

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In Re the Petition of U S WEST  
COMMUNICATIONS, INC. for an  
Accounting Order

Docket No. UT-980948

**POST-HEARING BRIEF OF PUBLIC  
COUNSEL, TRACER AND AARP**

The Public Counsel Section of the Washington Attorney General and intervenors Telecommunications Ratepayers Association for Cost-based and Equitable Rates (“TRACER”) and American Association of Retired Persons (“AARP”) -- hereinafter referred to together as “Public Counsel” for convenience -- respectfully submit this joint Post-Hearing Brief in the above-captioned proceeding.

**I. INTRODUCTION**

While this case arose out of a petition filed by U S West Communications, Inc. (“USWC”) for a declaratory order to end the imputation of Yellow Pages revenues from U S West DEX<sup>1</sup> to USWC, it is evident that the real party in interest is the parent of both U S West DEX and USWC, namely U S West, Inc. In fact, this case involves just the latest in a long series of efforts by U S West, Inc. and its subsidiaries, including USWC, to divert the revenues of the Yellow Pages publishing business and capture the entire opportunity for profit from that business without adequately compensating USWC or its ratepayers. The case for ending imputation presented in this proceeding rests entirely on a misreading of language contained in the Supreme Court’s opinion entered in *U S West Communications, Inc. v. Utilities and Transp. Comm’n*, 134 Wn.2d 74, 949 P.2d 1337 (1997) (hereinafter the “Supreme Court” decision). It is at heart an attempt to revise history.

U S West, Inc.’s motivation for doing so is clear. As the parent of USWC and U S West Direct, U S West, Inc. is benefitted whenever U S West Direct or USWC increase their earnings. If USWC’s theory of the case is approved by the Commission, the shareholders of

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<sup>1</sup> U S West DEX is the successor in interest to U S West Direct as the publishing affiliate to USWC. In this brief, for convenience, the publishing affiliate will be referred to as “U S West Direct.”

U S West, Inc. will be fully protected against any loss resulting from the transfer of the directory publishing assets, because what is lost by USWC in giving up the directory publishing business is gained by U S West, Inc. U S West, Inc.'s shareholders benefit if USWC and its ratepayers can be denied the full benefit of growth in the directory publishing income. Revenues denied to USWC can be made up to USWC and its shareholder, U S West, Inc., in the ratemaking process through increased rates. By removing the Yellow Pages gains from the regulated arena and replacing those with increased revenues from ratepayers, U S West, Inc. can realize both the unregulated profits of the publishing business and the replacement revenues from ratepayers. The Commission should not countenance such an outcome.

## **II. BASIS OF PUBLIC COUNSEL, TRACER AND AARP POSITION**

By contrast with USWC's theories, the position of Public Counsel, TRACER, and AARP in this case is based on a few straightforward principles. These principles are directly derived from the applicable law, Commission orders, the decision of the Supreme Court in UT 950200, and from the actual underlying facts.

### **A. The Directory Business Is Integrally Linked To The Provision Of Local Service.**

The publication of White and Yellow Page telephone directories has always been inextricably related to the provision of basic local telephone service. For this reason, the Commission and other regulatory commissions have consistently included the results of White and Yellow Pages publishing in setting rates. In the wake of the Supreme Court decision, USWC now appears to concede that due to this linkage of publishing with local service, ratepayers are entitled to the value of the Yellow Pages business, but only if it is valued as of 1984. (See discussion in Section VI.A. Imputation)

### **B. The Transaction That Occurred In 1984 Was Not A Complete And Permanent Transfer Of Ownership Of The Directory Publishing Business.**

In order to justify the 1984 valuation date which it has proposed in this docket, USWC is forced to revisit the 1984 transaction and recharacterize it as a complete transfer of

the directory publishing business. This is misleading and inaccurate. An integral part of the restructuring of publishing operations in 1984 was the publishing agreement, an affiliate transaction that clearly indicates USWC's ongoing interest in the directory business by allocating responsibilities, costs and benefits from publishing activities between USWC and U S West Direct. Essential elements of the publishing business were retained by USWC and only licensed or "rented" to the affiliate. The transaction which occurred in 1984 did not constitute a complete and permanent transfer of ownership so as to warrant treating imputation as if it were installment payments on a 1984 sale. In 1984 there was no valuation of the business, no buyer or seller, no consideration paid for the going concern value of the business, no sale agreement or other documentation, no application for approval of the sale or transfer of the entire business, and no Commission disposition of the gain. (See discussion in Section IV.C. Nature of the 1984 Transaction).

**C. The Commission Selected Imputation, Not Sale, As The Appropriate Regulatory Treatment.**

In its 1988 order in Docket U-86-156, the Commission identified three appropriate regulatory treatments for the transfer transaction: (1) approval of the contracts with appropriate adjustment of publishing fees, (2) the return of the publishing function to Pacific Northwest Bell ("PNB"), USWC's predecessor, or (3) the treatment of the transaction as the sale of a capital asset. *In the Matter of the Application of PNB for an Order Granting Authority to Contract to Provide Services to U S West Direct, a Colorado Corporation, An Affiliated Interest*, Docket No. U-86-156, Second Supplemental Order, October 12, 1988, pp. 12, 14. (U-86-156 Order). The Commission selected the first option and has subsequently employed imputation up to the present time. The order does, however, invite USWC to seek treatment of the transaction as a sale if it wishes to transfer all risks and benefits, including the entire opportunity for profit, to U S West Direct. At no time between the issuance of U-86-156 order and the filing of its petition in this case, a period of ten years, did USWC take up the opportunity offered in the U-86-156 order for treatment of the transaction as the sale of a capital asset. Therefore, USWC should not now be allowed to retroactively recharacterize

past events as if “treatment as a sale” has been occurring since 1984. (See discussions in Section III. History of Regulatory and Judicial Action; Section VI.C. Imputation)

**D. Imputation Adjustments And Publishing Fees Were Not Installment Payments On A Hypothetical “Sale” Of The Directory Business In 1984.**

Under USWC’s theory of the case, the value of the Yellow Pages business has already been paid and imputation must cease immediately. In order for this theory of the case to succeed, USWC must be able to characterize past imputation payments as, in effect, installment payments against the value of the Yellow Pages business fixed as of 1984. This simply does not square with the facts. As noted above, no true sale occurred in 1984. No consideration was received for the true value of the business and no gain was available for regulatory consideration by the Commission. No amortization schedule was ever established. Publishing fees were never referred to as consideration for a sale or a permanent transfer of the publishing business. Indeed, under USWC’s theory, the Company continued to, in effect, “pay” millions of dollars per year in imputation after 1993, the earliest point at which the publishing business was allegedly paid off. It is unclear why these so-called installment payments would be paid if they were not owed. (See discussion in Section VI.B. Imputation).

**E. Ratepayers Are Entitled To The Gain On The Sale Of The Yellow Pages Business. Ratepayers Have Continued To Be At Risk Since The Attempted Transfer Of The Yellow Pages Business And Are Entitled To The Growth In Value Of The Business. No Court Or Commission Decision Has Ever Fixed Ratepayers’ Entitlement At A 1984 Date.**

Prior to 1984, all of the revenues and expenses attributable to the publishing operation were included in PNB’s results of operation. Ratepayers in that period bore the risks of ownership of the publishing operation. The imputation calculations that have occurred since 1984 fully reflect the changes in revenues, expenses, and investments experienced by U S West Direct, causing ratepayers continue to fully bear whatever economic burden is attributable to directory operations. Yellow Pages publishing has always been treated as part of regulatory operations and is still so treated. Ratepayers were not guaranteed receipt of any business valuation as of 1984 (as now asserted by USWC), but instead have remained at risk

for the variability in directory revenues and income since the 1984 transaction through the imputation process. Ratepayers should therefore participate in the appreciation in value of the business as compensation for assuming these risks. (See discussions in Section V. Valuation, Section VI.E. Imputation.)

**F. Under the Decision of the Washington Supreme Court, Imputation Should Cease Only When Full Current-Period Fair Market Value Of The Business Is Determined, Received By USWC, And Fully Credited To Customers.**

The opinion of the Washington Supreme Court in UT 950200 gives guidance for the resolution of the Yellow Pages issue. The Court observes that USWC has never received fair value for the directory publishing business and has always been free to sell the business. The Court noted the Commission's ruling that if the transaction were treated as a sale of an asset and a fair price paid, then imputation would cease. On this basis the Court held that if and when USWC could show that it had received fair value, it could petition the Commission for an end to imputation. The "sale" remedy is clearly prospective in nature because it expressly requires that USWC itself receive fair value for the publishing business, which it has never done, a matter which is not in dispute.

The value of the Yellow Pages business has not yet been determined. For the first time in this proceeding, the Commission, the Company and other parties are making an effort to do so. The value should be based on a current-period fair market valuation. Until the business is properly valued, paid to USWC, and ratepayers appropriately credited, imputation must continue to return improperly transferred directory income to ratepayers. (See discussion in Section VI.F. Imputation)

**III. HISTORY OF REGULATORY AND JUDICIAL ACTION**

**A. Cause No. FR-83-159**

On December 22, 1983, Pacific Northwest Bell Telephone Company (PNB) filed an application seeking the Commission's approval of a publishing agreement between PNB and U S West Direct Company (U S West Direct) and the transfer of certain of its tangible assets associated with the publishing of telephone directories (directory assets) to Landmark

Publishing Company (Landmark). Landmark was a wholly-owned subsidiary of U S West Inc.<sup>2</sup> and the parent company of U S West Direct.

The net book value of these specified tangible assets totaled approximately \$23.5 million. They consisted of cash and other assets located in Oregon and Washington. The Washington assets included one leasehold, station equipment, office equipment and furniture. Ex. 110 at 2.

At the time PNB transferred these tangible assets to Landmark, it received in exchange a .21 share of Landmark stock. Landmark had one share of stock, and therefore PNB for an instant controlled 21% of Landmark. PNB declared a dividend of the .21 share of Landmark stock to PNB's shareholder, U S West, payable on January 3, 1984. Id. at 2-3. Of the \$23.5 million that was transferred from PNB to Landmark, \$22.2 million consisted of cash which PNB transferred to satisfy the cash working capital requirements of the directory publishing operation ultimately transferred to U S West Direct. This transfer of cash was PNB's part of the capitalization of the new company, Landmark. The capitalization of Landmark was done solely by PNB and the other U S West operating companies, not by U S West. Id. at 3. Clearly, such capitalization would not have been done were PNB negotiating with an independent third party, not a sister company.

In the publishing agreement PNB granted U S West Direct the exclusive right to publish PNB's exchange service directories (Id., ¶ 3.01) and the exclusive right to use PNB's trade name, trademark, and logo in connection with the directory publishing obligations. Id., ¶ 3.08. PNB agreed to furnish the basic listing information about its subscribers to U S West Direct (Ex. 602, ¶ 3.02). U S West Direct agreed to publish alphabetical exchange service directories for all exchanges in which PNB provides telephone service, including advertising, and also publish directories containing both the alphabetical exchange service information and the classified Yellow Pages. Id., ¶ 3.03. In the recitations section of the publishing

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<sup>2</sup> U S West Inc. (U S West) is a publicly-held corporation organized and existing under the laws of the state of Colorado with its principle place of business located in that state. U S West was incorporated on September 22, 1983 and was the sole shareholder of PNB and is the sole shareholder of U S West Communications, Inc.

agreement, the parties specifically recognized the unique value of publishing the alphabetical listings and the Yellow Pages directories together:

WHEREAS, the parties recognize and agree that there is unique value in the publication of directories containing both the utility service directory information and advertising by reason of the breadth of circulation and the right to use the name and logo of the Telephone Company in connection with the publication of such directories . . .

Id. at 1.

The term of the publishing agreement was three years, namely January 1, 1984, through December 31, 1986. PNB had the right to extend the agreement for two additional one-year terms until December 31, 1988. Id., ¶ 1.01.

In consideration of and in exchange for the right to use and publish subscriber listings; the exclusive right to publish the exchange service directories; the exclusive right to use the name, logo, and trademarks of PNB; and the other rights and obligations set forth in the publishing agreement, U S West Direct agreed to pay PNB a publishing fee of \$21.2 million in 1984, \$62.7 million in 1985, and \$67.5 million in 1986. PNB advised the Commission that the publishing agreement was a “good deal for PNB and its ratepayers”

because the Agreement effectively preserves a significant contribution from Yellow Page revenue to PNB’s earnings in the new more competitive marketplace after January 1, 1984. Further, this revenue stream is guaranteed, so that the risk and expense of this deregulated and increasingly competitive area of business are not borne by PNB’s ratepayers.

