB-2.

Q. What is the purpose of your testimony in this Docket?

A. My testimony is intended to explain, on behalf of Public Counsel, several issues arising from the proposed transfer of control that is described in the Application. My testimony explains the need for and basis of a directory imputation adjustment to account for Sprint's

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No. UT-970766; *In Re the Petition of US West Communications, Inc., for an Accounting Order*, Fourteenth Supplemental Order; Order Denying Petition, Docket No. UT-980948; and *In the Matter of the Application of Qwest Corporation Regarding the Sale and Transfer of Qwest Dex to Dex Holdings, LLC, a non*-affiliate, Tenth Supplemental Order: Approving And Adopting Settlement Agreement; Granting Application And Accepting Notice, Subject To Conditions, Docket No. UT-021120 (August 1, 2003) ("Dex Sale Order").

[4] Docket Nos. E-1051-88-146, E-1051-91-004, E-1051-93-183, E-1051B-99-105 and E-1051B-03-0454.

[5] PRC Case No. 3008.

[6] Utah Docket No. 99-049-41, Iowa Case No. SPU-99-27, Washington Docket No. UT-991358.

sale of its directory publishing subsidiary that resulted in a large gain on sale in 2003. In addition, I address certain other anticipated near term costs and risks associated with the proposed transfer of control that require regulatory attention. My testimony is complementary to that of Public Counsel witness Mr. Stephen G. Hill, who sponsors testimony on capital structure cost and risk issues arising from the Application.

Q. What information did you review in preparing your testimony in this Docket?

A. I reviewed Sprint Nextel's Application and the supporting Direct Testimony and Exhibits of witnesses Nancy L. Judy, John W. Mayo, Richard G. Pfeifer and Glenn R. Daniel as well as supporting workpapers prepared by these witnesses. I also reviewed Applicant's responses to data requests submitted by Commission Staff and by Public Counsel as well as certain publicly available information regarding past Commission treatment of directory publishing transactions and financial data associated with Qwest Communications, Dex Media, R.H. Donnelley and Sprint Nextel Corporation. I also participated in several conference calls between Sprint representatives, Public Counsel and Commission Staff where issues raised in this Docket were discussed.

II. EXECUTIVE SUMMARY OF TESTIMONY

Q. What is proposed by Applicants in this Docket and how is UTNW expected to be affected?

A. Sprint Nextel Corporation is proposing to separate the Local Telecommunications Division ("LTD") segment of its business and distribute the equity ownership of LTD to its shareholders in a tax free distribution. After the separation, UTNW would remain as part of LTD Holding Company, a new publicly traded company that would have its headquarters in Overland Park, Kansas. Existing UTNW assets and employees presently dedicated to UTNW would not be affected by the proposal, but the multiple shared automated systems, administrative and management personnel and shared assets would require systematic study and careful dis-integration so that LTD ultimately is entirely self-sufficient. This back-office separation involves the splitting of Sprint United Management Company ("SUMC") into separate administrative support companies for LTD and for Sprint Nextel. After the proposed spin-off, LTD Holdings would initially be capitalized with significant newly issued debt financing in an amount producing negative equity on a book basis.[7]

Sprint Nextel's existing wireless and long distance network assets would continue to use existing brands and trade names/marks, while the post-separation LTD entity would require re-branding, with new trade names and marks to be determined. To enable the LTD operating companies an opportunity to market a more complete bundle of telecommunications products, the surviving Sprint Nextel entity intends to provide wholesale wireless and long distance network services to LTD pursuant to contracts that include most favored nations clauses. Existing wireless customers in UTNW service areas would remain Sprint Nextel customers, while existing Sprint Communications long distance customers would generally be migrated into an LTD long distance affiliate to be served under the Sprint Nextel wholesale contract arrangement.

The proposed separation is designed to be largely transparent to local UTNW business operations and UTNW customers. The network facilities and local employees most directly contacting customers will not change. Aside from the re-branding of services, the principal changes are behind the scenes, involving how the business is

[7] See Highly Confidential Exhibit __(RGP-7C) of Sprint witness Mr. Richard G. Pfeiffer and the testimony of Public Counsel witness Stephen G. Hill for more information regarding this issue.

capitalized and how administrative, back-office functions are performed. Sprint Nextel claims in the Application that UTNW and its customers should benefit by eliminating conflicts that arise today within Sprint Nextel, allowing a renewed focus solely upon localized ILEC business interests.[8] Applicants also state that the appropriate standard of Commission review is simply a showing of "no detriment" from the proposed transfer of control of LTD, suggesting that the transparent nature of most of the proposed changes satisfies such a required showing.[9]

Q. Please summarize the recommendations that are set forth in your testimony.

A. I recommend that the Commission not accept the proposed transfer of control, because of Sprint's failure to demonstrate that the transfer is in the public interest. The only claimed benefits associated with the proposal relate to an improved philosophical orientation toward a stronger local emphasis and clarity of focus upon the wireline business, in contrast to Sprint Nextel's increasingly divergent, wireless-centric focus.[10] However, information contained in the filing and provided in response to discovery indicates increased costs and risks to UTNW will result from the transfer of control proposal, including the loss of UTNW directory imputation credits, higher UTNW operating expenses because of negative synergies associated with separating Sprint United Management Company ("SUMC"), incurrence of transaction, rebranding and transition costs that may be attributed to UTWN and a heavily debt-levered capitalization planned for

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8 See Application, Section VI. and the testimony of Ms. Nancy Judy, pp. 14-18 and Mr. John Mayo, pp. 7-10.

9 Application at ¶ 13 and ¶¶ 36-42.

10 This local emphasis and focus issue is developed at Application Section VI. The Establishment of Sprint's Wireline Local Service Operations as an Independent Business is Consistent With the Public Interest. At page 13 of the Application, Sprint states, "The standard for approval of the proposed transaction is whether it is consistent with the public interest. The transaction need not specifically benefit the public, but must simply cause no harm."

the new LTD Holding Company that would own and control UTNW. Given the abstract and uncertain nature of the claimed benefits, compared to the potential for far more tangible negative outcomes, the proposed transfer of control should be rejected unless enforceable regulatory conditions can be developed to overcome the increased costs and risks described in Public Counsel's testimony.

Q. What is the nature of the directory publishing issue in this Docket?

A. One major cost detriment to be addressed in this Docket is that Sprint has failed to provide for any replacement of the significant directory publishing revenue imputation that is necessary to accurately quantify the net cost of service incurred by UTNW in Washington. Sprint sold LTD's interest in directory publishing operations in 2003, by divesting the Sprint Publishing & Advertising, Inc. and Cendon, L.L.C. subsidiaries to R.H. Donnelley Corporation ("RHD") and concurrently obligated UTNW and the other Sprint local operating companies to long-term exclusive directory publishing contracts and non-competition agreements with RHD. In its Application in this Docket, Sprint makes no provision to transfer any of the monetized gain on sale proceeds it captured in 2003 that are associated with local telephone directory publishing rights for the benefit of UTNW or the other local telephone division operations. It is therefore necessary in any approval of the transfer of control to provide for future imputation of a reasonable amount of directory benefits, based upon the Washington share of the value of the gain that was realized by Sprint. This recommendation is based upon the Commission's longstanding recognition of regulatory asset status of directory publishing, the many linkages between the incumbent local exchange carrier ("ILEC") business and directory publishing business that create value for the publisher and the need to provide equitable ratepayer participation in the gain on sale to RHD. This recommendation is also consistent with prior WUTC decisions involving ILEC ratemaking as well as disposition of Qwest's directory publishing regulatory assets. I will discuss prior WUTC and Washington court decisions regarding directory publishing issues later in my testimony. Without a directory imputation commitment, the Application is not consistent with the public interest and should not be approved.

Q. What are the administrative cost impacts that cause the proposed transfer of control to be contrary to the public interest?

