BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Request of Sprint Nextel Corporation for an Order Declining to Assert Jurisdiction Over or, in the Alternative, Application of Sprint Nextel Corporation for Approval of the Transfer of Control of United Telephone Company of the Northwest and Sprint Long Distance, Inc. From Sprint Nextel Corporation to LTD Holding Company.	DOCKET NO. UT-051291

REBUTTAL TESTIMONY OF
GLENN R. DANIEL
ON BEHALF OF SPRINT NEXTEL CORPORATION

JANUARY 5, 2006

CONFIDENTIAL AND HIGHLY CONFIDENTIAL
PER PROTECTIVE ORDER IN DOCKET NO. UT-051291

[REDACTED VERSION]

SECTION 1: NAME/PURPOSE

Q. Please state your name and business address.

A. My name is Glenn R. Daniel. My business address is Houlihan, Lokey, Howard & Zukin Financial Advisors, Inc, One Sansome Street, 17th Floor, San Francisco, CA 94104.

Q. Are you the same Glenn R. Daniel who previously filed direct testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my Rebuttal Testimony is to respond to statements made in the testimonies of Mr. Stephen G. Hill, who filed Direct Testimony in this proceeding on behalf of Public Counsel and Ms. Kathleen M. Folsom, who filed Direct Testimony on behalf of the Staff of Washington Utilities and Transportation Commission ("Staff"). The testimonies were filed on November 30, 2005. In responding to these testimonies, I will clarify certain misrepresentations presented by the witnesses, as well as explain the flaws contained in various arguments they make regarding the financial viability of the new LTD Holding Company ("LTD Holding Company" or the "Company").

SECTION 2: Mr. Stephen G. Hill

Q. Mr. Hill claims that ltd holding company has modeled its capital structure to resemble other "comparable" local exchange telephone companies that "have debt

ratings, on average, that are well below investment grade and have high financial risk." (hill direct page 4, lines 13 – 18) do you agree with this claim?

A. Not at all. Mr. Hill mis-states the facts regarding the method in which Sprint Nextel Corporation ("Sprint") has developed the capital structure for LTD Holding Company. Sprint did not base its capital structure on that of the comparable companies (in fact Houlihan Lokey selected the comparable companies in order to conduct its analyses). Rather, we understand that the capital structure for LTD Holding Company has been selected to provide for a low cost of capital through a combination of debt and equity while providing for a reasonable level of equity capital to enable the Company to appropriately operate its business. The favorable comparative capital structure to the comparable companies is a result of Sprint's process for selecting a capital structure for LTD Holding Company. For example, the Company, as shown on page 26 of the Sprint Report, is expected to have less leverage than 4 of the 6 comparable companies. LTD Holding Company is also expected to have an investment grade credit rating. The fact that most of the comparable companies do not have investment grade ratings is a clear indicator that Sprint has selected a more conservative capital structure for LTD Holding Company despite the fact that a number of industry participants have chosen (and the capital markets have financed) a more highly leveraged capital structure for companies operating within the same sector.

Q. Mr. Hill believes that the spin-off is not an arms length transaction and therefore is not required to issue the amount of debt LTD Holding Company has chosen. Why is

the selected level of debt appropriate? (Hill Direct, page 5, lines 9-10)

A. Mr. Hill is correct in that Sprint employed its discretion in selecting the capital structure for LTD Holding Company. Some of the reasoning for Sprint's selection is described in the previous question. Houlihan Lokey's report further documents why it is my opinion that the selected capital structure for LTD Holding Company is reasonable. While Mr. Hill points out that the amount of debt could have been lower, he neglects to mention that the amount of debt could also have been higher which would have put LTD Holding Company more in line with the comparable companies. Mr. Hill argues that a lesser amount of debt would have resulted in a positive book value of equity. However, he does not state how this is at all relevant and I continue to maintain and will expand on this later in my testimony that the book value of equity is not an important factor when assessing a capital structure. Further, Mr. Hill states in this same paragraph that "LTD's financial safety is being minimized" without giving any credible reasoning or analysis to support such a general statement. After allocating approximately [redacted] ** to capital expenditures and $300 million for discretionary annual dividend payments, LTD Holding Company is expected to have approximately [redacted] ** in excess free cash flow, providing for financial flexibility in the event of unforeseen circumstances.