Ex. 110 at 3.

In its Order Granting Application in Part, In the Matter of the Application of PNB, Cause No. FR-83-159, at 3-4 (December 30, 1983) the Commission approved the transfer of the \$23.5 million in assets but reserved ruling on and retained jurisdiction over the reasonableness of any “fees, charges, or accounting allocations involved in carrying out the provisions of the agreements.” In doing so, it stated:

This order shall in no way affect the authority of this Commission over rates, service, accounts, valuations, estimates, or determinations of costs, or any matters whatsoever that may come before it, nor shall anything herein

be construed as an acquiescence in any estimate or determination of costs, or any valuation of property claimed or asserted.

In its Fourth Supplemental Order in Cause No. FR-83-159 the Commission approved PNB entering into the publishing agreement with U S West Direct but again reserved ruling on the reasonableness of any fees until a future time. In doing so, the Commission found that the transactions between PNB and U S West Direct were not conducted at arms' length. Id. at 6. However, because it was not able to determine the extent to which PNB might be undervaluing its directory publishing operations and thereby attempting to transfer them for less than full value to the detriment of PNB customers, the Commission did not approve the reasonableness of the publishing fees or the reasonableness of any profit margin PNB or U S West Direct may derive from them. Id. at 9.

At no time in connection with the application for approval of the transfer of tangible assets or of the publishing agreement was there a valuation of the entire Yellow Pages business conducted or offered to the Commission for its approval. Neither was there any mention of the permanent transfer of the going concern or good will value of the business or of all of the opportunity for profit from the directory advertising operations. Nor did the Commission approve such a transfer.

**B. Docket No. U-86-156**

**1. Second Supplemental Order**

On December 23, 1986, PNB filed an Application seeking the Commission's approval of ten separate agreements between PNB and U S West Direct relating to publishing, directory related services, unbundled directory services, and administration relating to support services to be provided by PNB. Included was a new two-year publishing agreement that would be effective for 1987 and 1988. In that publishing agreement the publishing fee was reduced from previous levels to \$41.6 million for 1987. In addition, it was designated a "subsidy" by U S West Direct to PNB. Ex. 112 at 14. The fee for 1988 was to be renegotiated between the parties and was ultimately set at \$33.9 million.

The Commission temporarily approved the agreements to permit the continued



publication of directories pending full review in the next PNB general rate proceeding, except that it again specifically did not approve the amount of the publishing fees contained in the publishing agreement. Second Supplemental Order, In the Matter of the Application of PNB, Docket No. U-86-156, at 13-14 (October 12, 1988). Indeed, the Commission found that “[t]he Yellow Pages publishing function is an asset of substantial value to Pacific Northwest Bell and as such should not be transferred under contract or otherwise to an affiliate without appropriate compensation.” Id. at 13, Finding of Fact 4. It also found that the publishing fee is a fee paid in exchange for value and not a subsidy as denominated by PNB, and further that it had not been shown that the amount of the fee constituted “an appropriate compensation for Pacific Northwest Bell in exchange for the Yellow Pages publishing function.” Id. The Commission then concluded that the publishing fee proposed by PNB was “unreasonable and not in the public interest pursuant to RCW 80.16.020.” The Commission also concluded that an appropriate compensation for PNB should be determined in the next PNB general rate case. Id. at 14, Conclusion of Law 4. Accordingly, it retained jurisdiction to establish the appropriate publishing fee. Id. at 12, 14-15.

The Commission also reserved authority to determine an appropriate remedy to ensure that the treatment of Yellow Pages revenue attributable to PNB would be in the public interest. Id. at 12, 14, Finding of Fact 4. As the Commission stated, “[t]he public interest requires that the full reasonable value of the directory publishing enterprise be deemed available to PNB for ratemaking purposes.” Id. at 12. The Commission went on to explain that “the remedy selected to achieve this goal should, as far as possible, reflect true values and market realities as if the transfer had been an arms length transaction, with each party seeking to maximize return.” Id. It listed three possible remedies that would be considered: (1) approval of the contracts with appropriate adjustment of publishing fees, (2) the return of the publishing function to PNB, and (3) the treatment of the transaction as the sale of a capital asset. Id.

If PNB and U S West Direct intended to accomplish a permanent and complete transfer of the Yellow Pages business, including all of the opportunity for profit, the

Commission stated that the transaction should be treated as a sale:

If, as the evidence appears to show, PNB and USWC intended a permanent transfer of the Yellow Pages, treatment as a sale may be most appropriate. Such treatment would allow for determination of consideration at the time of transfer that would fairly compensate PNB. PNB would assume none of the risk, and USWD would assume all of the risk attendant to the publishing enterprise. Such a result is appropriate if US West Direct seeks to ultimately acquire all of the opportunity for profit. Treatment as a sale is very likely to reflect a result that might have been achieved by parties bargaining at arms length. Also, no further supervision by the Commission of the publishing enterprise of an unregulated company would be necessary if the transaction is treated as a sale. US West Direct would be free to manage its business without involvement in future proceedings concerning the proper levels of compensation to PNB. PNB would have the reasonable value of its asset. Such a remedy is within Commission jurisdiction under RCW 86.16.030, and may well be the most economical regulatory option available to achieve the public interest.

Id. at 12.

It is clear from the above that the Commission did not consider the transfer of Yellow Pages assets in 1984 as sufficient to accomplish a permanent and complete transfer of all ownership interest in the Yellow Pages business from PNB to U S West Direct. Indeed, the Commission's discussion of possible remedies is entirely prospective in nature. If, as USWC now contends, a complete and permanent transfer of the entire business, including all opportunity for profit, was accomplished in 1984, there would have been no need to consider the appropriate remedy for the transfer in a future rate case. Further, the Commission clearly stated that if PNB and U S West Direct wished to effect such a permanent and complete transfer, they would have to treat the transaction as a sale. Only at such time as the transaction is treated as a sale—namely, the full reasonable value of the enterprise is determined and paid to PNB (now USWC) and PNB and its ratepayers retain none of the risk attendant to the enterprise—would U S West Direct be entitled to all of the opportunity for profit. That did not occur in 1984 and has not occurred to this date.

## **2. Termination of Publishing Fees**

Consistent with the U S West pattern of trying to divert revenues from the Yellow Pages revenues from its regulated enterprise, U S West Direct terminated the payment of

publishing fees at the end of 1988. In a letter, dated December 12, 1988, U S West Direct's then Vice President-Marketing, Max G. Johnson, wrote Dennis Okamoto, the Vice President-Treasurer of PNB (renamed USWC), advising him that "the intercompany 'subsidy' payment [publishing fee] will cease to be effective 12/31/88." Ex. 609. The reason stated was that the "subsidy" issue is controversial and is currently the subject of litigation in several states." Mr. Johnson proposed that the 1987-88 agreement be extended on a month-to-month basis, absent the "subsidy portion," subject to an 18-month notice of termination by either party. Id. at 1. This action was agreed to by Mr. Okamoto. Id. at 2.

### **3. Third Supplemental Order**

USWC subsequently filed an application for an order approving the revised, extended publishing agreement. The Commission again partially and conditionally approved the agreement, subject to a future review of the level of the publishing fee in a full rate case setting. Third Supplemental Order, In the Matter of the Application of PNB, Docket No. U-86-156 (February 7, 1989). In doing so, the Commission expressly stated its disapproval of the Company's "undisguised policy" of trying to "reduce and finally eliminate the publishing fee in order to enhance U S WEST's results at the expense of telephone subscribers." Id. at 1-2.

#### **D. The AFOR Case, Docket Nos. U-89-2698 and U-89-3245-P**

In 1989, the Commission filed a complaint against USWC, alleging that its earnings were excessive. The complaint was resolved by Commission approval of a settlement agreement in which USWC agreed that a portion of U S West Direct's Yellow Pages revenues should be imputed to the regulated revenues of USWC. The settlement agreement and the order approving it also contained a five-year plan for an "alternative form of regulation" (AFOR) for USWC. Fourth Supplemental Order, Docket Nos. U-89-2698 and U-89-3245 (January 16, 1990).

#### **E. The Merger Case, Docket No. U-89-3524-AT**

Also in 1989, PNB sought the Commission's approval of the merger of PNB, Mountain Bell, and Northwestern Bell Telephone Company into USWC. The Commission

initially approved the merger on condition that “U S West’s directory advertising revenues associated with Washington will be imputed, in perpetuity, in accordance with the formula in the AFOR Case settlement.” Second Supplemental Order, Docket No. U-89-3524-AT, at 10 (November 9, 1990)(emphasis added). PNB sought a “clarification” of this order and proposed an alternative condition:

[U S West’s wording change] is to reflect the reality that today’s commissioners cannot bind future commissions in perpetuity, and that it is improper to suggest that U S West should not be able to advocate ever to the WUTC changes in directory imputation, **based on future changed conditions that no party can predict with certainty today**. Because a future commission can always change the WUTC’s position on this issue, without agreement from U S West, fundamental fairness requires that U S West at least be able to request a commission to readdress this issue, **if that becomes necessary due to changed conditions**.

Id. at 3 (emphasis added). The Commission accepted USWC’s proposal, and the Commission’s Third Supplemental Order stated that the Settlement Agreement would be modified to require that directory advertising revenues associated with Washington be imputed, until December 31, 1994, in accordance with the AFOR formula. Thereafter, “these revenues will continue to be imputed accordingly unless and until altered by subsequent order of the Commission.” Third Supplemental Order, Docket No. U-89-3524-AT, at 2 (November 30, 1990). USWC did not appeal this order, as it was based upon the language USWC itself requested. Public Counsel, TRACER, and AARP’s Motion for Summary Judgment in this case explains why USWC should be held to the terms of the modified Settlement Agreement and precluded from arguing that imputation of Yellow Pages revenues was actually a form of installment payments against the 1984 value of the directory publishing business.<sup>3</sup>

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<sup>3</sup> In its Fifteenth Supplemental Order, Washington Util. and Transp. Comm’n v. U S West Communications, Inc., Docket No. UT-950200, 169 PUR4th 417, at 445-56 (April 11, 1996), the Commission held that USWC had waived its rights to contest imputation until further order, noting that USWC had every opportunity to litigate and every right to appeal the Commission’s order in U-89-3524-AT but did not. The Commission also noted that there was no evidence that the Commission or anyone else extorted the imputation agreement or that it was improper in any way. On the contrary, the agreement appeared to have been entirely voluntary. USWC appealed the finding of waiver, along with numerous other issues. In the Supreme Court decision, the Court determined that it did not need to reach the waiver

**F. The 1995 General Rate Case Order, Docket No. UT-950200, and the Supreme Court Decision**

**1. The 1995 General Rate Case Order**

On February 17, 1995, USWC filed a request for a statewide general rate increase for telephone services of approximately \$204 million a year, phased in over four years. During the ensuing rate proceedings, the Commission denied USWC's request to exclude the imputation of Yellow Pages revenues. Ultimately the Commission denied the requested rate increase and found, instead, that USWC was overearning by about \$91.5 million a year and ordered a rate reduction by that amount. Fifteenth Supplemental Order, U S West Comm., Inc. v. Utils. and Transp. Comm'n, Docket No. UT-950200, 169 PUR4th 417, 442-48 (April 11, 1996). USWC challenged the Commission Staff's proposed calculation of the imputation adjustment to the Company's revenues, raised eighteen arguments challenging the Commission's authority to impute Yellow Pages revenues, and argued that the Commission should not make the imputation adjustment, even if it had the authority to do so. All these arguments were rejected by the Commission.

The Commission's rulings on a number of USWC's arguments are significant to this case. First, USWC argued that by ordering imputation the Commission was attempting to seize the revenues of an unregulated affiliate, U S West Direct. The Commission rejected that argument stating that there was no seizure of U S West Direct's revenues, which at all times remained under that company's control. Instead, for regulatory purposes in calculating performance, the Commission imputes the "excess" revenues to USWC's results of operations. The Commission found "the directory publishing business to be a regulatory asset" and stated: "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 customers with expenses of the operation but with reduced offsetting revenues from related services." Id. at 444.

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issue, because it decided that the Commission did have the authority to impute income from the publishing of Yellow Pages to USWC.