A. My testimony describes incremental UTNW administrative costs and risks associated with the proposed transfer of control. Sprint estimates that separation of the existing Sprint United Management Company into separate administrative support entities for LTD and the Sprint Nextel business segments will result in dis-synergies that will increase future revenue requirement.[11] In addition, Sprint is incurring transaction and transition costs to implement the proposed change in control that may be chargeable in part to UTNW operations. Finally, significant new costs will be incurred by LTD Holdings to establish and promote a new brand and corporate identity. These cost increases cause the proposal to be inconsistent with the public interest and will increase future UTNW revenue requirements, as explained more fully in my testimony.

Q. Are there capital structure and financial condition concerns that contribute to the public interest assessment of Sprint Nextel's Application?

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[11] Sprint acknowledged and estimated the amount of anticipated dissynergies in its highly confidential response to Public Counsel Data Request No. 7, Attachment PC 7g. At page 6 of his prefiled testimony, Sprint witness Mr. Pfeiffer also acknowledges that operating expenses may increase as a result of transition from the former management company affiliate to new arrangements for separate management services for LTD.

A. Yes. Public Counsel witness Stephen G. Hill addresses the added costs and risks associated with the planned changes to the capitalization of UTNW and explain why such changes are contrary to the public interest. If Sprint's proposed capitalization plans for the UTNW and the other wireline operating companies has the effect of reducing their access to capital on reasonable terms, there may be financial pressures upon UTNW that contribute to reductions in service quality, as explained more fully in my testimony and Mr. Hill's testimony.

Q. How is the balance of your testimony organized?

A. My testimony is arranged by major topical area. A Table of Contents appearing at the beginning of the testimony sets forth this organization.

III. SPRINT / UTNW DIRECTORY PUBLISHING OVERVIEW

Q. How are United Telephone Company of the Northwest's official white and yellow pages telephone directories published in the UTNW service territory in Washington?

A. Since early 2003, when R. H. Donnelley Corporation purchased Sprint's directory publishing business for approximately $2.2 billion in cash, the UTNW official telephone directories have been published under an exclusive publishing contract arrangement with RHD. As part of the sale of Sprint's directory publishing business, RHD was granted a 50 year exclusive license to publish all of Sprint's Local Telecommunications Division ("LTD") directories, using certain Sprint licensed trademarks to ensure that consumers continue to recognize such directories as the official publication of the LTD companies including UTNW.[12] To ensure that Sprint entities such as LTD or UTNW did not reenter

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[12] Attachment Staff 10.5 within Sprint's response to Staff Data Request No. 10 is the Directory Services License Agreement, which was Exhibit 5.10 to the Stock Purchase Agreement by and between Sprint Corporation, Centel Directories LLC and R. H Donnelley Corporation as of September 21, 2002. Section 2.1 of the Directory

the directory publishing business in competition with RHD, a Non-Competition Agreement was also made part of the directory business sale to RHD for a 50 year term concurrent with the publishing agreement term.[13] Through these arrangements, Sprint Corporation was able to monetize the considerable income stream associated with advertising sales in the incumbent LTD white and yellow pages throughout all of Sprint's local exchange areas for the next 50 years. Sprint realized a large gain on sale from this transaction, but none of this gain was recorded on UTNW's books as a regulatory liability to its customers.

Q. Has the Commission previously considered regulatory treatment of the gain on sale associated with ILEC directory publishing affiliate assets and ILEC publishing rights?

A. Yes. In August of 2003, the Commission approved the sale of Qwest's directory publishing business and associated long-term publishing rights to a consortium of private equity investors, subject to a regulatory commitments set forth in a Stipulation and Settlement Agreement that required the attribution of most of the Washington share of the realized gain to Qwest Corporation ratepayers via ongoing revenue imputation credits and an immediate bill credit upon closing.[14] I served as consultant to Public Counsel and other parties in that Docket and am familiar with the resolution of issues arising from the Qwest Dex sale transaction.

Services License Agreement provides for the License to Publish, while Articles 6, 7 and 8 address trademark provisions, branding and term/termination, respectively.

[13] Attachment Staff 10.7 is the <u>Non-Competition Agreement</u>, which was Exhibit 5.16 to the <u>Stock Purchase Agreement</u>.

14 See *Dex Sale Order*.

Q. Should the gain on sale that was realized by Sprint Corporation from the sale of its directory publishing business be treated in a manner similar to the Qwest Dex sale?

A. Yes. The facts and regulatory history surrounding Sprint/UTNW directory publishing are comparable to the facts and regulatory history for Qwest/U S West directory publishing. Directory publishing rights arising from ILEC operations represent a regulatory asset for all of the reasons that I describe in the next section of this testimony. When this regulatory asset is sold or transferred to a third party buyer, the gain on such sale should be attributed to ILEC customers, rather than shareholders.

Q. Has Sprint previously sought or received Washington Commission approval for its sale of the directory publishing business?

A. No. To my knowledge there has been no Application or Docketed WUTC review of the Sprint directory sale transaction.[15]

Q. Has the Commission historically attributed the benefits from directory publishing to ratepayers?

A. Yes. In determining the Washington intrastate revenue requirement for UTNW, the Commission has imputed all of the excess profits earned from directory publishing for the benefit of ratepayers. The most recent UTNW rate proceeding dates back to Docket No. U-89-3067-S1, a rate case that was initiated by the Commission in 1989. In that Docket, United did not file testimony or exhibits, but a calculation of directory revenue was

[15] In Public Counsel Data Request No. PC-34, Sprint was asked for copies of all information that UTNW submitted to the WUTC Commission Staff in connection with the sale of Sprint Publishing & Advertising to R.H. Donnelley in 2002. The response included an objection and reference to Staff Data Request No. 10, which contained only a copy of the Stock Purchase Agreement and related Attachments, with no Application or Testimony seeking approval of same.

stipulated in a total annual amount of *******.[16] Since that time, the directory publishing agreement with UTNW's affiliated publishing company has been replaced by the previously mentioned Publishing License Agreement with RHD that provides no compensation for RHD's use of ongoing official publishing status and on behalf of UTNW. Sprint no longer earns directory publishing profits that can serve as the basis for directory revenue imputation in future UTNW rate proceedings because Sprint sold the entire business and related publishing rights to RHD so as to monetize the directory income opportunity as a lump sum gain on sale.

Q. Does the Application in the instant Docket address directory publishing for the LTD operation upon approval of the proposed spin-off of LTD?

A. No. The Application is silent with respect to directory publishing. In fact, in responding to Staff and Public Counsel discovery regarding directory publishing issues, the Applicant stated, "Sprint objects to this request on the grounds that it seeks discovery of information that is beyond the scope of Sprint's Application and is not relevant to this proceeding."[17] A serious negative impact upon LTD operations is assured by Sprint's 2003 sale of the directory publishing business, the corresponding long term licensing of LTD and UTNW's official publisher status to the buyer with no prospective compensation to LTD/UTNW for such licensing, and this proposed transfer of control that would permanently separate the value of the directory publishing business (Sprint's sale proceeds) from the origin of such value. The combined impact of Sprint's sale of directory publishing to RHD in 2003 and this proposed separation of LTD in 2006 would cause the proceeds from the sale and lump

16 Sprint Responses to Public Counsel Data Request 33 and WUTC Staff Data Request No. 12.

17 See, for example, Sprint's responses to Public Counsel Data Request No. 33 and Staff Data Request No. 12.

sum monetization of the directory publishing income stream to become permanently separated from any affiliation with UTNW.

Q. Why is the regulatory disposition of directory publishing relevant to the proposed transfer of control of UTNW and the other Sprint LTD businesses in this Docket?