Q. Mr. Hill goes on to state "…there is little room for error and the impact of an unforeseen negative financial event could drive down the bond rating." Is this true? (Hill Direct, page 6, lines 5-6)

A. As described above there is expected to be significant free cash flow according to the base case projections. Also, the debt repayments which are modeled over the projection period are optional, which means that the Company could choose to invest these funds differently. Additionally, the projected dividend payments are at the discretion of the board of directors of LTD Holding Company. In addition to assessing the base case forecasts for LTD Holding Company, HL considered downside scenarios, which are presented in detail in the Sprint Report and are discussed further in this testimony. These analyses demonstrate that the Company should be able to repay and/or refinance its debt even if LTD Holding Company underperforms in the future versus the base case projections. Lastly, the projections provided by Sprint do factor in loss of access lines as well as price declines, however they do not consider potential upsides. While the possibility exists, as it does for all companies, that LTD Holding Company's credit rating could be lowered, this by no means would result in financial distress or other emergency measures.

Q. Mr. Hill states that the transaction "creates an entity with a marginal financial position." Do you agree? (Hill Direct, page 6, lines 12-13)

A. No, I do not agree at all. While I do not know exactly how Mr. Hill defines a "marginal" financial position, the implication that the capital structure of LTD Holding Company put in place through this transaction will be financially unfavorable is erroneous and unfounded. The transaction will create a new entity with a reasonable capital structure, significant free cash flows, and financial flexibility, as stated previously.

Q. Mr. Hill claims that "if a firm elects to carry too much financial risk….that firm will have difficulty in raising the capital necessary to provide the service required by customers. Or, in the event that it is possible to raise capital, the cost of that capital would be significantly higher than it would be if the firm is capitalized with less debt. In that way, an under capitalized firm would not be operating in the public interest because a firm that more appropriately capitalized would be able to provide the same service at a lower cost." Are his claims correct? (Hill Direct, page 8, lines 14-18)

A. Generally speaking, the cost of debt does increase as leverage increases. However, Mr. Hill also recognizes later in his testimony that "debt is the least expensive form of investor-supplied capital for a firm" (Hill Direct Testimony, Page 10, Lines 8-9). Therefore there is an optimal capital structure in which the balance between "lower-cost debt" and "higher-cost common equity" is appropriate for the firm's financial risk and business risk. For LTD Holding Company, the capital structure selected, with a [redacted] ** debt to total (market value) capital ratio and investment grade ratings provides them with a lower cost of capital as compared to a capital structure with substantially lower debt levels. The fact that two nationally recognized credit rating agencies have independently assigned an investment grade credit rating further supports the reasonableness of the capital structure.

Q. Mr. Hill states in his direct testimony that "…the financial risk indicated by the capital structure that appears on the books of the parent company and reported to

the investment community is an important determining factor. The book value, then, does matter in regulation's attempt to balance the interests of ratepayers and investors." (page 14, lines 10-18) does book value of equity matter?

A. No it does not. As discussed in my Direct Testimony (Daniel Direct, page 7), book value of equity is often a function of accounting conventions and historical accounting treatment and, for companies like LTD Holding Company, is not a directly applicable figure for either valuation purposes or for assessing a company's capital structure. Book value results from the myriad accounting rules and often has no direct correlation to market value. This can be observed in the marketplace where companies with negative book equity values have positive and substantial market equity values. There is generally little correlation between the market value of equity of a company, the true indicator of the value of a company, and the book value of equity. As demonstrated on the attached [Exhibit GRD-1] to my Rebuttal Testimony, there is a lack of correlation between a company's market value of equity and book equity. For example, Proctor & Gamble, as of the date of the attached exhibit, had $132 billion of market equity value and less than $19 billion of book equity value. In fact, Proctor & Gamble's book equity would have been negative had it not been for goodwill that is held on the balance sheet. For companies like LTD Holding Company, market value (and not book value) is relevant for ongoing entities (for example when raising capital) and not only in an event of default as argued by Mr. Hill.