The Commission also rejected an argument that its authority to approve affiliate contracts does not authorize imputation, stating: “The issue here is not contract approval; it is accounting from income and expenses and assigning responsibility for the reasonable operation of the utility and the Company’s dealing with a regulatory asset.” Id.

The Commission rejected an argument that by ordering imputation it was improperly interfering with management prerogatives, stating: “The Commission did not prevent company management from doing anything. The Commission is making a ratemaking adjustment for excessive earnings that the Company earned or could have earned or retained the right to earn, based on agreement and historical precedent.” Id. at 445.

Similarly, the Commission rejected an argument that imputation was an inequitable and discriminatory subsidy to universal service in violation of the federal Telecommunications Act of 1996. In doing so, the Commission pointed out that imputation was a ratemaking adjustment, the purpose of which was to “reflect funds that would be available to the Company, but for Company action.” Id.

Finally, it stated that it was imputing Yellow Pages revenues on several grounds: “the Company’s foregoing its ability to maintain a historically integrated operation benefitting ratepayers, its failure to secure benefit for losing the regulatory asset, and its failure to secure compensation for the benefits that [U S West Direct] currently enjoys.” Id. Thus, the imputation ordered by the Commission remedies the loss of the regulatory asset that would otherwise occur.

## **2. The Supreme Court Decision**

USWC appealed the Commission’s decision to the King County Superior Court and then to the State Supreme Court. The Supreme Court upheld the Commission’s action. In its decision the Court held that the Commission has the statutory authority to impute excess Yellow Pages revenue in calculating USWC’s revenue requirement under both the affiliated interests statute, Chapter 80.16 RCW, and under its statutory ratemaking authority, RCW 80.36.140. 135 Wn.2d at 91. The Court specifically noted the Commission’s continuing

supervisory control over affiliate transactions set forth in RCW 80.16.050, which provides in pertinent part:

Every order of the commission approving any such contract or arrangement shall be expressly conditioned upon the reserved power of the commission to revise and amend the terms and conditions thereof, if, when and as necessary to protect and promote the public interest.

134 Wn.2d at 92. The Court also noted the power to disallow unreasonable compensation to an affiliated company for ratemaking purposes provided in RCW 80.16.030. 134 Wn.2d at 93. It then held that the Commission did precisely what the statutes authorize: it disallowed for ratemaking purposes, the unreasonable compensation USWC provided to its affiliate, U S West Direct, when it transferred the profitable Yellow Pages business to U S West Direct for grossly inadequate consideration. The Court stated: “No one represents to this Court that US West Direct has paid US West the fair price for the yellow pages business.” 134 Wn.2d at 94. It also stated : “The imputing of revenue is the result of the fact that the Company gave away a lucrative ratepayer-funded asset to an unregulated affiliate in return for little or nothing.” 134 Wn.2d at 96.

In its discussion of the Yellow Pages issue, the Court quoted with approval the following passage from a Colorado case dealing with ratepayers interests in Yellow Pages assets:

“Mountain Bell argues that the publishing assets belong to its shareholders who took the risks to develop the publishing business. . . . [W]e reject Mountain Bell’s characterization of its publishing operations as purely private. The directory publishing business was developed over the past fifty years within the protective shelter of Mountain Bell’s monopoly of telephone service. The assets were included in the base upon which Mountain Bell was permitted to earn a return. Mountain Bell concedes that the Yellow Pages always have generated “supra competitive” profits. It is an exaggeration to say that Mountain Bell’s shareholders took any significant risk in developing the directory publishing business, and **we find the public interest in those assets to be beyond dispute.**” *Mountain States Tel. & Tel. Co. v. Public Utils. Comm’n*, 763 P.2d 1020, 1027-28 (Colo. 1988)(citations omitted).

134 Wn.2d at 100 (emphasis added). Thus, the Washington Court recognized a beneficial interest on the part of ratepayers in the Yellow Pages assets.

The Court also noted a continuing interest of USWC in the Yellow Pages business when it rejected USWC's argument that it should not be required to stay in the directory publishing business. The Court said: "The Company has not been ordered to stay in the directory publishing business. **The record shows the Company has always been free to sell the business for a fair value.**" 134 Wn.2d at 98 (emphasis added). Obviously, the Company could not sell what it does not own; therefore, according to the Supreme Court the Company must still own rights to the publishing business that were not extinguished by the 1984 transfer.

It is also significant that in discussing the history of the Yellow Pages treatment by the Commission, the Court specifically noted the Commission's Second Supplemental Order in Docket No. U-86-156 and its recitation of the three available remedies for ensuring that the full reasonable value of the directory publishing enterprise be available to PNB for ratemaking purposes. 134 Wn.2d at 89, 102. As the Court said:

Similarly, as noted above, the Commission in its ruling regarding the transfer of the publishing rights explained that if the transaction were treated as a sale of the asset and a fair price paid, then imputation of revenue would cease. . . . We note that under the Commission's Order, the imputation is not necessarily permanent, and the Commission's prior orders show that when the Company has shown **it** has received fair compensation from its affiliate for the value of the asset it transferred, imputation may cease. We hold the Commission was within its statutory authority to impute excess revenues from the publishing of the yellow pages to the revenue of US West. US West may petition the Commission for an end to imputation if and when it can show **it** has received fair value for the transfer of the asset.

34 Wn.2d at 102 (emphasis added).

At no time was the Court presented with the issue, nor did it decide, the exact nature of the transaction by which USWC (PNB) transferred Yellow Pages assets to U S West Direct – other than to conclude there was not a sale nor had the transaction been treated as a sale. Beyond that, the exact nature of that transaction was not critical to the Court's



decision.<sup>4</sup> Further, the Court was never asked and never decided what the appropriate valuation date should be if the transfer transaction were to be treated as a sale. The Court was not critical of the Commission's selection of rate case imputation as a remedy for the improper affiliate relationship, from the menu of three options described in the Order in Commission Docket U-86-156. Thus, USWC's argument in this case that the Court has decided that a complete and permanent transfer of all right, title, and interest in the Yellow Pages business was transferred to U S West Direct in 1984 and that all ratepayer interest in that business was set at that date is without merit.

#### **IV. THE NATURE OF THE 1984 TRANSACTION**

##### **A. USWC Must Argue that a Complete Transfer of the Publishing Business Occurred in 1984 in Order to Justify its 1984 Valuation Date**

The record in this case, both in testimony and briefs, is burdened with extensive discussion on the part of USWC regarding the nature of the transaction which occurred in 1984. Much of the discussion revolves around whether the 1984 transaction was a complete transfer of ownership of the entire directory publishing business. The significance of this debate is that, to the extent USWC can successfully characterize the 1984 transaction as a "sale" or a full and complete transfer of the Yellow Pages publishing business, it can bolster its claim for the use of a 1984 valuation date. In turn, if it is successful in establishing a 1984 valuation date, then it will be successful in terminating any further imputation for the benefit of ratepayers. In addition, it will be successful in diverting all accumulations in the value of the Yellow Pages publishing business since 1984 to its shareholders rather than to ratepayers.

As discussed more fully in the balance of this section of the brief, the 1984 transaction cannot fairly be characterized as a sale or complete and permanent transfer of

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<sup>4</sup> For this reason, USWC's argument that the Court's descriptive references to the Yellow Pages transaction are now the "law of the case" must fail. The Court's references were clearly dicta, and the "law of the case" doctrine does not apply to dicta. *See, e.g., H.R. v. Revlett*, 998 S.W.2d 778 (Ky. App. 1999) (crucial requirement in determining whether the law of the case doctrine applies is that court has entered final decision on question, rather than merely commenting on issue); *State ex rel. Goettsch v. Diacide Distributors*, 596 N.W.2d 532 (Iowa 1999) (dicta is not law of the case); *In re Estate of Chavana*, 993 S.W.2d 311 (Tex. 1999) (same).

ownership of the directory publishing business. The sale or permanent transfer of a significant utility asset ordinarily includes valuation of that asset, a calculation of the gain realized on sale, and a determination of how to distribute the gain to ratepayers. None of those elements was present in 1984, nor are they present today. Furthermore, USWC's efforts to retroactively characterize this transaction as, in effect, a sale or complete transfer, are totally at odds with the facts of the transaction, and with the regulatory response to the initial and all subsequent transactions.

### **B. Description of the Initial Transaction**

The initial transactions involving PNB's directory publishing function took place in the context of the break-up the Bell system. Effective January 1, 1984, American Telephone and Telegraph (AT&T) divested itself of portions of its 22 wholly-owned subsidiary Bell operating telephone companies. At the same time, new regional Bell companies were formed, including U S West, Inc. After January 1, 1984, U S West, Inc., became the sole shareholder of PNB, the telephone company subsidiary providing service in Washington and Oregon. Landmark Publishing Co. was established as a wholly-owned subsidiary of U S West, Inc., and the parent of U S West Direct. As a result, U S West, Inc., Landmark, and U S West Direct became affiliated interests of PNB as defined in RCW 80.16.010.<sup>5</sup>

On December 22, 1983, PNB filed an application with the Commission under the provisions of RCW Chapters 80.12 and 80.16 for an order approving affiliated interest transactions involving PNB, U S West, Inc., Landmark, and U S West Direct . A detailed description of the application is in Section III.A. above. In summary, the December 1983 application sought approval of three related transactions:

- (a) A transfer of tangible assets to Landmark/U S West Direct (cash, office equipment, furniture) as a way to rearrange USW assets and accomplish initial capitalization of Landmark;
- (b) A publishing agreement between PNB and U S West Direct granting a right to use listings and other intangible assets for a defined period of time with extension options; and
- (c) An interim agreement of PNB to provide support services (data processing,

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<sup>5</sup> Docket U 86 156, Second Supplemental Order, p. 2.

billing and collection, payroll, personnel, medical and legal services) to U S West Direct.

PNB's application described the purpose of this transaction (the property transfer) as a "rearrangement of USW assets" to provide for internal capitalization of Landmark, which could have been accomplished simply by a dividend to USW. Ex. 110, p.3.; Ex. 110, Ex. D, p. 3. The form of the transaction was chosen "because it directly reflects and more completely disclose[d] where PNB knew USW would infuse the assets." Ex. 110, Ex. D, p. 3. The most important aspect of the transaction, for purpose of this proceeding, was the proposed publishing agreement between PNB and U S West Direct. As noted in Section III.A. of the brief, the agreement was described as a "good deal" for PNB ratepayers because it preserved a contribution from Yellow Pages revenue, through an allegedly "guaranteed" revenue stream. Ex. 110, p. 3. The publishing agreement (Exhibit 110, Ex. A.1) was not permanent, but was to run only for a three year term until December 31, 1986. The 1984 transactions did not constitute, and were never represented to constitute, a complete and permanent transfer of the ownership of the directory publishing business to U S West Direct.

**C. The 1984 Transaction Was Not a Complete and Permanent Transfer of the Directory Publishing Business**

While some form of "transfer" occurred in 1984, it was only incomplete and limited in scope. There is simply no factual basis upon which the Commission can find that the 1984 transaction was a complete and permanent transfer of the ownership of the publishing business, as alleged by USWC in this case.

First and foremost, the publishing agreement makes clear that PNB retained the ownership of critical elements necessary to operate the publishing function: (1) the subscriber listings, (2) the right to use the name, logo, and trademarks of PNB, and (3) the exclusive right to publish. USWC does not dispute that this was the case. Tr. 256-257, 276-279. (Inouye). See, Ex. 110, Ex. A.1, Article X. U S West Direct acquired only the "right to use" intangible assets. *Id.* Significantly, USWC witness Golden, in discussing his valuation methodology, equates this right to use with a borrowing or renting of the intangible assets. Tr. 566 (Golden). In prior proceedings, other USWC witnesses in this docket have stated that

only tangible assets were transferred to U S West Direct in the 1984 transaction.<sup>6</sup>

In its brief, USWC argues that the “goodwill” or “going concern” value of USWC was transferred to U S West Direct in 1984, thus effectuating the transfer of the directory publishing business.<sup>7</sup> As its only authority, the Company cites *Wilkinson v. Sample*, 36 Wn. App. 266 (Div. 3, 1983). *Wilkinson* does not stand for the proposition for which it is cited, namely, that under Washington law, goodwill is transferred when the advertisers are told of the transfer of the business to a successor. The notification of the advertisers was simply a contractual provision agreed to between the specific parties in the portion of the contract relating to goodwill. 36 Wn. App. at 269. The failure to notify was held to be a breach of the contract for the sale of the business, not a violation of any state legal principle regarding transfer of goodwill. At no point did the court cite any authority on the transfer of goodwill, nor did it announce a holding on that issue.