A. Prior to completion of the proposed transfer of control, Sprint Nextel is the parent company that realized the proceeds from the sale of the directory publishing business and the related publishing rights to RHD. In future rate case proceedings under the existing ownership arrangement, a directory imputation adjustment could be considered by the Commission with knowledge that UTNW's parent received the monetized gain on sale proceeds as offsetting compensation for any reduced UTNW earnings and cash flows arising from imputation. However, after the proposed transfer of control, there would no longer be any affiliate relationship between Sprint Nextel Corporation and UTNW. The parent of UTNW will have been permanently separated from the directory sale gain proceeds and will have no offsetting compensation or assets on its books to support directory imputation regulatory adjustments. What is proposed by Applicants in this Docket is a permanent prospective separation of Sprint's ILEC business segment from the directory publishing gain benefits that were captured and retained by Sprint.

Q. If Sprint Nextel Corporation's proposed transfer of control over UTNW and its other LTD businesses is approved, over the objections of Public Counsel, what should be done to address the changes to directory publishing arrangement that impact UTNW and its ratepayers?

A. The gain realized by Sprint when it sold the directory publishing business and the related LTD publishing rights must be fully accounted for in formulating a regulatory condition to any transfer of control. Otherwise, the separated LTD businesses including UTNW would be left without any value for their official directory publishing rights that have been transferred through the year 2052, after being monetized by Sprint in 2003. I have calculated an appropriate long-term directory revenue imputation commitment that should become a regulatory commitment in Washington as a condition to any approval by the WUTC of the proposed transfer of control. This calculation is set forth in Exhibit No. ___MLB-5HC and is explained in a subsequent section of this testimony.

Q. In absence of any long-term regulatory commitment for directory revenue imputation in the amounts your recommend, is the proposed transfer of control consistent with the public interest?

A. No. UTNW ratepayers would be subject to much higher future revenue requirements in rate case proceedings unless there is a secure provision made to replace directory imputation amounts previously recognized by the Commission. The loss of directory imputation represents a very material net detriment arising from the proposed transfer of control – a transfer that seeks to permanently separate Sprint Nextel and its gain on sale of the directory business and publishing rights from UTNW and the other LTD businesses that hold a regulatory asset claim upon such publishing rights.

IV. DIRECTORY PUBLISHING IS A REGULATORY ASSET

Q. Is the directory publishing business integrally related to the local exchange telephone business?

A. Yes. Directory publishing is a profitable by-product income stream that is realized by each of the major incumbent telephone companies -- either by selling advertising in directories or by sale of the entire directory publishing business and related official publishing rights to third parties.[18] Directory publishing was developed by telephone companies to add value to their public telephone networks, by providing printed subscriber listing information in alphabetical and classified formats. The printed telephone directory has evolved to include significant commercial advertising, particularly within the classified directories where consumers seek information about desired products and services at the time they are prepared to make purchasing decisions. Advertising revenues were useful to the telephone companies for decades to defray the costs of compiling and distributing the printed directories and have grown to become significant enough to also contribute profits to offset the overall costs of operating the business. The telephone companies have for many years used their established relationship with customers, their telephone listings data, their brand name and business reputation and their first mover advantage and other intangible assets to dominate the directory publishing industry.[19]

Q. Have any of the large ILECs chosen to not engage in directory publishing?

A. No. The largest ILECs such as Verizon, SBC, BellSouth and, until recently Sprint and Qwest, have all participated in and dominated the directory publishing business in their telephone service territories for many years. This dominance has occurred for many reasons, including the first mover advantage experienced when phone books were first issued by telephone carriers, historical control over telephone listings, shared branding of directories in the name of the carrier to convey "official" publisher status and through many other linkages between the telephone and directory operations. Sprint and Qwest only recently exited the directory publishing business and were able to realize extremely

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[18] Qwest and Sprint have liquidated their publishing businesses in sale transactions that provided for long-term exclusive publisher status to the Buyer and other intangible asset grants in return for a one-time monetized value yielding a large capital gain.

[19] Where the ILEC's directory publishing business has been sold, as in the case of Qwest and Sprint in Washington, exclusive official publishing and non-competition agreements grant the buyer most of these benefits and protect the buyer against competitive re-entry into directory publishing by the telephone company.

large gains on the sale of the directory publishing business by bundling a long term exclusive "official" publishing contract and a long term non-competition agreement into the transaction, so as to convey the full value of the official publisher status to the buyer of their directory businesses.[20]

Q. Please elaborate upon the nature of the regulatory asset associated with directory publishing.

A. The directory publishing business primarily employs intangible assets to create value for advertising customers. There are relatively few physical assets employed beyond the facilities required to automate publishing, physically print and distribute the directories and provide office space for employees. Much more important are the intangible benefits associated with the Sprint directory's "official" status conveyed by the linkages described above and the brand awareness created by telephone company operations. These intangible assets position the Sprint branded directory advertising product as the incumbent telephone company directory that is able to command higher advertising rates and thereby larger revenues and profits than independent publishers.

Thus, the regulatory asset is the directory publishing opportunity arising from United Telephone Company of the Northwest's ILEC business and is not a physical or tangible asset residing on the books that required any actual capital investment to develop. Instead, the directory publishing asset arises from UTNW's status as a major ILEC, which creates the opportunity and indeed a regulatory expectation that telephone directories be published containing commercial advertising at prices designed to prudently exploit this

[20] In Sprint's case, the Stock Purchase Agreement between Sprint and R.H. Donnelley provided for a 50 year exclusive directory publishing and a conterminous non-competition agreement in favor of the Buyer. The cover of the current classified directory in United Northwest territory continues to bear the Sprint name and logo consistent with the terms of the Stock Purchase Agreement and related Exhibits.

income opportunity, so as to offset the common overhead costs of operating the telephone business.

Q. Has the WUTC historically found intangible assets used in directory publishing to be regulatory assets?

A. Yes. The intangible, going concern value of the directory publishing business that arises from affiliation with the telephone business is what this Commission has recognized to be a regulatory asset for many years. For example, in its Second Supplemental Order, in Docket No. U-86-156 and in all subsequent U S West imputation decisions, the Commission treated Directory publishing as a regulatory asset and determined that "the public interest requires the full reasonable value of directory publishing be available to PNB for ratemaking purposes." The intangible assets used in directory publishing have already been found by the WUTC and the Washington State Supreme Court to be an asset retained by the regulated business until a showing has been made that the full, fair value has been transferred for reasonable consideration to the telephone company.[21]

Q. Has the Commission ever departed from its conclusion that directory publishing operations represent a regulatory asset?

A. No. In the Commission's Fifteenth Supplemental Order in Docket No. UT-950200, a summary of prior Washington decisions associated with directory imputation is recited, as follows:

> Before 1984, Pacific Northwest Bell, the predecessor in Washington State of US WEST Communications, Inc., published its own telephone directory, including Yellow Pages. [footnote omitted] Ex. 390-T, p.16. The publishing revenues and expenses were a part of the Company's results of

[21] See in particular *In Re the Petition of US West Communications, Inc., for an Accounting Order,* Fourteenth Supplemental Order; Order Denying Petition, Docket No. UT-980948, at ¶¶ 169 through 175.