Q. Mr. Hill expresses concern that the Moody's rating "is contingent on having everything go as projected [redacted] * However, things rarely occur as planned and if they do not, LTD could be [redacted] * bond rating." (Hill Direct, page 16, lines 26-29). Ms. Folsom states a similar concern on page 21 of her direct testimony. Are these concerns valid?

A. While a [redacted] * is possible in any situation, the concerns of a material impact on LTD Holding Company are not warranted. Firstly, I believe that through the credit rating process the agencies consider a certain level of possible under-performance or over-performance versus the base case forecasts. Therefore, simply missing a forecast figure by a small amount does not immediately cause a [redacted]. * Of course, a [redacted]* is certainly possible based on company performance or other industry events. However, if at some point in time LTD Holding Company [redacted] * rating, this would not immediately have a material effect on the Company's existing cost of debt. Any potential effective rise in cost of capital would not take effect until either a refinancing of current debt or an additional debt issuance. A [redacted]* could impact the market price of the Company's debt securities but for the Company, the interest payments would not immediately change.

Q. Have you taken into consideration in your analysis the impact of things not occurring as planned?

Yes I have. A potential downturn in LTD Holding Company's business performance beyond the declines forecasted in the base case projections has been considered in my analysis. I have performed an analysis (Houlihan Lokey report, pages 65-73), which tests the impact of underperformance versus plan for LTD Holding Company. Based on this analysis, it is my opinion that LTD Holding Company should be able to pay and/or refinance its debts as they become absolute and mature. In the normal course of conducting its analyses, Houlihan Lokey modified a number of Sprint management's assumptions for drivers of future revenue, operating expenses and capital expenditures in order to assess the impact on, among other things, future cash flows and credit ratios (Houlihan Lokey report, pages 65-73). This analysis included changing individual assumptions as well as simultaneously changing multiple assumptions in order to arrive at a "downside case". While there are an infinite number of combinations of possible projection assumptions, Houlihan Lokey selected one downside case, which in its view represented a substantially unfavorable possible outcome for the LTD Holding Company. For example, this case includes a [redacted]** in access lines of [redacted]** percent by the end of 2010 versus [redacted]** percent for the base case as well as [redacted]** voice and data revenues per line. In this example, despite a [redacted]** percent [redacted]** EBITDA level in 2010 than in the base case (and [redacted] ** percent [redacted] ** than in 2004), LTD Holding Company would have a leverage ratio in 2010 similar to that of a number of RLECs today.

Q. On page 17 lines 17-25, Mr. Hill addresses the buy-out of Verizon's local exchange business in Hawaii by the Carlyle Group, and the change in credit rating since the

transaction. Is this a valid indication of the future for LTD Holding Company?

A. The Verizon Hawaii and the Carlyle Group transaction is instructive as it demonstrates the amount of debt placed on the Hawaiian assets. The Carlyle Group completed the leveraged buyout at a debt amount of 5.9x Pro Forma EBITDA, ** the amount of leverage as compared to LTD Holding Company's planned leverage of ** 2006 EBITDA. S&P stated the reasoning for its initial rating of B+ for Hawaiian Telcom was to "reflect its aggressive financial policy, concentrated service area, potential accelerated competition from cable telephony, and risks associated with building a new back-office infrastructure." Three of the four reasons for the change in ratings are Hawaiian Telcom and transaction specific, and not applicable to LTD Holding Company. The fourth reason, which is applicable to LTD Holding Company, is the reference to the competition from cable telephony; however, this is an industry wide phenomenon. This has been taken into account in the analysis and projections of LTD Holding Company through the loss of access lines as well as price declines. Finally, the Verizon Hawaii - Carlyle Group transaction debt rating was based on an "aggressive financial policy" whereas S&P recently issued a press release stating that the proposed LTD Holding Company had a "relatively moderate capital structure, strong EBITDA margins, and good discretionary cash flow characteristics"[1]. This is completely different than Hawaiian Telcom, which was a leveraged buyout, and included higher leverage and high yield debt. The transaction before the commission is a separation in which the resulting company (LTD Holding Company) is appropriately capitalized with an investment grade rating.