The greater significance of *Wilkinson* is how the sale in that case contrasts with the facts here. *Wilkinson* involved the sale of a cleaning business for \$30,000 pursuant to a written agreement. The contract allocated the purchase price to inventory, fixtures and equipment (\$5,000), a covenant not to compete (\$10,000), and for the existing business acquired (\$15,000). The latter was described by the court as “simply goodwill.” 36 Wn. App. at 267. Of course, in the Yellow Pages case there is no arm’s length negotiation, no contract for the sale of the business, and no consideration for, identification of, or allocation of value to the goodwill of the business asserted to have been transferred in 1984. *Wilkinson* is thus clearly distinguishable from the case presented here and, if anything, can be cited for the elements missing in USWC’s asserted transfer of ownership.

Goodwill cannot be transferred apart from the sale of the entire assets of the business with which it is connected. 38 Am.Jur.2d § 10, 795. Here, USWC agrees that there was no

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<sup>6</sup> Tr. 378-79 (Johnson) (inconsistent testimony in Docket U-86-156); Tr. 1001 (Koehler-Christensen) (inconsistent testimony in deposition in USWC’s federal proceeding challenging imputation on First Amendment grounds (Ex. 519)).

<sup>7</sup> USWC Brief, p. 30. Notably, in this section USWC never refers to a complete and permanent transfer of ownership, merely to a “transfer.”

sale, and indeed argues that no sale is or was necessary. Furthermore, USWC acknowledges that ownership of certain intangible assets of the business was not transferred, including the PNB trademarks, the right to publish the directories, and the subscriber lists. When an entire business is sold, there is a presumption that goodwill is transferred. *Id.* Absent such a sale, involving the entirety of the business, the presumption must be to the contrary.<sup>8</sup>

Even if the Commission concludes that goodwill was “transferred,” that does not establish that a complete transfer of the ownership of the publishing business occurred. Goodwill can be leased. As the Washington Court of Appeals has noted: “[t]here is nothing about the nature of goodwill that is analytically inconsistent with the notion that a lease of a going business may include a lease of good will.” *Blue Mountain Convalescent Center v. Dept. of Social and Health Services*, 21 Wn. App. 593, 599, 585 P.2d 832 (1978). In this case, to the extent any transfer of goodwill occurred, it was only on a periodic basis, limited to the term of the publishing agreement in effect.

USWC has produced no documentation of a sale or other permanent transfer of ownership to support its reinterpretation of the 1984 transaction. The only documentation provided then or now was the 1983 application and its attachments. Ex. 110. USWC provided no additional documentation regarding the 1984 transaction in response to data requests, Ex. 307, Ex. 313, nor did its witnesses identify additional documentation upon cross-examination. Tr. 363, 366, 381 (Johnson); Tr. 498-499 (Inouye); Tr. 1005, 1008-11 (Koehler-Christensen). The documentation that does exist is quite different than that which would ordinarily exist to reflect an ordinary arms-length sale to a third party. Tr. 341 (Inouye).

USWC’s predecessor PNB did not present to the Commission in 1984, and USWC has not produced now, any contemporaneous evidence of any valuation of the publishing

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<sup>8</sup> Professor Perlman concedes that not all the intangibles of the publishing business were transferred, acknowledging in particular that the ownership of the trademark was retained. Ex. 201, p. 9. He describes the trademark as the symbol of the “reputational good-will” of a business. *Id.*, p. 10. This testimony significantly undermines the assertion that good will was permanently transferred to U S West Direct.

business. In response to a data request from Public Counsel requesting any valuation work or studies performed at that time, USWC responded: “No valuation studies of the directory publishing business were performed in 1983 in connection with the negotiation of the publishing agreement.” Ex. 312; Tr. 270 (Inouye); Tr. 426-427 (Johnson).

No consideration was paid by U S West Direct to PNB for the value of the publishing business. There was only an accounting change reflecting the removal of the book value of the assets transferred - \$23.5 million for the cash.<sup>9</sup> The publishing fees referenced in the 1984 agreement were not intended as compensation for the fair market value of the business. Tr. 273, 276 (Inouye). As the Supreme Court noted in its opinion, “[n]o one represents to this Court that U S West Direct has paid USWC the fair price for the yellow pages business.” 134 Wash. 2d at 94. The publishing fees were stated in the agreement as being paid for the “right to use”, during the term of the agreement, the intangibles discussed above, the ownership of which was retained by PNB, and to maintain the level of contribution to revenues that had been previously provided by Yellow Pages revenues. Tr. 274 (Inouye); Ex. 110, Ex. D, pp.3-5.

A salient feature of the arrangement between PNB, its successor USWC, and U S West Direct, is its impermanent nature. The initial publishing agreement was effective for only three years, with a maximum extension of only two years, in one year increments, solely at PNB’s discretion. Ex. 110, Ex. A.1, Sec. 1.01. Subsequent publishing agreements have also been for limited terms.<sup>10</sup> This is entirely consistent with what one would expect to see in a situation, where, as here, ownership to critical components of the publishing business was retained by the original publisher, PNB. On the other hand, the notion advanced by USWC in this docket, that a complete and permanent transfer of ownership can somehow be accomplished by means of temporary, limited term publishing agreements, abandons logic. USWC witness Inouye attempts to avoid this problem by arguing that “permanence” is not

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<sup>9</sup> Even using the Golden valuation as of the 1984 date, this represents only about 10 cents on the dollar for the business enterprise value.

<sup>10</sup> USWC Response to Bench Request No. 3.

relevant. Such protestations cannot negate the fact that fundamental to a sale or complete transfer of ownership is an element of irrevocability. If a party transfers rights only for “use,” and only for a limited term, and subject to that party’s re-exercise of those rights following the arrangement, it is difficult to see how such a transaction can be fairly characterized as a change in ownership or a sale. USWC has not produced any documentation of a permanent transfer of rights to intangibles, nor any documentation of a permanent designation of U S West Direct as the official publisher of directories.

The limited nature of the “transfer” is further underlined by the fact that the publishing agreements clearly provide for the possibility of PNB or USWC re-entry into the publishing business, a right which was conceded by USWC witnesses at the hearing. Tr. 269 (Inouye). Commissioner Hemstad’s exchange with USWC witness Inouye is instructive:

COMMISSIONER HEMSTAD: If the Publishing agreement had a limited duration, what was supposed to happen at the end of that three-year period?

MR. INOUE: I don’t know. I don’t think that the people knew at the time what was going to happen.

COMMISSIONER HEMSTAD: But how does that square with the idea that there was a complete sale of the ongoing business venture? In other words, put it this way: Assume for the purposes of discussion that PNB with a change of heart decided it didn’t want to continue the Publishing agreement, what became [of] USW Dex, what would be the consequences of the decision?

MR. INOUE: Of deciding not to continue?

COMMISSIONER HEMSTAD: Yes

MR. INOUE: Reentering the directory business would have been one option.

COMMISSIONER HEMSTAD: But not a transfer back to the Company of the business venture that it had earlier transferred?

MR. INOUE: That is another possibility.

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COMMISSIONER HEMSTAD: The fact that the Agreement had a limited duration is at least troubling isn’t it?

MR. INOUE: I believe that what they anticipated that there would be future contracts [sic].

COMMISSIONER HEMSTAD: I understand, but the Agreement did not contain language such as it would continue permanently or in perpetuity.

MR. INOUYE: No, it did not.

Tr. 337-339.

While USWC witness Johnson tried to argue at the hearing that U S West Direct would remain active in the directory publishing business, competing against its affiliate, even if USWC re-entered, he eventually conceded that this decision would be made by the parent corporation, based on the best interests of the shareholders. Tr. 438, 457-459 (Johnson).

The limited nature of the 1984 transfer was acknowledged by USWC's own counsel in the U-86-156 docket. USWC's brief stated:

The staff's apparent theory is that something the staff calls the "publishing function" was transferred from PNB to U S West Direct in 1984, and that on an unjust enrichment theory, PNB should be compensated by U S West Direct to put PNB in the same position it would have been in during 1987 and each succeeding year had the transfer not occurred, with respect to the opportunity cost of the transferred function. *As noted above, the fact is that PNB could publish now if it chose, so nothing was transferred in 1984.*<sup>11</sup>

The inconsistency between this characterization of the 1984 transaction, and the picture painted by the Company in this docket is glaring, to say the least.

USWC indeed presents a confused picture of the transaction which is supposed to have occurred. On the one hand, it concedes that a sale did not occur, and argues that the existence of sale in 1984 or at present is not necessary for it to prevail.<sup>12</sup> On the other hand, through various witnesses it argues that a complete and transfer of ownership did occur.<sup>13</sup> Apparently, therefore, a complete transfer of ownership must have occurred without benefit of a sale. Absent a sale, this could only have occurred by a gift, presumably. In its brief in this docket, USWC develops a third variation on the theme, characterizing the 1984 transaction as "part gift, part sale."<sup>14</sup>

All of these arguments have problems. USWC's argument that no sale is required in

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<sup>11</sup> Brief of Applicant Pacific Northwest Bell Telephone Company, Cause No. U-86-156, p. 24.

<sup>12</sup> USWC Brief, p. 21.

<sup>13</sup> Tr. 250 (Inouye); Tr. 378-79, 381 (Johnson "wouldn't call it a sale")

<sup>14</sup> USWC Brief, p. 20.



1984 or now is at odds with the directive of the Supreme Court that it is only through “treatment as a sale” that imputation can end.<sup>15</sup> USWC’s argument that a transfer of ownership occurred (but not a sale) is not supported by the evidence, which shows that important elements of the publishing business were retained by USWC. The argument that the transaction was all or part gift raises the question of why PNB or USWC did not in 1984, or any time subsequently, seek approval of a transfer by gift from the Commission under RCW 80.12. If they had, no doubt, the Commission would have denied the application. The notion that a regulated telecommunications utility can transfer ownership of valuable assets which are an integral part of its regulated operations by a “gift” to an affiliate, or any other party for that matter, without regulatory approval, is novel. It is hard to imagine any regulator granting such a request.

**D. USWC’s Theory is Incompatible with the Actual Regulatory Treatment Which Occurred**

The Commission’s regulatory treatment of the transfer of directory publishing operations is set out in detail in Section III (History of Regulatory and Judicial Action) above. USWC’s new theory in this docket is entirely inconsistent with that treatment. At no time has the Commission treated the 1984 transaction, or any subsequent event, as a sale or complete and permanent transfer of ownership of the directory publishing business. Upon sale or permanent transfer, the Commission could have distributed the realized gain and no longer concerned itself with the directory business. Instead the Commission has continued its jurisdiction over directory publishing and adopted the regulatory tool of imputation. The fundamental point here is that imputation of publishing revenue to USWC’s results of operations is a perpetuation of the *status quo*, that is, it replicates the situation prior to the attempted transfer of the publishing operation and revenue to U S West Direct. The purpose

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<sup>15</sup> USWC’s position that the “formalities” of a sale are not required mistakes the significance of this point. It is the absence of the formalities which undermines the Company characterization of the 1984 transaction as a complete transfer of ownership. Absent the formalities, the Company’s burden is an even heavier one to show that ownership was transferred. The Company is forced to grasp at straws such as the “gift” theory, or the argument that there was an unstated or implicit agreement of some kind.

of such an approach is to protect captive ratepayers from the harm which would result from diversion of those revenues. This approach is premised on the absence of a sale or transfer of ownership. This is a different regulatory response than that which would apply to the sale or transfer of ownership of a utility asset, which would involve valuation, determination of the gain, and distribution of the gain to ratepayers.