> operation for regulatory purposes and constituted a regulatory asset of the Company. Effective January 1, 1984, directory publishing was placed in Landmark Publishing Company. The publisher is now US WEST Direct (USWD), a division of US WEST Marketing Resources Group, Inc. (MRG). Between 1984 and 1988, the affiliated directory publisher paid annual publishing fees to USWC, ranging in amount from $14.9 million to $40.5 million. The payments ceased after 1988, according to USWC, ". . . because USWC recognized that there was no operational or business need for a cash payment to flow between the two US WEST companies." There is no indication that PNB or USWC received compensation other than the publishing fee for the transfer of the directory business or that it received compensation for the termination of the publishing fee. USWD is the exclusive publisher of directories for USWC, which provides billing and collection services exclusively to it. [footnote omitted]
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> In the Second Supplemental Order in Cause No. U-86-156, the Commission treated the Directory as a regulatory asset and determined that the public interest requires the full reasonable value of directory publishing be available to PNB for ratemaking purposes. It found that the then-current publishing fee was not determined in an arms-length transaction with each party seeking to maximize return, but deferred adjusting the value until a later time. [footnote omitted]
>
> As a condition to the merger of PNB into USWC, all of the parties including USWC agreed in a signed stipulation, presented to the Commission and approved, that if the merger were approved, Yellow Page revenues would be considered as though the merger had not taken place. [footnote omitted] The order provided that the Commission could modify the arrangement by a future order. The Alternative Form of Regulation (AFOR) agreement between the Commission and the Company in 1990 contained an implicit directory imputation calculation.[22]

The Commission also stated at that time,

> The Commission finds the directory publishing business to be a regulatory asset. Commissions have historically been authorized to impute revenues from interrelated operations that have been transferred to affiliates, to prevent utilities from taking profitable aspects and leaving captive utility

[22] *WUTC v. US West Communications, Inc.*, Fifteenth Supplemental Order; Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling. Docket No. UT-950200, pp. 32-33.

> customers with expenses of the operation but with reduced offsetting revenues from related services.[23]

The directory imputation ordered by the WUTC in Docket No. UT-950200 was appealed by U S West and the Commission's findings were ultimately upheld by the Washington State Supreme Court, which held in pertinent part:

> We hold US West has not carried its burden of demonstrating the invalidity of the Commission's decision regarding the imputation of revenue. The yellow pages publication business is a lucrative revenue-producing asset which was developed as a result of the Company's long, de facto monopoly dominance of the telephone business in Washington. The transfer of an undervalued asset constitutes a payment of compensation prohibited by the affiliated interest statute, RCW 80.16. The commission acted within its discretion conferred by that statute and within its authority to set just and reasonable rates pursuant to RCW 80.36.140 when it imputed yellow pages revenues to US West.[24]

A more exhaustive history of the Commission's treatment of directory publishing operations within a telephone company affiliate can be found in the "HISTORY" section of the Commission's Fourteenth Supplemental Order in Docket No. UT-980948 that denied U S West Communications' request for an Accounting Order ending imputation.

Q. Do these regulatory findings regarding U S West / Qwest also apply to United Telephone Company, as evidenced by the Commission historically imputing directory publishing revenues in calculating United's revenue requirement?

A. Yes. As noted previously, in the last UTNW Washington rate case, Docket No. U-89-3067-SI, the DirectoriesAmerica affiliated publisher was **************************

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[23] *Id.*, p. 34.

[24] *U S West Communications, Inc., v. WUTC*, 134 Wn. 2d 74, 102, 949 P.2d 1337 (1997).

*** ********************************** to telephone company ratepayers.[25]

Q. Is the Washington Utilities and Transportation Commission unique in its treatment of directory publishing as a regulatory asset?

A. No. Many regulatory and court decisions over the years have found directory publishing operations and profits to be properly considered as a regulatory asset and used to offset ILEC revenue requirements due to these linkages and advantages.[26]

Q. Has Sprint acknowledged that much of the value associated with its directory publishing business arises from the relationship between directory publishing and the local ILEC business?

A. Yes. Documents prepared by Sprint to offer the directory publishing business for sale confirm such a characterization. In Sprint's <u>Confidential Offering Memorandum</u> for the sale of SPA, the following quotes indicate Sprint's understanding of how its directory business opportunity arises from and is linked to its ILEC business:

> ***, *** *** *** **************************
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> *** *** ***

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[25] Confidential UTNW response to Commission Staff Data Request No. 12.

[26] See for example: Colorado PUC Decision No. C02-899 http://www.dora.state.co.us/puc/decisions/2002/C02-0899_36247.pdf; Utah Supreme Court Decision No. 980082 http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=ut&vol=supopin&invol=uswest3_lhr; Public Utility Commission of Oregon Order no. 97-171, http://www.puc.state.or.us/orders/1997ords/97-171.htm; New Hampshire PUC Order No. 24385, http://www.puc.state.nh.us/Regulatory/Orders/2004orders/24385t.pdf.

**[27]

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27 The Company's highly confidential attachment to its response to Public Counsel Data Request No. 18(d), p. 2.

28 *Id., p. 3.*

29 *Id., p. 7.*

30 *d., p. 13.*

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> **.[31]

It is my view that Washington is one of the state commissions that should seek a share of the sale proceeds from the sale of the directory publishing business and associated long-term publishing rights to RHD, as a matter of equity for UTNW ratepayers and to maintain consistency with long standing WUTC regulatory policies and court decisions.

Q. Does R. H. Donnelley, the buyer of Sprint's directory publishing operations, also describe the business it acquired in a manner that supports the Commission's characterization of directory publishing as a regulatory asset?

A. Yes. In its 2004 SEC Form 10-K Report at page 2, R. H. Donnelley Corporation states the following in describing its purchase of the Sprint Publishing & Advertising ("SPA"):

> On January 3, 2003, we completed the acquisition of SPA by purchasing all the stock of two subsidiaries of Sprint, DirectoriesAmerica, Inc. and Centel Directory Company (''Centel''), for $2.23 billion in cash. This transaction was consummated pursuant to a purchase agreement dated as of September 21, 2002 by and among RHD, Sprint and Centel Directories LLC. The acquired SPA Directory Business now operates as R.H. Donnelley Publishing & Advertising, Inc., one of our indirect wholly owned subsidiaries.
>
> In connection with the SPA Acquisition, we entered into a directory services license agreement, a trademark license agreement and a non-competition agreement (collectively, ''SPA Directory Services Agreements'') with Sprint. The directory services license agreement grants us the exclusive license (and obligation as specified in the agreement) to produce, publish and distribute yellow and white pages

[31] *Id., p. 39.*

> directories for Sprint (and its successors) in the markets in 18 states where Sprint provided local telephone service at the time of the transaction. The trademark license agreement grants us the exclusive license (and obligation as specified in the agreement) to use certain Sprint trademarks, including the Sprint diamond logo, in those markets. The non-competition agreement prohibits Sprint (and its affiliates and successors) in those markets from selling local directory advertising or producing, publishing and distributing print directories, with certain limited exceptions. The SPA Directory Services Agreements are all interrelated and each has an initial term of 50 years, subject to automatic renewal and early termination under specified circumstances.

Then, at page 7 of its 10-K, RHD states the following regarding its "SPA Directory Service Agreements" and how these agreements position RHD with a competitive advantage in the Sprint markets that are served:

> The United States print directory advertising industry is highly competitive. Approximately 80% of total United States directory advertising sales are attributable to Regional Bell Operating Company (''RBOC'') and other incumbent directory publishers (collectively, with RBOC publishers, ''incumbent publishers'') that typically publish directories where they (or their licensors or affiliates) offer local phone service. More than 240 independent yellow pages directory publishers operating in the United States compete with those incumbent publishers and represent the remaining market share.
>
> In nearly all markets, we compete with one or more yellow pages directory publishers, which are predominantly independent publishers, such as the U.S. business of Yell Group Ltd, TransWestern Publishing Company LLC and White Publishing Company. We believe that acting as the exclusive, official incumbent publisher of directories for the incumbent local telephone company (SBC and Sprint) in our markets provides us with a competitive advantage over independent publisher competitors due to better recognition of our brands, higher usage of our directories by consumers and our longer relationships with advertisers in our markets. As an incumbent publisher, we also believe that we can deliver a better value proposition to our advertisers than our independent competitors, largely due to user perception of up-to-date accuracy and completeness that comes with our affiliation with the local telecom service provider. As an incumbent publisher having operated in our markets for many more years

> than our independent publisher competitors, we believe that we also benefit from established consumer usage patterns and loyal advertiser bases. We also believe that our established operational infrastructure is a competitive advantage over our independent competitors. Our printing, publishing and distribution functions all benefit from longer-term relationships with our key vendors.
>
> We believe that these factors motivate independent publishers to compete with us based on price while they attempt to build their advertiser bases, which results in advertising rates significantly lower than our prices for the same size advertisement. In some markets, we also compete with other incumbent directory publishers in overlapping and adjacent markets. We compete with all these publishers based on value, accessible price point, local relevance, quality, features and distribution.