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[1] S&P Press Release November 10, 2005.

Q. On page 18 of his direct testimony Mr. Stephen G. Hill takes concern in the fact that under both base case and downside case projections, book value of equity [redacted], ** citing this as evidence that the company does not show future improvement in its financial position. Is his concern justified?

A. No, his concern is not valid. As stated previously, book value of equity is often a function of accounting conventions and historical accounting treatment and, for companies like LTD Holding Company, is not a directly applicable figure for either valuation purposes or for assessing a company's capital structure. In addition, I note that if this transaction were a purchase the goodwill created in the transaction would eliminate the negative book equity. The Company, in fact, is expected to generate annual free cash flow of approximately [redacted] ** after providing for approximately [redacted] ** in capital expenditures annually and distributing $300 million a year in dividends. The Company's substantial free cash flow is applied to debt pay-down in our financial model, but such a pay-down is not required, and the Company may use its free cash to fund growth initiatives and service enhancements. Finally, the downside case illustrates a scenario where the Company would have less free cash flow and therefore, be able to repay less debt and correspondingly decrease shareholders equity on the balance sheet to a lesser degree. Even in the downside scenario, however, as stated previously, LTD Holding Company should be able to pay and/or refinance its debts as they become absolute and mature.

Q. Between pages 19-23 Mr. Hill cites service quality concerns and financial viability with two of the comparable companies, Valor and Iowa Telecom after their transactions, with Verizon and the purchase of 295 exchanges in Iowa, respectively. How are these instances applicable to LTD Holding Company?

A. The relevant issue to consider from a financial point of view is the level to which LTD Holding Company will reinvest in its business. Sprint provided Houlihan Lokey with estimates of capital expenditures required to at least maintain its current level of service. These capital expenditures are included in my analysis. My analysis indicates that LTD Holding Company should have the ability to make these investments while continuing to generate free cash flow to pay down debts or reinvest in other growth opportunities.

<u>SECTION 3: Ms. Kathleen M. Folsom</u>

Q. On page 12 of her direct testimony Ms. Kathleen Folsom states a concern with Houlihan's analysis that "the Houlihan valuation utilized projected financial statement information for ltd that was supplied by LTD management and was not independently verified as to accuracy or completeness by Houlihan." Does HL generally verify the accuracy and completeness of projections?

A. No. Houlihan Lokey is not an accounting or auditing firm and, as described fully in the report, did not undertake to independently verify any of the information that was provided by Sprint Nextel or any third party and used for purposes of its evaluation. Further, it is Houlihan Lokey's understanding that certified public accounting firms do not issue audit opinions relating to financial forecasts and as such the preparation of financial forecasts is inherently different than those of audited historic financial statements.

Q. Another of Ms. Folsom's concerns with Houlihan's analysis is that "the final terms and conditions of the transaction could change prior to the actual separation." Has anything come to the attention of Houlihan that would impact the analysis?

A. No, through consistent discussions with the Company, nothing has been brought to my attention that would impact my analysis. Further, I am not aware of any reason that the financial terms of the transaction, including the level of debt and expected future dividends, would be materially different than those that have been proposed.

Q. Another of Ms. Folsom's concerns with Houlihan analysis is that "book value of equity was not considered a relevant indicator for valuation purposes and therefore, Houlihan did not discuss it." How does book value of equity affect the valuation?

A. As discussed previously in this testimony, it is my view that book value of equity does not affect the valuation of LTD Holding Company or an assessment of its capital structure. I address this in detail in my Direct Testimony as well. For the relevance of book value to the cost of capital for regulatory purposes, I direct the reader to the testimony of Richard Pfeifer.