Of course, if a utility sells or transfers ownership of an asset, there is no need for imputation since the gain will be accounted for, ratepayers will be compensated, and the utility no longer owns the asset and can no longer be deemed to receive revenues as a basis for further imputation. On the other hand, so long as no sale or other form of complete transfer has occurred so as to provide full fair market value for the asset at issue, imputation should continue indefinitely, just as revenues would continue to flow indefinitely from any other asset which continues as part of regulated operations. The two regulatory tools – revenue imputation and treatment as a sale – are mutually exclusive in the context of this case. Prior to a sale or transfer of ownership, and final regulatory disposition, imputation is the appropriate tool, allowing continued recognition of revenues. Once the transaction is treated as a sale, however, with valuation, determination of gain and distribution of gain, imputation is no longer necessary and ceases. Moreover, past imputation is not subtracted from the gain which goes to ratepayers upon sale.<sup>16</sup>

The Commission itself recognized this distinction in its 1988 order in U-86-156 when it described the three regulatory remedies available to deal with the Yellow Pages transfer: (1) approval of the contracts with appropriate adjustment of the publishing fee, (2) return of the publishing function to PNB, or (3) the treatment of the transaction as the sale of a capital

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<sup>16</sup> The Commission treatment of Continental Telephone and its affiliated publisher is consistent with this approach. Imputation was employed up until sale of the affiliate (Leland). After the sale of the publishing business to a third party, amortization of the gain was used to reduce revenue requirement. Past imputation was not offset against the gain. Staff Motion for Partial Summary Determination, Affidavit of Paula Strain, Feb. 18, 1999, pp. 9-10.

asset. Docket U-86-156, Second Supplemental Order, p. 12.<sup>17</sup> As the discussion of regulatory history above explains, the Commission chose to proceed with the first option, the imputation approach, and has never treated the transaction as the sale of a capital asset. In its U-86-156 order, the Commission described the character of the sale remedy as involving (1) a determination of consideration at the time of transfer that would fairly compensate PNB, (2) assumption by U S West Direct of all of the risk of the publishing enterprise, (3) no further supervision by the Commission of the publishing enterprise, (4) freedom for U S West Direct to manage its business without involvement in future proceedings regarding the proper levels of compensation to PNB, and (6) receipt by PNB of the “value of its asset.” *Id.* On cross-examination, USWC witness Inouye acknowledged that none of these components of the sale remedy have yet come to pass. Tr. 306-310.

If none of these characteristics of the sale approach is present, how can USWC now argue that a sale or complete transfer of ownership occurred? If a complete transfer of ownership occurred, as USWC now asserts, why did not the Commission adopt the third option – treatment as a sale - at some point between 1984 and the present, rather than imputation? The answer is obvious – no permanent transfer of ownership for fair value has ever occurred.

Not only has no permanent transfer of ownership of the entirety of the business occurred to date, but on no occasion prior to this docket did USWC represent to the Commission that one occurred. As the Supreme Court noted, “the Company [USWC] has always been free to sell the [publishing] business for a fair value.” 134 Wash. 2d at 99. This statement makes no sense if a sale or permanent transfer had already occurred. It reflects the Court’s understanding that it had not. USWC has been free to seek treatment as a sale since 1984, and the opportunity was expressly extended to it by the Commission in 1988.

The characteristics or components of the sale remedy were clearly laid out in the 1988 order. Until this docket, USWC has never attempted to establish any of those components as

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<sup>17</sup> USWC’s failure to mention the “treatment as a sale” option when discussing the U-86-156 order is noteworthy. USWC Brief, p. 34.

a basis for ending imputation. Second Supplemental Order, Docket No. U-86-156, p. 12. Up until this docket, the Company has chosen not to pursue such treatment, and has instead chosen to either stipulate to imputation, or, most recently, to challenge its underlying legality with the goal of depriving the ratepayers of any benefit whatever from the business.

In its final order in USWC's 1995 rate case, the Commission reaffirmed its view of the nature of imputation. There the Commission summarizes its regulatory treatment of Yellow Pages as follows:

[F]or regulatory purposes in calculating performance, the Commission imputes "excess" revenues [of U S West Direct] to USWC results of operation.

Docket No. UT 950200, Fifteenth Supplemental Order, p. 34 (emphasis added). What this language again makes clear is that imputation is a regulatory tool used by regulatory commissions to redress efforts to improperly shift *revenues* (the "profitable aspects") to an affiliate. Irrespective of what USWC now claims it "transferred" in 1984, as recently as the 1995 rate case, this Commission continued to recognize a regulatory claim upon the directory business as a regulatory asset. Imputation continued in the 1997 rate case. Imputation is based on the actual income levels achieved by the affiliate, here U S West Direct, as if the transfer had not occurred. Imputation amounts represent the income stream or "rent" produced by the regulatory asset. The Commission did not in the UT 950200 order, or in any other proceeding, approve the transfer of this regulatory asset, nor has it ever determined a value for that asset. On the contrary, the Yellow Pages publishing business has from the outset been treated as a part of regulated operations, and continues to be so treated today.<sup>18</sup> USWC's new theory of a complete transfer of ownership in 1984 is entirely incompatible with the regulatory treatment afforded the transaction by the Commission.

#### **E. Summary: No Transfer of Ownership Occurred**

USWC's attempts to recharacterize the events of 1984 and subsequent regulatory treatment to fits its own strained theory of the case should be disregarded. Much of their case is based on semantics, quotes taken out of context, and Company interpretations which

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<sup>18</sup> *WUTC v. USWC*, Docket No. UT-970766, Tenth Supplemental Order, (Jan. 16, 1998).

“rewrite” Commission orders and court decisions. USWC’s outcome-driven argument in this case for use of a 1984 valuation date hinges entirely on USWC’s success in establishing that a complete and permanent transfer of ownership of the publishing business occurred in 1984. It has failed to do so for the basic reason that the facts do not and will not support such a post-hoc interpretation of events.

When the argument and rhetoric are stripped away the simple factual evidence establishes that the “transfers” that occurred in 1984 were of three kinds:<sup>19</sup> (1) a transfer of tangible assets (cash, one leasehold, station equipment, office equipment and furniture); (2) a publishing agreement which transferred only for a limited term a “right to use” critical elements of the publishing business, ownership of which was retained by PNB, and (3) contracts for administrative services. None of these individually or together can reasonably be said to accomplish the sale or ownership transfer of the entire Yellow Pages business. There was no documentation of any transfer of ownership, no valuation, and no consideration paid. The transactions were never represented to the Commission as a complete and permanent transfer or ownership although USWC had the option of “treatment as a sale” presented to it ten years before the filing of this petition. Not only is there no evidence that the 1984 transaction was intended at the time as a sale or transfer of ownership, such an interpretation of events is inconsistent with the regulatory treatment accorded the transaction. USWC’s position must fail.

## V. VALUATION

### A. The Central Issue in Valuation is the Selection of the Correct Time Period

The heart of the Company’s case is the complete revision of the history of actual transactions that occurred in 1984 and of the review by the Commission at that time and later. Mr. Timothy Golden, a professional appraiser and partner with PricewaterhouseCoopers, was retained by U S West to prepare the valuation component of the Company’s

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<sup>19</sup> There was also a Memorandum of Understanding regarding contracts for certain administrative services.

reconstruction of history. He was instructed to value the business only as of 1984 and was not provided with information about the history of regulatory treatment in Washington until later. TR. 534. Given the nature of the assigned task, Mr. Golden employed, by necessity, numerous assumptions regarding the identity of presumed buyers, growth rate assumptions, the buyer's cost of capital, and other key variables required to retroactively value the business. By his own admission, the exercise Mr. Golden was asked to engage in was unusual, since most valuation exercises are conducted in a time period coincident to the valuation date, rather than 15 years after the fact.<sup>20</sup> As properly noted in the Company's Opening Brief, "The central issue in this case is the identification of the proper valuation date".<sup>21</sup> The Commission should consider the tortured logic and frail assumptions upon which Mr. Golden was forced to rely for his work, given the unusual nature of his assignment.

Notably, Mr. Golden did not prepare any direct or rebuttal valuation estimates for the USWD publishing business more current than 1984, even though both Staff and Public Counsel provided considerable evidence that current valuation of the business is required if cessation of imputation is to be considered.<sup>22</sup> Staff presented the testimony of Dr. Lee Selwyn, a Ph.D economist with more than 25 years experience with telecommunications ratemaking and policy issues, to explain the relationship and transactions between U S West Direct and USWC and the many reasons why a current valuation of the directory business is required. Dr. Selwyn concluded that USWC has never received from its directory affiliate "payment" for the value of the publishing business and that the relevant 1999 value of the publishing business ranges from \$5.6 billion to \$7.4 billion depending upon the long term growth rate and discount rate assumptions that are employed.<sup>23</sup>

Public Counsel witness Michael L. Brosch, a regulatory consultant and professional accountant with over 20 years of public utility experience, presented extensive direct and

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<sup>20</sup> Ex. 401-T, page 3; Tr. 511-512 (Golden)

<sup>21</sup> USWC Opening Brief, page 36.

<sup>22</sup> Exhibits 601-T, 608-T, 801-T and 806-T.

<sup>23</sup> Ex. 801-T, pages 4-6, Ex. 804-C.

surrebuttal testimony explaining the reasons why a retroactive valuation of the directory publishing business is inappropriate.<sup>24</sup> Mr. Brosch indicated that a 1999 valuation estimate of the business would produce a result of up to \$8.5 billion using Company-provided forecast information and discounted cash flow approaches consistent with the Company's own analysis, except for input assumptions.<sup>25</sup> Mr. Brosch noted the importance of two key financial assumptions regarding the long term growth rate and discount rate used in the income approach to valuation estimation and calculated a matrix of 1999 valuation outcomes to illustrate the sensitivity to these assumptions within a valuation range of \$4.8 to \$9.3 billion.<sup>26</sup> Aside from the issue of valuation date, most of the dispute surrounding valuation involves these two issues.

### **B. Cost of Equity**

Mr. Golden is said to have “developed a cost of equity of a purchaser of the business based on an analysis of newspaper publishers, and a group of RBOCs as hypothetical purchasers.”<sup>27</sup> It is necessary to assume “hypothetical purchasers” because there was no true sale of the business in 1984, but instead a partial transfer between affiliates. Among the types of hypothetical purchasers Mr. Golden assumed relevant were newspaper publishers and a group of RBOCs. These purchasers contrast markedly to the 1984 transaction presented to the Commission which moved assets between controlled affiliates within a common parent RBOC. Noting this linkage to Mr. Golden's own analysis, Public Counsel witness Brosch recognized that this Commission has already rendered its own findings with respect to the cost of capital reasonably assigned to U S West, one of the RBOC's established at divestiture. In Cause No. U-82-19 and later again in U-85-52, which employed a 1985 test period, the Commission authorized a 14.75 percent return on equity, a return much lower

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<sup>24</sup> Ex. 601-T, pages 5-23.

<sup>25</sup> *Id.*, page 51.

<sup>26</sup> Ex. 608-T, page 48. A chart displaying sensitivities to various assumed WACC and Terminal Growth assumptions, using Company-prepared forecasts for USWD/Dex and Mr. Golden's DFC model.

<sup>27</sup> USWC Opening Brief, page 37.

than Mr. Golden employed in his hypothetical RBOC.<sup>28</sup> Mr. Golden's weighted average cost of capital ("WACC") and corresponding discount rate for valuation purposes is also excessive simply due to the date of valuation assumed by U S West, as indicated by historical trends in capital costs.<sup>29</sup> At almost any other time since 1960, the cost of capital to an assumed buyer of any business would have been lower than in the early 1980's, yielding a higher valuation for the firm than was estimated by Mr. Golden.

### **C. Growth Rate**

Another problematic assumption in revising the history of actual directory business transactions is Mr. Golden's effort to divine a growth rate for the business, in a sale to an assumed buyer as of 1984. The Commission should remain mindful of the fact that prior to 1984 there was no separately identified entity that operated or accounted for the directory publishing function within PNB. In his income approach to valuing the business, Mr. Golden used two calculations, an Actual Case and a Projected Case containing management's five year projections of USWD's income and actual USWD income from 1984 through 1997, respectively.<sup>30</sup> Beyond this "explicit" forecast (or actual income) period, it was necessary for Mr. Golden to estimate an assumed long term growth rate for the business.<sup>31</sup> In his rebuttal, Mr. Golden elaborated upon his long term growth rate, by explaining that it was comprised of an assumed 3 percent average level of inflation observed from 1926 to 1983, to which he added an additional 2 to 3 percent to reflect the real growth the business would likely enjoy and sustain, on average, beyond the terminal year.<sup>32</sup> However, Mr. Golden's combination of historically high capital cost rates in 1984, coupled with long run growth rate assumptions for USWD based upon only 3 percent ongoing inflation, tend to understate the value of the business in 1984. Further, Mr. Golden's own graph of the relationship between USWD

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<sup>28</sup> Ex. 601-TC, page 34.

<sup>29</sup> Ex. 603.

<sup>30</sup> Ex. 411, page 6.

<sup>31</sup> *Id.*, page 3.