I have included excerpts from this R. H. Donnelley, Inc. SEC filing as Exhibit No. ___MLB-3.

Q. In comparison to the SPA sale to RHD, has the competitive benefit associated with "official publisher" status also been acknowledged by any other entity that recently purchased an ILEC official directory publishing business?

A. Yes. Dex Media, Inc. was the buyer of Qwest's directory publishing business in a transaction approved by this Commission in August of 2003.[32] In its Amendment No. 1 to Form S-4 filed with the Securities and Exchange Commission on August 2, 2004, Dex Media describes its business as follows:

> We are the exclusive publisher of the "official" yellow pages and white pages directories for Qwest in the following states where Qwest is the primary incumbent local exchange carrier: Arizona, Colorado, Idaho, Iowa, Minnesota, Montana, Nebraska, New Mexico, North Dakota, Oregon, South Dakota, Utah, Washington and Wyoming, or collectively the "Dex States." Our contractual agreements with Qwest grant us the right to be the exclusive incumbent publisher of the "official" yellow pages and white pages directories for Qwest in the Dex States until November 2052 and

[32] See *Dex Sale Order*.

> prevent Qwest from competing with us in the directory products business in the Dex States until November 2042. (page 87 "Business").

Considerable additional detail regarding industry overview, industry outlook, competition and Dex Media strategies is described in this document. I have included excerpts from this Dex Media, Inc. SEC filing as Exhibit No. ___MLB-4.

Q. How can the gain on sale realized by Sprint when it sold its SPA directory publishing agreement be considered a regulatory asset associated with operations of the telephone company if there are some independent directory publishers who exist without such an affiliation and that compete with R.H. Donnelley?

A. The directory publishing industry is stratified between "incumbent" publishers who are affiliated with telephone companies and those publishers which are "independent". This market stratification is described in the R.H. Donnelley SEC Form 10-K Report that was quoted above. The directory operations of the telephone company affiliated "official" publishers have been highly profitable for many years, because of the distinct competitive advantages associated with incumbency and affiliation with the ILEC. These advantages contribute to higher pricing and profit margins for the ILEC-affiliated publishers than are experienced by the independent publishers. The consistently superior profitability of the telephone company publishers, relative to independent publishers, is reasonably attributed to the many advantages associated with affiliation with the regulated telephone business.

Q. Do the incumbent telephone company publishers of directories control most of the yellow pages advertising market as a result of their incumbent position and the benefits of affiliation with the telephone companies?

A. Yes. According to the R.H. Donnelley Report cited above, about 80% of the directory advertising sales market is concentrated among the "incumbent" publishers that are affiliated with ILEC telephone providers.

Q. Is it necessary for independent publishers to charge lower prices for yellow pages advertising because they do not enjoy the pricing power of the incumbent telephone company publishers?

A. Yes. Independent publishers have been able to successfully expand their share of the directory publishing market at the expense of the incumbent telephone company publisher primarily by offering significantly lower prices to enter new markets. In my opinion, the differential in pricing and profit margins between incumbent telephone company publishers and the independent publishers of directories is a strong indication of value associated with affiliation to the regulated telephone company business and the utilization of the regulatory asset described herein.

Q. When Qwest sold its directory publishing regulatory asset to Dex Media, were ratepayers compensated for the transfer of the regulatory claim upon directory profits?

A. Yes. A Settlement Agreement was approved by the Commission that provided for up-front payments to customers of $67 million in bill credit form, as well as ongoing annual revenue credits in lieu of imputation starting at $110 million per year for four years and $103.4 million per year, thereafter, for an additional 10 years.[33]

V. QUANTIFICATION OF THE DIRECTORY GAIN ON SALE DISTRIBUTION

33 *Id.*, pp. 12-13 and Appendix B.

Q. Have you prepared an Exhibit that calculates the Washington share of the gain on sale that was realized by Sprint in 2003 when it sold the directory publishing business and the official publisher rights of UTNW and the other Sprint LTD business units as well as a distribution proposal for such amounts?

A. Yes. Exhibit No. ___ MLB-5HC sets forth the calculation and allocation of the directory sale proceeds and gain on sale, indicating the Washington share of the Sprint Publishing & Advertising gain on sale before and after income taxes. This Exhibit then proposes a series of imputation credits to be funded with the "Pretax Washington Value For Customer Attribution" that I have calculated – including an accounting for the amounts of "Embedded Imputation" within the existing UTNW revenue requirement from the last rate case and a series of increased revenue imputation credits applicable in future rate cases through the year 2020.

Q. What are the sources for the Sale Proceeds, Book Investment in Assets Sold and Selling and Administrative Expenses amounts shown at lines 1 through 3 of Exhibit No. ___MLB-5HC?

A. These amounts were all provided by Sprint, in their highly confidential response to Public Counsel Data Request No. 35b. The net of these figures yields the "Estimated Pretax Gain on Sale" that appears on line 4.

Q. Why did you provide for income taxes at 35% on line 5?

A. While it may have been possible for Sprint to defer payment of income taxes on the gain from sale of the directory business due to its consolidated tax return position, [34] I have

[34] According to its SEC Form 10-K for 2003 at page F-52, Sprint Corporation had $2.6 billion of Operating Loss Carryforwards listed as an asset on its balance sheet and stated the following regarding the sale of directory publishing, "In 2002, Sprint reached a definitive agreement to sell its directory publishing business to R.H. Donnelley.

allowed fully normalized income tax expense on the realized gain to maintain consistency with the Commission's treatment of the Qwest Dex sale. Allowing Federal income taxes at the full 35 percent statutory rate is a significant concession to Sprint in relation to actual cash-basis taxes paid on the sale. By allowing income taxes at the full statutory rate on the gain, any cash flow benefits to Sprint on its consolidated income tax return arising from the realization of income tax losses in prior periods or in unprofitable business lines are retained entirely for the benefit of shareholders.

Q. Please explain the allocation to Washington calculations that appear at lines 7 through 11 of Exhibit No. ___MLB-5HC.

A. Sprint did not maintain directory publishing profitability data by state or individual directory that would allow for allocation of the gain on sale amount based upon income or cash flow performance in Washington, relative to other states.[35] The best available allocation basis is therefore relative directory advertising revenues in Washington versus other Sprint Publishing & Advertising states. Line 8 sets forth the Washington directory advertising earned by Sprint in 2001 and 2002 and these amounts are divided by overall SPA revenue in each year on line 9, to yield the percentage values shown on line 10. The Washington percentages for the two years are averaged together on line 11 and applied to the overall SPA sale gain amount from line 6 to arrive at the Washington share of the post-tax gain amount on line 12.

Q. Why is it necessary to factor the post-tax gain back up to a revenue level, as shown at lines 13 and 14?

Due to the anticipated gain on the sale, Sprint recognized $292 million of tax benefits in the third quarter of 2002 on previously recorded investment losses."

[35] Sprint Response to Public Counsel Data Request No. 21.

A. Imputation credits and revenue adjustments flowing from imputation are pretax amounts. Therefore, to calculate the pre-tax equivalent amounts, one must apply the conversion factor shown on line 13 that is based upon the formula (1 / 1- tax rate). As on line 5, income taxes are again provided for at the statutory Federal income tax rate of 35%, since Washington has no state corporate income tax.

Q. Please explain your recommended utilization of the line 14 "Pretax Washington Value for Customer Attribution", as set forth in the bottom half of Exhibit No. ___MLB-5HC.