Q. Another of Ms. Folsom's concerns with Houlihan analysis is that "the additional [redacted]. ** in new debt results in a highly leveraged LTD (approximately

[redacted] ** which, along with LTD's shareholder equity (approximately [redacted] **) may make it hard for LTD to weather any future financial difficulties if its capital expenditure, financial needs or future competitive harm prove greater than anticipated." Are her concerns with the financial flexibility of LTD Holding Company justified?

A. No. While leverage may appear high when basing one's analysis on book value, as previously mentioned it is my opinion that LTD Holding Company's capital structure is reasonable when considering, among other things, the pro forma credit ratios of LTD Holding Company. When assessing the amount of debt to total capital (which is debt plus market value of equity less cash), it is clear that the Company's capital structure is reasonable relative to its comparable industry peers, because of its lower leverage and level of debt to total capital, as shown on page 26 of the HL report [Exhibit].

It is important to stress that the Company has sufficient cash for a continued level of capital spending above the peer mean and planned dividend payments, as well as "optional" growth initiatives, debt repayment, or even additional dividends. It is this "financial flexibility" that is the true underpinning of LTD Holding Company's financial strength and credit quality. The Company recognizes that its business has been and will continue to be subject to competition from a number of competitive communication providers including wireless voice and data providers, cable companies offering voice services and potentially other competitors in the future. The expectation for future competition is factored into the Company forecasts in which are assumed access line losses, declining prices in certain of its product offerings and market share gains in its growing DSL business.

We have also addressed and focused on the ability of the Company to service its customers and provide a comparable level of service quality, while being able to invest almost [redacted]** in its business annually, including both maintenance and growth capital. Our analysis also takes into consideration anticipated dividend distributions of approximately $300 million a year, which is in the range of [redacted]** to [redacted]** of the Company's available cash flow, whereas LTD Holding Company's industry peers distribute approximately 60% of free cash flow. As noted above, the Company has relatively more cash flow available for all uses than its comparable peers.

Furthermore, dividend payments will be at the discretion of the board of directors of LTD Holding Company. Based on the forecasts for LTD Holding Company, the Company is expected to have sufficient cash flows from operations to reinvest in its business through capital expenditures, pay the dividend, and make principal payments on its debt.

Finally, we have recognized the fact that unforeseen circumstances may arise and that LTD Holding Company will have access to an additional approximately [redacted]** a year of excess free cash flow after making expected distributions to its shareholders, while maintaining a cash cushion of [redacted]** to provide financial flexibility for a changing market and changing demographics.

Q. On page 23 of her direct testimony Ms. Kathleen Folsom expresses concern with the $300 million that she believes is committed to being paid as a dividend by LTD. How do you address her concern?

A. First, we note that this is not a required dividend. The declaration and payment of the dividend will be at the discretion of the board of directors of LTD Holding Company. In assessing LTD Holding Company as a consolidated entity, we examined the ability for LTD to pay this dividend. The $300 million annual dividend is less than [redacted]** of free cash flow (cash flows after capital expenditures, interest and taxes) and is substantially lower than the dividend payout ratio of the comparable companies. Therefore, I do not believe that this is a valid concern.

Q. Based upon your reading of the testimony by Mr. Hill and Ms. Folsom, do the conclusions cited in your prior testimony change?

A. No. There is nothing in my Direct Testimony that changes as a result of their testimony. To summarize, I concluded in my Report that LTD Holding Company, as an independent company with a size that places it well within the Fortune 500, should have numerous alternatives for accessing capital in the future. In addition, I determined that the Company should be able to pay its debts as they become absolute and mature while continuing to generate sufficient cash to re-invest in the business at a level indicated by the Company necessary to maintain the current level of service, and pay dividends in accordance with the planned dividend policy.

Lastly, I concluded that the fair value of the assets of LTD Holding Company is reasonably stated in the range of [redacted] ** to [redacted]. **

Q, Does this conclude your rebuttal testimony?

A. Yes it does.