BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of 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

PREHEARING BRIEF OF COMMISSION STAFF

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I. The Commission should consider the rebalancing of access charges and local rates in this proceeding, to determine whether to approve the proposed transfer of control of United Telephone Company.

1 Sprint's application to spin-off its local telephone affiliate, United Telephone Company, and transfer control of United to a newly created entity, LTD Holdings, Inc., poses substantial concerns that need to be addressed in this proceeding in determining whether the transaction should be approved. Most significantly, it is critical that United be financially viable going forward, with a rate structure that is legal, reasonable, and sustainable. The fact that United will, henceforth, be separated from Sprint-Nextel's lucrative wireless business makes concerns regarding United's continued viability even more acute, and certainly relevant for the Company, its ratepayers, and the Commission. A newly-separated company that is premised upon artificially subsidized, unsustainable local rates and unreasonably high and unsustainable access charges will not likely be viable. If the company's business model is not sustainable, then the transaction is not in the public interest.

2 It is, thus, entirely appropriate for the Commission to consider rate issues as part of the transaction approval process. In particular, as set forth in the direct testimony of Staff witnesses Mr. Zawislak, Staff is concerned that: (1) United's originating access rates are unreasonable under the standard used by the Commission in the Verizon access charge case, Docket No. UT-020406; (2) United's

terminating access rates are unreasonable because they include an "interim terminating access charge" (ITAC) amount that is both unreasonably high and unnecessary to maintain affordable and reasonably comparable local rates (which is the sole purpose of the ITAC); and, (3) United's local rates are unduly discriminatory or preferential, in violation of RCW 80.36.170 and 80.36.180. *See Response Testimony of Timothy W. Zawislak, Exh. No.__ (TWZ-1T), at 10-17.*

3 The issue of unreasonable and unsustainable rates is not merely tangential to the present proposal to spin off United into a new, less diversified and smaller corporate entity. Rather, it is directly related to and will directly impact the new corporate venture. As Mr. Saunders points out, United has a pattern of local and exchange access rates that do not come close to matching the cost of providing the specific services in specific locations. This leaves the company with significant business risk from regulatory or competitive activities that could take away the company's higher margin access services, such as exchange access and local exchange service in its larger communities. Services priced above cost are vulnerable to competition and arbitrage, which may jeopardize revenue flows that are used to maintain low local service rates, and thus, the stability of the company. Moreover, in order to promote competition in the public interest, the new company cannot be permitted to operate on the basis on anti-competitive access rates. Rather, these

charges will have to be adjusted to assure a healthy competitive environment.

Response Testimony of Wilford Saunders, Exh. No. __ (WS-1T), at 15-17.

4 Mr. Zawislak shows that United's originating access charges are inconsistent with what the Commission ordered for Verizon in Docket No. UT-020406, to correct illegal and anticompetitive rate discrimination. He shows that United's ITAC interferes with the Commission's fundamental access charge policy established in Docket No. UT-970325, which states that rates charged for terminating calls should be based solely on the actual cost of the service. An ITAC should be permitted only to the extent necessary to assure reasonably affordable and comparable local exchange rates. As Mr. Zawislak states, United's ITAC violates this principle and is unreasonably high.

5 Furthermore, United's local rates in many exchanges are discriminatory and preferential, in violation of RCW 80.36.170 and .180. Making certain rates unreasonably low (for example, the residential and business rates in Stevenson are just over half those in Poulsbo and Sunnyside) unfairly requires some customers to subsidize an excessive level of support that is not needed to keep rates affordable and comparable.

6 Put simply, United will not be able to sustain its current access charges and local rates into the future. The Commission should not, therefore, as United

apparently suggests, determine whether to approve the proposed spin off of United on the false assumption that the new company can continue to operate based on a business structure that includes these unreasonable costs. Rather, these issues should be resolved now.

7 Sprint contends that changes in rates are simply irrelevant to, and incompatible with, the decision whether to approve the transfer of control of a regulated public service company. Mr. Mayo goes so far as to allege that "the tethering of such [rate change] requirements to the approval of the transaction makes precious little sense," and that it is akin to a "hostage taking." *Rebuttal Testimony of John W. Mayo, Exh. No. __ (JWM-3T), at 9-10*.

8 But at least in the Commission's view, this simply is not the case. It is quite common for the Commission to address problem areas in a company's rates or operations at the same time that it considers a merger or transfer. Indeed, it is hard to find an example of a transaction approved by the Commission that did not address what Mr. Mayo would characterize as "hostage" issues. In the US WEST/ Qwest merger, the Commission ordered changes in tariff and operations to correct service quality deficiencies. *In Re Application of US WEST Inc., and Qwest Communications Int'l, Inc.,* Docket No. UT-991358, Ninth Supplemental Order (June 19, 2000). In the GTE/Bell Atlantic merger, the Commission ordered a reduction in

access charges, an increase in local rates, a limit on future rate changes, and the consolidation of a rate structure that turned cost recovery on its head—a set of rate changes remarkably similar to what Staff advocates here. *In the Matter of the Application of GTE Corp. and Bell Atlantic Corp.,* Docket No. UT-981367, Fourth Supplemental Order (Dec. 16, 1999). In the Verizon/MCI merger, the Commission ordered tariff changes to eliminate a surcharge for expanded local calling (as Staff is recommending here) and limit future rate changes. *In the Matter of the Joint Application of Verizon Communications Inc. and MCI, Inc.,* Docket No. UT-050814, Order No. 07 (Dec. 23, 2005).