A. I recommend Sprint's realized gain on sale of SPA be used to accomplish several important goals. The first $800,000 should be used to provide an immediate direct and tangible benefit to consumers in the form of a one-time customer bill credit to be applied on a per access line basis. This tangible customer bill credit benefit could assist the Commission in reaching a finding that the proposed transfer of control is consistent with the public interest, if the other concerns raised by Public Counsel can be adequately addressed. This up front credit is proportional to the amount of the Qwest Dex gain on sale of Qwest's directory business that was agreed to among parties and approved by the Commission in that transaction.

The remainder of the Washington share of the gain from the sale of Sprint Publishing & Advertising should be used to replace directory imputation amounts in future rate proceedings that will no longer be available as a direct result of the sale of SPA. Specifically, UTNW should be ordered to provide future revenue credits in any of its Washington rate proceedings that may occur between now and 2018, again in keeping with the structure of the Qwest Dex regulatory treatment approved by the WUTC. In Exhibit

MLB-5HC, these annual amounts by year are displayed in the bottom half of the schedule. Notably, there is a high/low structure to the credits patterned after the Qwest Dex arrangement, with higher credits in the first four years so as to mitigate any negative cost impacts associated with the transfer of control.

Q. Why have you accounted for embedded imputation in the years 2003, 2004 and 2005?

A. UTNW has not had a general rate case for many years and, as noted in my prior testimony, directory imputation in the amount shown is "embedded" within the Company current revenue level, based upon calculations performed in that last rate case. Since the directory business was sold at the beginning of 2003, I have assumed that the Washington share of the realized gain has been used to support embedded amounts of imputation for all of 2003, 2004 and 2005.

Q. Please explain the basis for the 8.5 percent interest rate that is used to recognize the delayed attribution of the gain on sale to customers in column C.

A. This interest rate is based upon recent regulatory proceedings occurring in Washington in which an overall rate of return finding was reached. In the most recent Verizon Northwest, Inc. rate case, Docket No. UT-040788, a Settlement Agreement was reached that stipulated an overall rate of return on 8.68% that is to be used in Verizon reports to the Commission. While the Settlement was the result of a compromise of issues and was not to be used as precedent before the Commission, it provides the only recent indication of the overall cost of capital for a Washington ILEC. In another recent rate case before the Commission where cost of capital was a litigated issue but the utility involved was not an ILEC, Puget Sound Energy, Inc. was allowed an overall rate of return of 8.40 percent in the Final Order dated February 18, 2005.[36] Because there is no evidence of an applicable UTNW cost of capital at this time, I employed an 8.5 percent interest rate as a reasonable estimate of the overall cost of capital using these two values for other utilities as a guide.

Q. If the Commission approves the allocation and application of Sprint's gain on sale arising from the transaction with R.H. Donnelley in 2003 in the manner you recommend, what should be done with respect to the commercial agreements entered into by Sprint and R.H. Donnelley as part of that transaction?

A. In the next section of testimony, I describe the new official directory publishing commercial agreements that Sprint and RHD negotiated as part of the sale of the directory publishing business. For the reasons I describe, those agreements are unreasonable and imprudent from the perspective of UTNW and the other Sprint LTD operating companies. However, if the gain on sale is treated in the manner described herein, the commercial agreement can be found reasonably compensatory to UTNW and its ratepayers.

VI. NEW DIRECTORY PUBLISHING CONTRACTS ARE UNFAIR TO UTNW RATEPAYERS

Q. Earlier in your testimony, you referred to the Directory Services License Agreement and the Noncompetition Agreement between the Sprint local telephone companies and R.H. Donnelley that were negotiated as part of Sprint's sale of the directory business to RHD. Please describe these contracts.

[36] See *WUTC v. Verizon*, Order No. 15; Order Approving and Adopting Proposed Settlement; Rejecting Filed Rates; Accepting Proposed Rates, Docket Nos. UT-040788 and UT-040520 (April 12, 2005); Settlement Agreement, p. 15 (February 23, 2005); and *WUTC v. Puget Sound Energy*, Order No. 06 Final Order Rejecting Tariff Sheets; Authorizing and Requiring Compliance Filing; Requiring Subsequent Filing, Docket Nos. UG-040640, UE-040641, UE-031471 and UE-032043 (February 18, 2005).

A. The Directory Services License Agreement and the Non-competition Agreement between RHD and the Sprint Corporation were negotiated as part of the Stock Purchase Agreement with RHD dated September 21, 2002. These agreements, along with a Trademark License Agreement represent the formal documentation of a long-term official publisher arrangement that Sprint sold to RHD for about $2.2 billion.[37] Collectively, these agreements represent commitments made by Sprint, on behalf of its ILEC subsidiaries as follows:

> Sprint LTD hereby grants to Publisher a non-transferable (except as provided in Section 19.1 of this Agreement), exclusive license, without the right to sublicense, to produce, publish and distribute on behalf of Sprint LTD the physical media and non-physical media Sprint LTD Directories on the terms and conditions set forth in this Agreement and the other Commercial Agreements; provided, however, that nothing in this Section 2.1(a) will be deemed to preclude any Sprint Entity from taking any actions or engaging in any activities (or authorizing a third party to take any actions or engage in any activities) not otherwise prohibited under the Non-Competition Agreement.

These three agreements have a 50 year term and provide for no compensation to UTNW or the other Sprint ILEC subsidiaries for the granting of these official publisher privileges.

Q. Did the affiliate publishing agreements that existed at the time of UTNW's last Washington rate case provide some compensation to the telephone company for use of the regulatory asset, the intangible official publishing rights associated with the telephone business?

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[37] See Sprint's Response to Staff Data Request No. 10, Stock Purchase Agreement Exhibits 5.10, 5.16 and 5.18, respectively.

A. Yes. While imputation may have still been required historically, due to the size of the publishing fee received by the telephone company, at least there was some contractual recognition of the value of the official publisher right during the last rate case.

Q. What was the publishing fee and why was it paid to the telephone company in the 1980's?

A. UTNW received a publishing fee that was paid by the affiliated directory publishing company to compensate the telephone company for use of its intangible assets, including its corporate identity, established relationships with telephone company customers and the official directory status that arises from such relationships.[38] The affiliate publisher's ability to sell advertising in the telephone company's official directory was an extremely lucrative opportunity and regulators have been resistant to efforts by the telephone holding companies to transfer that economic opportunity into separate publishing affiliates. It is my understanding that publishing fees were generally the result of non-arm's length affiliate "negotiations" that were designed with an intent to gradually remove directory profits from the telephone company's books (and out of revenue requirement calculations) in a manner that was hoped to be acceptable by regulators. UTNW's publishing affiliate paid such a publishing fee to UTNW that was found to be insufficient in the last rate case and this fee arrangement was subsequently terminated by subsequent affiliate contract amendment.

Notably, U S West Communications attempted to adopt a similar fee-based affiliate publishing agreement at divestiture, but then in 1988 terminated the "publishing fee" that

[38] Sprint's response to Public Counsel Data Request No. PC-15(a) states, "The R. H. Donnelley contract that would have been in place in 1988 has not been retained." However, the confidential response to Staff Data Request No. 12 indicates that at that time UTNW's publishing affiliate,***
*******************************.

was previously paid to the telephone operating companies. The Commission consistently required imputation of excessive directory publishing income on the books of the publishing affiliate of U S West within rate cases, so as to correct for the misappropriation of the telephone company's intangible assets without due compensation. Ultimately, upon sale of the Qwest Dex business, further compensation to ratepayers was agreed upon for the transfer of valuable intangible assets used in directory publishing, as noted earlier in my testimony.[39]

Q. Could a publishing fee serve as an appropriate arrangement, if the amount were reflective of the ongoing value associated with the official directory publisher opportunity?

A. Yes. However, UTNW was not afforded the opportunity to secure such a fee arrangement, because its parent company monetized this value when it sold the directory publishing business to Donnelley and granted the 50-year UTNW official publisher license to RHD for a lump sum payment that was not payable to UTNW.