<sup>32</sup> Ex. 403-T, page 25.



actual revenue growth and a CPI measure of inflation<sup>33</sup> supports a conclusion that, except for accounting aberrations in 1987, the real growth of USWD over 14 years is consistently higher than the assumption of 2 to 3 percent employed by Mr. Golden as of 1984. This demonstrated ability of USWD as publisher of the only official U S West directory to achieve consistent real growth well in excess of underlying inflation is supportive of Mr. Brosch's decision to employ a 5.5 percent terminal growth rate in his own 1999 vintage valuation estimate for the USWD/Dex business.<sup>34</sup> Dr. Selwyn's valuation estimate assumed long term growth rates ranging from 3.75 to 4.50 percent, based upon averages of growth rates used by U S West's Financial Advisors in 1997 and by Mr. Golden in 1984.<sup>35</sup> As noted above, Public Counsel witness Brosch provided a sensitivity table in his surrebuttal that indicates valuation estimates for the business enterprise in 1999 based upon alternative long term growth rate inputs the Commission may find reasonable.<sup>36</sup>

#### **D. The Effect of Tax Rate Changes**

The Company's income-approach valuation of U S West Direct business based upon actual results realized by the business from 1984 through 1997 uses other than actual income tax rates. This inconsistency was never clearly explained by Mr. Golden, particularly where he states in rebuttal that "my intent was to use 14 years of actual Business income statement and balance sheet information as a proxy for financial projections"<sup>37</sup> and further explains "there may have hypothetically been a very well informed manager in the Business in late 1983 who could have projected 14 years of pre-tax cash flows in line with actual performance." However, in spite of the claimed use of "actual" income statements as a proxy for perfect foresight, Mr. Golden inexplicably removes the actual income tax rate reductions that occurred and are recorded in the actual data. In its Opening Brief, the Company claims that "no one in 1983 could have foreseen the changes in the tax law", without attempting to

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<sup>33</sup> Ex. 406.

<sup>34</sup> Ex. 608-T, page 45.

<sup>35</sup> Ex. 804-C.

<sup>36</sup> Ex. 608T, p. 48.

<sup>37</sup> Ex. 403-T, page 39.

reconcile this dismissal with Mr. Golden's own premise regarding use of "actual" data as a proxy for hypothetically perfect management projections. Mr. Golden simply cannot have it both ways, presuming that a very well informed manager in the business can foresee all impacts upon actual business results 14 years into the future, while also pretending that manager to be blind as to future tax rate changes. The inconsistency in Mr. Golden's analysis does not exist in the current valuations prepared by Messrs. Brosch and Selwyn that employ current (lower) 1999 income tax rates.

**E. Mr. Golden's Market Approaches Are Flawed.**

USWC asserts that it is important in valuing a business to use more than one approach and that Mr. Golden employed two different market analyses, a Market Multiples comparison on his Schedule 5 and a Comparable Transactions summary on his Schedule 6. What is telling about these studies is the distinct absence of any transactions or multiples bearing a relationship to the hypothetical sale of directory publishing businesses like U S West Direct in 1984. Mr. Golden's failure to find any regional Bell company that has sold its official publishing business to a third party or any RBOC directory publishing business that separately trades in the capital markets weakens the usefulness of these secondary approaches.<sup>38</sup> Mr. Golden's analysis reveals that there is no precedent for the hypothetical transaction being modeled by the Company in this proceeding.

**F. The Commission Must Value the Publishing Business As of the Present Time, Not As of 1984.**

At page 36 of its Opening Brief, US West states correctly that no other party produced any estimate of the value of the directory asset as of 1984. This is true. Such a valuation is inconsistent with historical fact. All necessary elements of the USWD publishing operations were not permanently sold in 1984 and the directory asset continued to exist from a regulatory perspective and be recognized by the Commission in subsequent years. From a contractual perspective, the value of the exclusive right to publish the PNB (later USWC) white and Yellow Pages was also not transferred in 1984, but was instead periodically

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<sup>38</sup> Transcript Vol. 12, 538 and Ex. 419.

granted pursuant to publishing agreements effective every year thereafter. Imputations that have occurred represent the regulatory remedy associated with the inadequate levels of periodic compensation provided for under the publishing agreement, but have nothing to do with the hypothetical value of the publishing business in a true sale to an assumed third party buyer in 1984. U S West was unable to cite any Commission imputation order that identified imputation as bearing any relationship to the value of the publishing business as of 1984.

Both Staff and Public Counsel produced evidence of the range of values that might be assigned to the USWD business currently. Again, as in Mr. Golden's analysis, numerous judgments and assumptions are required in preparing such estimates, creating a wide range of potential outcomes using even Mr. Golden's income-based valuation model.<sup>39</sup> Mr. Brosch points out that even if the inputs<sup>40</sup> from the Company's own 1997 valuation are applied to the more current Company forecasts using Mr. Golden's model, a current valuation range of \$5.4 - \$6 billion is produced. More reasonable terminal growth rate assumptions that assume some real earnings growth for Dex produce much higher valuation estimates. For obvious reasons, U S West has elected to not address the present value of the publishing business, instead asserting that such value should be viewed as "fixed" in 1984 and offering only criticism of Staff's and Public Counsel more current estimates. Irrespective of quibbling over the input assumptions and estimation techniques, what is undeniable is that the directory publishing business within U S West's affiliate has experienced extraordinary value appreciation since 1984. The Company's goal in this proceeding is to deny the benefits of such value appreciation to ratepayers.

## **VI. IMPUTATION ISSUES.**

### **A. The Nature and Purpose of Past Yellow Pages Imputation in Washington**

Critical to USWC's present case is a gross mischaracterization of the directory imputation process that has been consistently employed by the Commission. According to the Company's Opening Brief, it is a "fact that directory revenues (and publishing fees) that

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<sup>39</sup> Exhibit 608-T, p. 48.

<sup>40</sup> WACC discount rates and the relatively low terminal growth rates.

have been included in rates since 1984 have fairly compensated ratepayers for the value of the asset transferred, thus meeting the final requirement for ending imputation.”<sup>41</sup> This “fact” is completely at odds with the historical purpose of imputation, the manner in which it has been calculated, and the Commission’s own rationale for imputation in its orders. Moreover, Company witnesses acknowledged at the hearing that this is a reversal of the Company view of imputation at all times prior to the Supreme Court decision. Tr. 284 (Inouye): Tr. 989-990 (Koehler-Christensen).<sup>42</sup>

The publication of white and yellow page telephone directories has always been inextricably related to the provision of basic local telephone service, a fact recognized by Judge Green during the AT&T divestiture. *U. S. v. AT&T*, 552 F. Supp. 131 (1982); *see also*, Docket U-86-156, Second Supplemental Order, pp. 8-10, also citing *U.S. v. Western Electric*, 592 F. Supp. 846, 865 (1984) (observing that, by diverting directory publishing and its revenues to affiliates, some RBOCs appear to have breached the understanding upon which they received the Yellow Pages publishing operations in the divestiture decree).

This historical foundation for directory revenue imputation was noted in the Supreme Court decision:

Historically, US West and its predecessor, PNB, published telephone directories which included the yellow pages advertising. The companies then included revenues from the advertising in their regulated results of operations. The telephone directory business is a very lucrative business, and US West acknowledges that revenues collected from selling yellow pages advertising far exceed the costs of producing the advertising and the directories.

134 Wash. 2d. at 87-88; *see also id.*, at 99-100. Regulatory commissions have consistently included the results of white and yellow pages publishing in setting rates. When Bell operating companies began the process of removing the Yellow Pages operations to affiliates,

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<sup>41</sup> USWC Brief at page 48.

<sup>42</sup> It is again worth noting here that USWC also agreed in both the AFOR and Merger case settlements to a continuation of imputation. The effect of the Company’s settlement of the merger case is the subject of Public Counsel’s separate brief on our Motion for Summary Determination, filed concurrently herewith.

regulatory commissions employed imputation as a means of continuing the appropriate recognition of the directory publishing revenues in the overall revenue picture of the operating company. *Turpen v. Oklahoma Corporation Commission*, 769 P.2d. 1309, 1327 (Okla. 1988).<sup>43</sup>

Imputation and publishing fees are associated with the continuing operations and profits of the directory affiliate on a periodic basis. Imputation is a regulatory tool designed to preserve the flow of revenues from a regulatory asset and maintain the pre-transaction *status quo* with respect to the directory segment of the business, as if no transfer had occurred at all.<sup>44</sup>

This purpose of imputation has been made clear by the Commission in its rate orders. As noted above in Section IV.D., in its Fifteenth Supplemental Order in Docket No. UT-950200, the Commission stated:

[F]or regulatory purposes in calculating performance, the Commission imputes the “excess” revenues to USWC results of operation. The Company agreed that the merger would have no effect on imputation. 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 customers with expenses of the operation but with reduced offsetting revenues from related services.

Fifteenth Supplemental Order at 34. This Commission has never adopted USWC’s premise that the directory business is no longer a regulatory asset.<sup>45</sup>

**B. Imputation and Publishing Fees Are Not Installment Payments for Transfer of the Fair Value of the Publishing Business.**

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<sup>43</sup> See additional citations in Washington Supreme Court decision, 134 Wash. 2d at 100-101 and footnote 9.

<sup>44</sup> Ex. 608-T, p.4; Tr. 259, 347 (Inouye: acknowledging this description of imputation)

<sup>45</sup> A closely related line of authority holds that regulators may require “royalty” payments from a long distance subsidiary to compensate a local exchange parent and its ratepayers for intangible benefits received from the parent including use of name, logo, goodwill, and availability of finance and personnel. *United Telephone Long Distance v. Nichols*, 546 So. 2d 717, 179-720 (Fla. 1989); *In Re Rochester Telephone Corporation*, 145 P.U.R. 4<sup>th</sup> 419 (NYPSC 1993).

U S West Direct paid publishing fees pursuant to Article X of the initial 1984 publishing agreement in exchange for certain defined rights and obligations of USWC and U S West Direct over a period of several years.<sup>46</sup> Among the rights obtained by U S West Direct was the ongoing designation as the exclusive publisher of the official U S West white and Yellow Pages. Out of necessity in its reconstruction of history, USWC now recharacterizes publishing fees to be compensation for the value of assets allegedly transferred completely in 1984. However, nowhere in the publishing agreement is there any reference to assets that were transferred or the value of such assets. The publishing agreement is also silent with respect to the Company's new theory that such payments now represent installment payments related to 1984 asset transfers.<sup>47</sup>

A further problem with USWC's theory is the fact that the publishing fees paid by U S West Direct were discontinued after 1988. This is at least five years prior the date when, under USWC's new calculations, full fair value was received by ratepayers. Tr. 992 (Koehler-Christensen). For the Company's historical reconstruction to have any credibility, one would expect to see such fees continued until full fair value had been paid, USWC has been unable to point to any finding by a court or this Commission that imputation amounts to installment payments on the 1984 value of the directory business, nor has USWC cited to any party's description of them as such. What is most apparent from a review of the history of prior dockets is that USWC has abandoned its numerous prior bases for objecting to imputation and has now adopted a new and far-fetched installment sale argument.<sup>48</sup> As noted in the publishing agreement, publishing fees that existed in the early years after formation of U S West Direct were to compensate for the use of intangible assets that were retained by USWC and not transferred to the publishing affiliate.<sup>49</sup> Indeed, U S West Direct continues to serve as the "official publisher" of USWC's directories on an exclusive basis under the publishing agreement currently in effect, and in that capacity is the only publisher

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<sup>46</sup> Ex. 602 at page 10; Ex. 110 (Ex. A.1).

<sup>47</sup> Ex. 608-T, page 14.

<sup>48</sup> Ex. 601-T, page 12.

<sup>49</sup> Id., page 15.

to receive business referrals from USWC.<sup>50</sup>

**C. USWC Has Never Taken the Available Alternative to Imputation - To Have the 1984 Transaction Treated as A Sale**

USWC could have asserted its installment sale theory in earlier proceedings before the Commission but has failed to do so. As discussed above in Sections III and IV, the Commission clearly laid out the option of “treatment as a sale” in its Second Supplemental Order in Docket No. U-86-156 at page 12:

The remedies to be considered include the approval of the contracts with appropriate adjustment of publishing fees, the return of the publishing function to PNB, or the treatment of the transaction as the sale of a capital asset.