Q. Did Sprint make any apparent effort to maximize the value of the ILEC official publisher status in a manner that might have provided compensation directly to UTNW and the other LTD operating companies, rather than simply compensating the Sprint parent company?

A. No. In Public Counsel Data Request No. 22, Sprint was asked the following question:

[39] See In the Matter of the Application of Pacific Northwest Bell telephone Company for an Order Granting Authority to Contract to Provide Services to US West Direct, a Colorado Corporation, an Affiliated Interest, Second Supplemental Order, Docket No. U-86-156 (October 12, 1983); WUTC v. US West Communications, Inc., Fifteenth Supplemental Order; Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling. Docket No. UT-950200; and In Re the Petition of US West Communications, Inc., for an Accounting Order, Fourteenth Supplemental Order; Order Denying Petition, Docket No. UT-980948.

> Before agreeing that R.H. Donnelley would be designated as the exclusive directory publisher for the Sprint ILECs in the markets where Sprint currently provides local telecommunications service, did United Telephone Company of the Northwest (or any person/entity acting on behalf of UTNW) solicit competing offers for directory publishing services that may have yielded publishing fees, revenue sharing or some other form of compensation to UTNW for such designation? If not, please provide a complete explanation why such an arrangement was not pursued. If affirmative, please explain the actions taken and provide complete copies of all documents associated with such efforts.

The Company objected to the question and then, without waiving its objections, stated:

> Sprint did not solicit alternative transactions to the sale of the directory business. Sprint determined that the directory publishing business did not fit with its strategic goals and that the sale of the business was an appropriate strategy. Further, Sprint's evaluation of the market did not identify any potential parties who would be interested in transactions other than purchase of the directory publishing business.

Q. What should the Commission conclude regarding the new publishing agreements that were implemented at the time Sprint sold its directory publishing business to R.H. Donnelley?

A. The Commission should conclude that the new commercial agreements that Sprint bundled into the sale of its directory publishing business are imprudent and unreasonable from the perspective of UTNW and the other Sprint ILEC subsidiaries because the <u>Directory Services License Agreement</u> and the <u>Non-competition Agreement</u> provide no compensation to UTNW for the granting of official publisher status, while at the same time preclude UTNW from re-entering the directory publishing business for its own benefit. In addition, the Commission should recognize that Sprint Corporation was compensated for the granting of these valuable exclusive publisher rights to R.H. Donnelley through the proceeds of the sale of the business and, therefore, the gain on sale should be properly allocated and credited to UTNW ratepayers in lieu of the publishing fees and directory imputation that would otherwise be available in future rate cases.

VII. INCREASED EXPENSES ARISING FROM THE PROPOSED TRANSFER OF CONTROL

Q. Other than issues involving capital structure and capital costs, what measurable financial impacts upon UTNW operations are indicated by the Company's evidence in this Docket?

A. At pages 6 through 9 of her testimony, Applicants' witness Ms. Nancy Judy explains that the proposed separation will "have little if any impact on United" with explanations of how local facilities and staffing will remain unchanged, causing the transition to be "transparent to customers" except for "A new corporate name and logo [that] are being developed and will be introduced on or near the effective date of the separation." Then, at page 12 of her testimony, Sprint witness Ms. Nancy Judy describes how the management structure and staffing will be impacted by the proposed change in control, stating:

> United and LTD Long Distance will continue to receive certain management services from the corporate level, including human resources services, finance services, tax services, communications services, legal services, planning services, general support services, and information services. Although the services will be the same as those provided today, and staffed by many of the same experienced and knowledgeable people currently providing those services, the entity that provides it will be a new management company subsidiary of LTD Holding Company. By continuing to maintain these centralized functions, the individual operating companies, including United will benefit from the efficiencies of centralized support services.

Ms. Judy also describes, at page 9 of her testimony, that while assets that are shared today are "being reviewed to determine which entity has the predominant use", certain

"Transition Services Agreements" will be negotiated between Sprint Nextel and the new LTD organization "to provide access to needed assets to ensure the continuity of services ass the separation is completed."

According to Sprint witness Mr. Richard Pfeifer at page 5 of his testimony, "There will be no significant impacts" as a result of changes in the centralized services provided to United by the new management company. In highly confidential testimony at page 6, he states, "Initially, operating expenses may increase as much as *** an amount which is not significant to either United or LTD Holding Company. Further, consistent with the manner in which Sprint has managed its operating expenses over the last several years, LTD Holding Company will either manage these costs such that any incremental increase is eliminated over time or offset them by reducing other costs."

Q. Are there any contracts or other documents containing the formal terms and conditions associated with the separation and transfer of control of UTNW that is the subject of this Docket?

A. No. According to Applicants' response to Public Counsel's Data Request No. 3:

> The key terms of the separation of LTD Holding Company's business from Sprint Nextel, and the distribution of LTD Holding Company securities to Sprint Nextel shareholders will be contained in a master separation and distribution agreement. The separation and distribution agreement will identify assets to be transferred, liabilities to be assumed and contracts to be assigned to LTD Holding Company by Sprint Nextel and by LTD Holding company to Sprint Nextel as part of the separation, and will describe when and how these transfers, assumptions and assignments will occur. It also will describe the procedures pursuant to which NLC[40] will become a separate and independent company, including

[40] While not defined in this response, the acronym "NLC" is believed to stand for National Local Company, which is equivalent to the LTD acronym used throughout this testimony.

> any conditions that must be satisfied or waived prior to the separation and distribution. The separation and distribution agreement will not be entered into until immediately prior to the separation and distribution, and thus is not available for production at present. We expect to have a draft of the master separation and distribution agreement in January. Contracts for Transition Service Agreements and Commercial Service Agreements (currently in the form of term sheets) are being developed and drafts have been provided in response to Commission Staff Requests 2 and 3.

The absence of formal documentation for the proposed separation and related asset and liability transfers, assumptions and assignments and for the commercial agreements is reflective of the complexity of the process required to effect the separation. Moreover, it is possible that the regulatory review and approval of the proposed transaction may impact the final terms incorporated into formal documentation.

Q. Does any definitive agreement exist to document the scope or pricing of the Transition Services to be provided by Sprint United Management Company during the interim transition phase of operations?

A. No. A statement of how each of the planned "transition" services were provided historically and a cost estimate of projected monthly transaction amounts for Transition Service Agreements was requested in Public Counsel Data Request No. 6. In its response, Applicants stated, "Services to be provided post-separation under Transition Services Agreements (TSAs) have historically been provided through the assets, systems and personnel of the Sprint United Management Company"("SUMC"). Regarding projected monthly cost amounts, Sprint responded, "The specific information requested is not yet available. Many of the TSAs have no costs associated with them. For those TSAs where a price is set, the price will be based primarily on the cost that United Telephone Company of the Northwest is currently allocated for the use of those services today. Thus, United

Telephone of the Northwest should see little, if any, cost changes related to the purchase of TSA services during the transition period."

In its highly confidential Attachment Staff 3.1, the Company provided a ******* ** ** **********. This listing indicates the complexity and sheer number of services presently provided by SUMC that must be transitioned to the new separated management services affiliate if the proposed change in control is approved.

Q. Has the planning for the permanent separation of Sprint United Management Company (SUMC) has been completed, so that detailed estimates of ongoing cost of service impacts to UTNW may be determined?

A. No. As noted in the previously quoted data response, formal scoping and pricing of transition services has not been completed. Public Counsel inquired into the process, timeline, tasks, work product deliverables and milestone dates for the separation of SUMC. In its response to Data Request PC-7, Applicants responded by providing an "Organization Design and Staffing Plan" that indicated plans for a 17 step process of management staffing, determination of new local company culture issues, labor/compensation/benefits policy definitions and the progressive completion of management layers, starting with executive management and working through the selection of layer 5 and 6 personnel.[41] This timeline indicates intended completion of all work by 12/31/2005.