Subsequently, USWC could have advanced the installment sale theory in the AFOR proceeding, the merger proceeding, or the UT 950200 rate case, but did not. It may not now be heard to argue that imputation was all along part of “treatment as a sale” or that the valuation of the business was fixed as of 1984.

**D. USWC’s Criticism of the “Rent” Analogy Is Not Well-founded.**

In its Opening Brief, the Company states that the “rent” analogy employed by Staff and Public Counsel is unsupported “because no party advocating that theory provided any support whatsoever for the value of the assets allegedly “rented” or the reasonableness of the amount of imputation as a rental payment.”<sup>51</sup>

In fact, USWC’s own witness Golden uses the term “rent.” Estimating that publishing fees effect an approximately \$200 million reduction in his valuation, he stated:

So really a base case of 1.5 billion to 1.8 billion was sort of the best case. That assumed that in that price, in that price it can’t get any better; *that you have the right to use the intangible assets, and anything you would have to pay to borrow them or rent them* would only detract from the value so the business could not have been worth any more than that.

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<sup>50</sup> Response to Bench Request 3, Attachment A, at para. 5.2.

<sup>51</sup> USWC Brief at 50.

Tr. 566 (emphasis added). USWC’s argument is a “straw man” which falls upon consideration of the way in which imputation has been calculated by the Commission, based upon the achieved excess earnings of the directory publishing affiliate. It was never necessary to “value assets” for the Commission to conclude that imputation is required. Imputation was a ratemaking adjustment representing a periodic calculation of the annual amount of excessive returns and revenues realized by the publishing affiliate. These revenues were realized because of inadequate consideration from the affiliate under the publishing agreement for the intangible benefits associated with the linkage to the regulated telephone company. Such a periodic, annual imputation amount that is based upon achieved income earned in a particular test period is quite analogous to “rent” on the directory publishing regulatory asset. There was never a need for imputation to be labeled “rent” for the economic substance of the imputation calculation to be understood.<sup>52</sup>

**E. Ratepayers Have Continued to Bear the Risks of the Publishing Function Under Imputation.**

The Company asserts that cumulative publishing fees and imputation amounts should be considered compensation for the fair value of the directory publishing business as of 1984.<sup>53</sup> The effect of this approach is to “fix” or “freeze” the valuation of the business and deny ratepayers any participation in the appreciation in business value since 1984. This is clearly inequitable, since ratepayers have remained at risk for the costs and risks of the publishing business under the imputation approach continuously since 1984. Because imputation caused ratepayers to remain “at risk” and not have the security of assured payments,<sup>54</sup> ratepayers now are entitled to claim the appreciation in the value of the business. Fundamental regulatory principles require that ratepayers receive the full value attributable to the Yellow Pages publishing business. Prior to the 1984 transaction, all of the revenues and

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<sup>52</sup> Ex. 608-T at 11.

<sup>53</sup> USWC Brief at 51.

<sup>54</sup> The initial publishing agreement was promoted as promising ratepayers assured future payments in application before the Commission. However, such payments were inexplicably halted after 1988. Ex. 609 (Okamoto/Johnson letter)



expenses attributable to the publishing operation were included in PNB's results of operation. Ratepayers have continued to bear the risks of ownership of the publishing operation. The imputation calculations that have occurred since 1984 fully reflect the changes in revenues, expenses, and investments experienced by U S West Direct, causing ratepayers to fully bear whatever economic burden is attributable to directory operations.<sup>55</sup> Ratepayers have remained at risk for the variability in directory revenues and income since the 1984 transaction through the imputation process and ratepayers should therefore participate in the appreciation in value of the business as compensation for assuming these risks.<sup>56</sup> These risks of ownership can be compensated only if ratepayers receive all of the benefits of the sale of the publishing business.

This is consistent with the prevailing rule that ratepayers are entitled to the gain on the sale of utility property when ratepayers shoulder the burdens attributable to ownership. *Democratic Central Committee v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786 (D.C. Cir. 1970); Leonard S. Goodman, The Process of Ratemaking, 746 (1998). This principle is well established in this Commission's decisions. In a 1997 USWC application for authorization to sell its interest in Bellcore, the Company argued that there was no basis to allocate the gain between shareholders and ratepayers, because the asset being sold had never been in ratebase. The Commission rejected this argument, holding:

The Commission is of the opinion that all of any gain realized from the sale of Bellcore should accrue to the benefit of the ratepayers who, through time, have funded USWC's investment in Bellcore through a return element included in payments to Bellcore for services. Any Washington intrastate gain on the sale of Bellcore should promptly be passed through to the benefit of customers in this state.<sup>57</sup>

Here, similarly, imputation includes a return element, since imputation is based only upon excess revenue above the authorized rate of return. In *Puget Sound Power & Light Company*,

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<sup>55</sup> Ex. 608, p. 10.

<sup>56</sup> Ex. 608, p. 11.

<sup>57</sup> *In the Matter of the Sale of U S West Communications, Inc.'s Interest in Bellcore Research Communications, Inc.*, Order Granting Application (August 27, 1997). The application was filed under protest after the Company was ordered to obtain authorization in a Declaratory Order in Docket UT-961596.

Cause No. U-85-53 Fourth Supplemental Order, pp. 30-34, (May 16, 1986), the Commission considered the proper ratemaking treatment of the electric utility's gain from the sale of surplus property, much of which was transferred to a subsidiary, Puget Western, at book value. The Commission accepted Public Counsel's argument that it was unfair not to recognize the gain on sale for the benefit of ratepayers, declaring: "The arguments are persuasive that, because the ratepayers have shouldered the risks of ownership, they should share in the benefit of the sale." *Id.*, Fourth Supplemental Order at 33. The Commission went on to note the significance of the fact that many of the sales involved Puget's own affiliate:

Circumstances here are particularly sensitive because of the transactions between Puget and its subsidiary, PWI. As Puget diversifies, the temptations and the opportunities for self-dealing among subsidiaries and affiliates multiply. The proposed adjustment will reduce such temptations.

*Id.*, at 34. This approach to gain on sale has been repeated reaffirmed by the Commission in subsequent decisions.<sup>58</sup>

The Commission's U-86-156 order recognizes this apportionment of risk as one of the characteristics of the "treatment as a sale" remedy.<sup>59</sup> Because that component of the sale remedy has not yet come to pass, and risk remains with ratepayers, it is not appropriate to value the publishing business as if a transfer of ownership occurred in 1984 or at any date prior to the current time frame of this docket.

#### **F. The End of Imputation**

A core issue in this proceeding is whether and when imputation should end.<sup>60</sup> As the

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58 *WUTC v. Puget Sound Power & Light Co.*, Docket Nos. U-89-2688-T, U-89-2955-T, Third Supplemental Order, pp. 52-53; *In the Matter of Application of Washington Water Power Company for Orders Authorizing and Approving the Terms of a Sale and Leaseback of the Applicant's General Office Building and Certain Adjacent Properties*, Cause No. FR-86-150, Order Granting Application, p. 2 (authorization based on premise that 100 percent of gain on sale is credited to ratepayers). *See also WUTC v. Puget Sound Power & Light*, Docket Nos. UE-920433, 920499, and 921262, Eleventh Supplemental Order, pp. 49-50.

59 Docket U-86-156, Second Supplemental Order, p. 12.

<sup>60</sup> If it is determined that imputation should end, the question of how it should end is addressed in Section VIII of the brief -- "Recommended Action".

Washington Supreme Court stated: “US West may petition the Commission for an end to imputation *if and when* it can show *it* has received fair value for the transfer of the asset.” 134 Wash 2d. at 102. (emphasis added).

It is Public Counsel’s position that under the Supreme Court’s decision imputation can end only when USWC itself has established that it has received fair value for the publishing business. Fair value had not been received as of the Supreme Court’s decision at the end of 1997, a fact reflected in the Court’s statement that “[n]o one represents to this Court that U S West Direct has paid U S West the fair price for the yellow pages business.” 134 Wn.2d at 94. There is no evidence in the record that fair value has been received by USWC since 1997. The Supreme Court also makes clear that it is when the transaction is treated as a sale of the asset and a fair price paid, that imputation of revenue can cease. *Id.* at 102.

USWC’s entire case is little more than an attempt to finesse the Supreme Court requirement. Although USWC engaged Mr. Golden to estimate what a fictional buyer of the directory business might have paid for the business in 1984, the Company cannot avoid the obvious fact that no real transaction at such fair value actually occurred. If we follow the historical reconstruction to a logical conclusion, such a payment of fair value in 1984 would have enabled the Commission to consider in 1984 how to credit customers with a large liquidating payment in lieu of ongoing imputation, publishing fees or other “rents” produced by the business. However, none of this happened and U S West Communications still cannot show that *it* has received fair value for the directory business, as required by the Court.

The Company’s Brief attempts to distract from this failed showing by pointing to a single sentence from Public Counsel and AARP’s 49-page Supreme Court brief in UT-950200.<sup>61</sup> USWC apparently now argues that its entire theory of the case is based on this

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<sup>61</sup> Brief at pp. 1, 50. The passage cited states: “If U S West believes that imputation has been sufficient, it should petition the WUTC to perform a valuation of the asset that was transferred (the publishing right) and the value that had been received from imputation to determine whether imputation should continue.” Response Brief of Public Counsel and

passage and that Public Counsel invited the Company to redefine imputation and publishing fees to now be installment payments on a fixed 1984 fair value. USWC's argument reads its own desired meaning into this language, takes it out of context, and gives it undue significance. USWC had not in UT 950200 or any prior case characterized imputation as the equivalent of installment payments on a sale of the business. The issue was not before the Commission or the Court and was not being briefed or argued by the parties. The quoted language makes no reference to the installment payment theory or the use of a 1984 valuation date. The section of the brief from which this statement is drawn addresses the question whether imputation is a "subsidy," an issue which the quoted language does not address. Read in context, the statement in Public Counsel's brief was clearly an aside, at most a preliminary effort to anticipate how the issues might be framed. Moreover, the cited statement only suggests how USWC's filing might look, it does not agree not to dispute the issues raised in that filing, including the effect of imputation.<sup>62</sup>

USWC also engages in selective quotation from Mr. Brosch's deposition to support or "affirm" that imputation is "compensation for the fair value of the business." Mr. Brosch actually said in deposition:

It is important that ratepayers receive compensation in an appropriate amounts at an appropriate time. And my testimony explains in greater detail what that means today, given what has transpired in the past...It's conceivable that ratepayers could be compensated without US West communications receiving payment. In fact, ratepayers have been compensated without US West Communications receiving compensation through the imputation process on a periodic basis for a number of years.<sup>63</sup>

The use of the general term "compensation"<sup>64</sup> here is interpreted by the Company to mean installment payments on a sale. In the context of his entire testimony in the case, Mr. Brosch

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AARP, Washington State Supreme Court No. 64822-1, p. 34.

<sup>62</sup> In its brief, USWC suggests that Public Counsel's witness, Michael Brosch, "repudiated" this statement on cross-examination at the hearing. On redirect, Mr. Brosch made clear that what he repudiated was USWC's interpretation of the language and its theory of the case. Tr. 749.

<sup>63</sup> Ex. 610 at 59.

<sup>64</sup> Supreme Court decision, 134 Wash. 2d. at 94, n. 7 (defining compensation).

is obviously referring to revenue imputation. This is compensation in a periodic sense, related to the achieved earnings of the directory business in a given test period.

A more relevant point later in the same deposition was not cited in the Company's Opening Brief:

It's conceivable that this lump sum payment to ratepayers, in lieu of imputation, might occur without communications— U S West Communications receiving full fair value in a complete sale. But I suspect that the company would object to that, since it previously has challenged ratepayer entitlement to such a liquidating payment.<sup>65</sup>

Only a treatment as a sale with receipt of fair value proceeds by USWC would position the Company to credit customers a lump sum amount in lieu of continued imputation, and no such sale or lump sum has yet materialized except in the Company's imagination.

## VII. OTHER ISSUES

USWC makes much of the fact that its basis for bringing this proceeding is simply to follow the dictates of the Supreme Court regarding valuation of the Yellow Pages business. By raising the additional issues addressed in this section, USWC makes it apparent that its overall goal continues to be diversion of the benefits of the business to the shareholders of the parent and away from ratepayers.<sup>66</sup> Under USWC's Section 253 and Takings Clause arguments, even if its 1984 valuation theory fails, and even if prior imputation is held not to constitute installment payments on the value of the publishing business, imputation would still come to an end, even though USWC had never received fair value. These arguments, or variations on these arguments, have been raised by the Company before and have been rejected. They should be given short shrift here.

### A. Section 253 Barrier to Entry

USWC now asks the Commission to consider whether imputation of Yellow Pages

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<sup>65</sup> *Id.* 64.

<sup>66</sup> USWC's First Amendment claim is not addressed here, pursuant to the Ninth Supplemental Order in this docket. Public Counsel, AARP and TRACER support the Staff's motion and adopt the argument and authority set forth in Staff's memorandum. Response of Public Counsel, TRACER and AARP to Commission Staff's Motion for Partial Summary Determination (filed March 9, 1999).

revenues is barred by Section 253 of the Telecommunications Act of 1996. The basis of USWC's argument is that such imputation "constitutes a subsidy to local service, designed to support and encourage universal service[.]"<sup>67</sup> USWC's argument is not a new one. It has been arguing for many years that imputation amounts to a subsidy of local service. The "subsidy" argument was expressly raised in the UT 950200 rate case as one of the Company's 18 different arguments against imputation. The Commission responded:

The Commission rejects this argument. The proposal [imputation] is not a universal service subsidy. It is a ratemaking adjustment. Its purpose is to reflect funds that would be available to the Company, but for Company action. In any event, the Commission finds in this Order that existing rates for local exchange service do cover incremental costs of providing that service, which thus needs no "subsidy," and the Commission does not attribute or " earmark" the directory imputation directly to any class of customers. Thus the subsidy argument is inapposite.

UT 950200, Fifteenth Supplemental Order at p. 36.<sup>68</sup> This holding was not disturbed on appeal. This proceeding has not examined the question of whether imputation is a "subsidy" and the Commission's order in UT 950200 finding that local service is not subsidized still stands. USWC does not point to any economic evidence in the record of this docket in support of its argument. There is no basis in the record to support such a finding by the Commission.<sup>69</sup>

USWC's brief argues that the so-called subsidy is akin to the type of barrier disfavored under antitrust law and is anti-competitive. The Supreme Court rejected basically the same argument when it was made by USWC in the UT 950200 appeal:

The Company also argues that to price services that are subject to competition below cost by subsidizing them with revenues may violate the antitrust laws. First, the Commission concluded, and there has been no contrary showing on appeal, that price subsidies do not exist. Further, the record shows that

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<sup>67</sup> USWC Brief at 55.

<sup>68</sup> *See also*, UT 950200, Fifteenth Supplemental Order at 36 ("The Commission specifically finds that the imputed revenues do not provide a subsidy to any customers or class of customers.")

<sup>69</sup> In fact, absent imputation, ratepayers are subsidizing the shareholders of the parent holding company. 134 Wash. 2d. at 100-101, citing *Turpen v. Oklahoma Corporation Comm.*, 769 P.2d. at 1327.

U S West has admitted that no legal action has been brought against U S West or any other regional Bell telephone company alleging that the imputation of yellow pages revenues is anticompetitive or in violation of antitrust laws, in spite of the many jurisdictions imputing income. U S West also argues that imputation will stifle competition. None of the parties in this case which are competitors support U S West's argument that imputation will harm competition. We consider this inquiry to be a matter of policy within the discretion of the Commission.

134 Wash. 2d. at 99. USWC has cited no case law whatever regarding the application of Section 253, much less any case law in support of its theory that imputation violates that section. The Company has provided no evidence of any competitor whose entry into the telecommunications market has been barred, or even hindered, by imputation. No competitors have intervened in this proceeding to argue for an end to imputation on this theory. This effort to reargue a challenge to imputation that was, in its essentials, argued to and rejected by the Commission and the Supreme Court in UT 950200, should be denied.

**B. Imputation of Yellow Pages Revenue Does Not Constitute an Unconstitutional Taking Without Just Compensation.**

USWC's petition also alleges that imputation constitutes a "taking" in violation of the Fifth and Fourteenth Amendments of the United States Constitution and Article I, Section 16 of the Washington Constitution. USWC argues that imputation improperly sets rates for regulated services based upon non-public utility activity involving property in which the telephone ratepayers have no interest and for which fair value has been received. USWC also argues that USWC is denied revenue to which it is otherwise entitled.

Again, USWC seeks to reargue positions which it lost when presented in UT 950200. In that case, the Company argued, *inter alia*: (1) that U S West Direct revenues were nonregulated revenues "and not only may the Commission not consider them, it exceeds its statutory authority and commits a dire constitutional violation by attempting to do so;"<sup>70</sup> (2) that the Commission cannot interfere with the Company's right to conduct a nonregulated business; and (3) that imputation regulates advertising, which is not subject to regulation by

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<sup>70</sup> UT 950200, Fifteenth Supplemental Order at 34.

the Commission. Here, the Company argues that Yellow Pages publishing is not associated with USWC's furnishing of telephone service, but rather belongs to U S West Direct and its shareholders. Essentially, both in UT 950200 and here, the Company is arguing that the Commission is attempting to regulate the unregulated affiliate and exceeding its authority. The argument that the Commission is somehow trying to regulate the affiliate was addressed in UT 950200:

There is no seizure of revenues, which are at all times entirely under the control of the affiliate and are never used or directed by the Commission. Id. at 34

\* \* \*

The proposed imputation does not interfere with USWC's right to conduct any business its wants, nor does it interfere with its affiliate's right to conduct any business. Id. at 34

\* \* \*

The Commission exercises no jurisdiction over advertising, which is not regulated in any way by this [imputation] proposal. Only the utility is regulated or affected, pursuant to statutory and Constitutional authority. Id. at 35

The Supreme Court concurred in the Commission's analysis that it did not intend to "regulate the yellow pages business." 134 Wash.2d. at 96.

USWC's basis for a takings claim is confused and poorly supported. It is unclear upon whose behalf it is making such a claim. USWC refers to the taking of property from U S West Dex, and to the failure of U S West, Inc., to earn a fair return on its investment. Neither Dex nor US West, Inc., are parties to this proceeding. The Commission should not entertain claims made on their behalf by USWC. USWC's own claim seems to be based on an alleged failure to earn a fair rate of return on its investment. The record in this docket does not contain evidence regarding whether USWC is or is not earning a fair rate of return. The issue was not litigated. Indeed, the Supreme Court observed that "[i]mputation does not keep the company from earning its revenue requirement -- it simply rectifies an unfair transfer." 134 Wn.2d at 98. In order to make out a takings or confiscation claim, USWC must show that the Commission's actions produce overall rates so low as to jeopardize the financial integrity of



the Company. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989)(the “end result” test). USWC’s ability to substantiate a takings claim here is surely rendered more difficult, if not impossible, by the fact that both USWC and U S West Direct are owned by the same corporate parent and have no shareholders of their own.

USWC has provided no case law to support its proposition that imputation violates the Takings Clause. Persuasive authority to the contrary does exist however. The Colorado Supreme Court, in a case involving Mountain Bell’s transfer of its Yellow Pages operation to U S West Direct rejected the Bell company’s argument that the Colorado Commission had engaged in an unconstitutional taking of private property, holding:

Mountain Bell argues that the publishing assets belong to its shareholders who took the risks to develop the publishing business...[W]e reject Mountain Bell’s characterization of its publishing operations as purely private. The directory publishing business was developed over the past fifty years within the protective shelter of Mountain Bell’s monopoly of telephone service. The assets were included in the base upon which Mountain Bell was permitted to earn a return. Mountain Bell concedes that Yellow Pages have always generated “supra competitive” profits.

*Mountain States Telephone and Telegraph Co. v. Public Utilities Commission*, 763 P.2d. 1020, 1027-28. (Colo. 1988), *cited with approval* , *USWC v. WUTC*, 134 Wash. 2d. at 100; *see also, United Telephone v. Nichols*, 719 So. 2d at 720 (royalties do not amount to a taking).

Perhaps the most surprising argument presented by USWC is the suggestion that imputation does not result in a taking until after 1995, allegedly the date after which the value of the publishing business was fully compensated. This argument ignores the fact that USWC never claimed that the asset was fully compensated, and hence that imputation should have ended, whether in 1993, 1995 or at any other time, until this docket.

### **VIII. RECOMMENDED ACTION**

USWC has the burden of proof in this docket to show that it has established a basis for imputation to cease. As set forth in the Order Denying Petition to Enter Declaratory Order, USWC’s first claim is that “fair value has been received for the yellow pages directory

asset.”<sup>71</sup> The Commission stated that this issue required the production of evidence upon:

- 1) the appropriate period in which to value the asset;
- 2) the fair value of the asset; and
- 3) the actual amount of revenue received in satisfaction of that fair value.

Id.

USWC has not carried its burden on these issues. For the reasons set forth in this brief, and in the evidence of record, USWC has failed to establish that the asset should be valued as of 1984. Because the 1984 valuation date is improper, and because of other flawed input assumptions and methodologies, USWC’s hypothetical valuation for that date must be disregarded. Furthermore, USWC has failed to establish that imputation and publishing fees constitute payment in satisfaction of the full value of the Yellow Pages publishing business, that USWC has ever treated the 1984 transaction as a sale, or has otherwise received compensation for the fair market value of the publishing business.

Under the holding of the Supreme Court decision, imputation may cease when USWC has made a showing that it has received full and fair compensation from U S West Direct for the value of the Yellow Pages publishing business. USWC has not made that showing.

Accordingly, Public Counsel recommends that the Commission continue imputation at this time. There has been no material change in the circumstances present in the last two rate cases in which imputation was ordered to continue. Regulatory imputation remains appropriate because the affiliate contracts involved in USWC directory publishing are unreasonable and result in ongoing inadequate compensation for the telephone company and its ratepayers.<sup>72</sup>

In the event that the Commission decides that imputation should cease at this time, it should require that ratepayers receive a liquidating payment based upon the full fair market

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<sup>71</sup> Order Denying Petition, p. 2. As argued in Section VII., USWC has also failed to establish that imputation is unlawful under its other claims (Section 253, Takings Clause). Public Counsel also relies on its Motion for Summary Judgment, the separate brief for which is filed concurrently herewith.

<sup>72</sup> Ex. 601T, p. 57.

value of the directory publishing business, including all intangible assets. This value should be a current period estimate, rather than on the basis of Mr. Golden's 1984 estimate.<sup>73</sup>

To reasonably quantify a liquidating value credit to ratepayers in lieu of continued imputation, customers credits in an amount no less than \$861 million and up to \$2.3 billion may be determined reasonable and compensatory in Washington. If the Commission were to determine and specify appropriate financial inputs, such as Weighted Average Cost of Capital discount rates, growth rates, and the projected financial results thought to be the most reasonable, a more refined liquidating value within this broad range could be calculated.<sup>74</sup> One approach would be to determine from the record a most appropriate WACC discount rate and growth rate and then apply the business value from the table set out in page 48 of Exhibit 608T. After applying a Washington allocation factor to this value, the credit to customers can be derived.<sup>75</sup>

Public Counsel recognizes that USWC has elected not to provide a statement of its position with respect to current valuation assumptions. It may, therefore, be more appropriate to allow the Company another opportunity to present valuation evidence, once a determination is made by the Commission of the appropriate valuation date.

Mr. Inouye offers an alternative ratemaking process in the event the Commission determines that 1984 is the proper valuation date but that some amount of value has not yet been provided to ratepayers. His alternative is to apply a rate base credit.<sup>76</sup> Public Counsel opposes this alternative. It is inappropriate to credit rate base in lieu of directory imputation amounts otherwise due ratepayers. A rate base credit would seriously dilute the economic benefits that ratepayers are entitled to in the absence of a treatment as a sale at fair value and a liquidating credit. A rate base credit creates revenue requirement "savings" of less than 15 cents per dollar of rate base. Mr. Inouye does not propose an amortization of the rate base credit, but would simply retain the principal amount as if permanently added to the

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<sup>73</sup> Id.

<sup>74</sup> Id., pp. 57-58.

<sup>75</sup> Ex. 608T, pp. 48-49.

<sup>76</sup> Ex. 608T, pp. 34-35.

depreciation reserve balance. This approach is unsupported by any analysis of depreciation rates or reserves and should be left for careful analysis within the context of ratemaking.<sup>77</sup>

### IX. CONCLUSION

For the foregoing reasons, Public Counsel, TRACER and AARP respectfully request that the Commission deny USWC's petition to end imputation, or in the alternative, adopt the approach set out in Section VIII. Recommended Action.

DATED this 25<sup>th</sup> day of October, 1999.

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<sup>77</sup> Id.