Q. Has the estimated overall staffing been determined for the LTD Holding Company Headquarters Staff by Function?

[41] The attachment provided in the Company's response to Public Counsel Data Request No. 7a summarizes this process and the "% of Work Complete" for each step.

A. In its highly confidential response to Public Counsel Data Request PC-7c, "Estimated Headquarters Staff" values were indicated under ** functional Executive groupings. These staffing counts totaled ***** employees overall, with the disclaimer, "********* ***."

Q. Given the uncertainties that are known to exist regarding planning for a separated SUMC organization, does the Applicant have any estimates of the net impact upon UTNW administrative expenses that may result from the planned separation?

A. Obviously, no definitive estimates are possible since the newly separated management organization is still being studied and designed. However, Applicant's own estimates are that there will be "**********************" resulting from the separation of SUMC. In its highly confidential response to parts e and g of Public Counsel Data Request No. PC-7, Applicants estimated the annual ** **Relative to actual operating expenses allocated to UTNW Washington from SUMC in 2004 of ***** million, the estimated increased affiliate charges for management services are estimated to **************************. I do not view estimated changes of this magnitude to be insignificant, particularly given the magnitude of work to be done and uncertainties surrounding changes to be made to separate and redesign the Sprint United Management Company to serve all centralized back-office systems and functions that are required to operate Sprint Nextel and the LTD business at the same time Sprint Corporation is working on the integration of its Nextel acquisition.

Q. Beyond the changes to annual ongoing costs you just discussed, are there also expected to be one-time costs associated with effecting the reorganization and

separation of SUMC as well as the specific transaction and transition costs directly related to the proposed change in control?

A. Yes. As indicated in the Application, the new LTD Holdings entity will be re-branded with a new corporate name and identity to be determined and announced in the future. This process will cause the new LTD entity to incur one-time costs for implementation and for the associated public relations promotional efforts. In its highly confidential response to Staff Data Request No. 16, Applicants stated, “****************************** ** ** ** ** ********”

Another category of one-time costs to be considered are for the fees and expense incurred to actually plan, document, receive required consents and approvals and close the separation transaction (“transaction costs”). In Public Counsel Data Request No. PC-10, Applicants were asked for “the most detailed available itemization of such costs” and in its highly confidential response to this question Sprint provided a summary attachment indicating "** ***. This response included a disclaimer stating the amounts represent “a current view of known transaction costs associated with the separation, additional transaction costs will likely be incurred to these amounts.”[sic]

Q. Have Applicants provided any information to support a conclusion that any measurable cost savings or other tangible benefits will be created by the proposed separation of UTNW and the other LTD entities from Sprint Nextel?

A. No. Applicants are claiming no tangible, positive net savings or synergies.

Q. Given the expectations for higher costs to UTNW and its ratepayers on a one-time and continuing basis, what are your recommendations to the Commission?

A. From a revenue requirements perspective, because of the potentially significant increased costs and risks that are created, the proposed transfer of control is not consistent with the public interest in Washington and should not be approved. In the event the Application is approved, over the objections of Public Counsel, I recommend that the following conditions be applied to mitigate the risk of unreasonable cost impacts:

- Sprint Nextel and LTD Holdings should be required to segregate within their accounts all expenditures made that relate directly or indirectly to planning, negotiating, implementing, gaining approval for or closing the proposed transfer of control transaction including all related transition and segregation costs incurred to separate SUMC and any other corporate entities that may charge or allocate costs to UTNW Washington accounts. Any general rate case filing submitted by UTNW that utilizes a test year including any of the 24 months subsequent to closing shall include a detailed accounting for all such costs on a cumulative monthly basis, indicating which amounts incurred were charged to (specified) UTNW Washington accounts.

- If any Washington rate case test year is used by UTNW to change rates that utilizes a test year including any of the 24 months subsequent to closing, the Company should be required to fund, sponsor and submit with its filing an audit report from an independent auditing firm (approved by Staff and Public Counsel) tasked to conduct a rigorous and detailed audit to ensure that none of the direct or indirect one-time or continuing transaction or transition costs that were caused by the transfer of control and separation of LTD/UTNW operations from Sprint Nextel Corporation are included in test year expenses. This audit and the related report is not limited in scope to verification of the accounting segregation prescribed above, but shall also investigate for direct and indirect costs caused by the change in control that were not included in such accounting segregation.

- To provide added assurance that transaction and transition cost increases caused by the transfer of control, which may be prove difficult to accurately isolate, have been reasonably quantified, any rate case that utilizes a test year including any of the 24 months subsequent to closing shall include a Washington allocated share of SUMC charges that is no higher than the simple average of such expense amounts actually charged to Washington operations in the calendar years 2004 and 2005.

VIII. SERVICE QUALITY CONCERNS ARISING FROM THE PROPOSED TRANSFER OF CONTROL

Q. Does the proposed change in control transaction also raise concerns about the quality of service being provided by UTNW in Washington?

A. Any change in control that materially impacts the financial circumstances of the regulated business can potentially impact the level of service quality that is achieved in the future. Because of this concern, it is not uncommon for regulators to provide strengthened service quality regulatory devices as part of any approval of a utility reorganization transaction such as Sprint Nextel is proposing in this Docket.

Q. Is it your understanding that the proposed change in control is expected to materially and negatively impact the financial strength of UTNW?

A. I have not independently analyzed the proposed capitalization ratios, debt financings or dividend policy being proposed by Applicants. However, Public Counsel witness Hill's testimony explains why the proposed change in control should be rejected by the WUTC out of concerns associated with these matters. It is widely recognized that the consistent provision of high quality public utility services is dependent upon access to capital on reasonable terms, as well as the maintenance of adequate staffing levels and network investment. In the event the Commission elects to approve the proposed transaction in spite of these concerns (and the other concerns noted in Public Counsel's testimony), I propose certain changes to the UTNW service quality measures now in place in Washington, so as to mitigate the risk that financial pressures upon the separated LTD Holdings companies may reduce resources available to and needed by UTNW to maintain good service quality.

Q. Is it your view that the "Service Quality Performance Reports" required of Class A companies pursuant to WAC 480-120-439 are inadequate as a tool to track and monitor service quality provided by UTNW?

A. No. I am not proposing any changes to the service quality measures required to be reported under this rule or to any of the performance standards set forth in specific provisions of WAC 480-120. Instead, I recommend several enhancements to such reporting for a reasonable interval of time subsequent to any separation of the LTD companies as proposed in the Application. In particular, I recommend that:

- UTNW service quality reports pursuant to WAC 480-120-439 be submitted to both the Commission Staff and to Public Counsel.
- UTNW reports should be supplemented with monthly statistical information for the current month and comparable prior rolling 12 month periods:
    - Employee staffing levels by functional category (installation/repair, call center, network admin, executive, etc.)
    - Capital expenditure amounts by functional category (outside plant, interoffice, switching, etc.)

    - Total Washington Per Books Operating Expenses by Part 32 major category.
    - Access lines served (residential, business, coin, wholesale, official, etc.)

- If UTNW reports actual performance levels that are not in compliance with any of the specific tracked measures for compliance under the specific provisions within WAC 480-120 for any month, a narrative explanation for the root causes contributing to such non-compliance shall be submitted coincident with the service quality report for that month.
- If UTNW reports actual performance not in compliance with any of the specific tracked measures for compliance under the specific provisions within WAC 480-120 for any three consecutive months, the Company shall submit a formal, detailed report to the Commission Staff and Public Counsel indicating planned measures to immediately achieve compliance and specific proposals to equitably compensate affected customers, for consideration by the Commission in any Docketed proceedings.

If the proposed transfer of control is approved, over the objections of Public Counsel, these enhanced reporting requirements should remain effective for at least the first 36 months after the transaction is closed.

Q. Does this conclude your testimony at this time?

A. Yes.