9 On the energy side, the Commission has included rate-affecting and service affecting provisions in the Puget Power/Washington Natural Gas merger (*In the Matter of the Application of Puget Sound Power & Light Co. and Washington Nat. Gas Co.,* Docket No. UE-960195, Fourteenth Supplemental Order (Feb. 5, 1997)), and the Scottish Power/PacifiCorp transaction (*In the Matter of the Application of PacifiCorp and Scottish Power PLC,* Docket No. UE-981627, Second Supplemental Order (Mar. 16, 1999)), and these provisions are part of the all-party settlement now before the Commission in PacifiCorp/MidAmerican Energy transaction.

10 These provisions do not represent "hostages," as Mr. Mayo suggests, but rather the Commission's and the parties' legitimate effort to ensure that change in control does not harm the public interest. The Commission rightly has chosen not to limit its inquiry to the particulars of the financial transaction itself, and it should not feel constrained to put on blinders in this case. These transactions can have significant effects on the financial and operational ability of a utility to provide good service at fair rates. The issue of proper going-forward rates is likewise relevant to the proposed spin-off of United, arguably more so because the new company here will be in a much weaker financial position (*see Response Testimony of Kathleen M. Folsom, Exh. No. __ (KMF-1THC))*, than the companies that formed as a result of the above mergers.

11 If the Commission should conclude that United's rate structure is not relevant to this proceeding, Staff recommends that the Commission not set these issues aside entirely. In any event, the Commission should not accept the Company's suggestion to ignore these important issues altogether. They are clearly relevant to the transfer of control application that has been brought before the Commission. An alternative approach would be to address the rate issues by issuing a complaint against United's access charges and local rates or requiring United to file a rate case as a condition of the Commission's approval of the transaction.

II. The Commission should consider the treatment of directory sale proceeds in this proceeding to determine whether to approve the proposed transfer of control of United Telephone Company.

12 In 2003, Sprint Nextel Corporation (Sprint) sold its yellow page directory publishing business, Sprint Publishing & Advertising, Inc. (SPA), to R.H. Donnelley Corporation for $2.23 billion dollars, and recognized a substantial pre-tax gain on sale.[1] None of this gain was allocated, distributed, or assigned in any way to Sprint's local telephone division, which includes United Telephone Company of the Northwest (United). This is true despite the fact that United, under agreements signed in conjunction with the sale, may not compete with Donnelley either by publishing a yellow page directory, or selling directory advertising, for fifty years. *Response Testimony of Paula M. Strain, Exh. No. __ (PMS-1THC), at 2-3.*

13 Now, in this proceeding, Sprint is proposing to transfer the control of United to a newly created entity, LTD Holding Company. If the Commission were to approve this transaction, United would be severed from its former parent, Sprint. There would no longer be any affiliate relationship between Sprint and United, and the directory sale gain proceeds held by Sprint--in which United's ratepayers have a substantial interest--would no longer be available to United.

[1] The amount of pre-tax gain is a highly confidential number that is set forth at page 2 of Ms. Strain's testimony.

14 As a condition of approving the proposed transfer of control of United, Staff has recommended that the Commission require Sprint to make a payment to United in the amount of the Washington directory sale gain to properly transfer the directory gain to United, and to then amortize the gain to revenues over a ten-year period for ratemaking purposes. *Response Testimony of Paula M. Strain, Exh. No. __ (PMS-1THC), at 9-11*. Public Counsel has recommended that the Commission require imputation of directory sale proceeds in future rate cases (through the use of revenue credits) to compensate ratepayers. In either event, it is clear that this issue needs to be considered now, while there is still offsetting compensation and assets on the books of the parent Sprint to support either a cash payment or directory imputation adjustments to United. *Accord, Response Testimony of Michael L. Brosch, Exh. No. __ (MLB-1THC), at 14-15.* Put simply, if ratepayers compensation for the 2003 sale of Sprint's directory business to Donnelley is not addressed in this case, then the proposed spin-off and transfer of control of United is clearly not in the public interest.

15 Contrary to the statements of Sprint witness Mr. Pfeifer (*Rebuttal Testimony of Richard G. Pfeifer, Exh. No. __ (RGP-9THC), at 4),* there is plainly a "rational relationship" between this transfer of control proceeding and the question of how to address the directory sale gain. Sprint says that resolution of this issue should

simply be delayed into the indefinite future, until such time as United decides to initiate a rate case. Sprint would have the Commission believe that if United were to initiate a rate case five or ten years from now, long after the company has been severed from the directory sale proceeds, it would readily acquiesce in a Commission decision to determine a cash payment or imputation amount arising from the 2003 directory sale that would then be unsupported by any offsetting sale assets. Sprint makes this argument, notwithstanding the additional fact that all the financial and accounting information necessary to make a proper determination at a future date may not be available (as often happens with the passage of time). Staff believes that this contention is simply without merit, and that Sprint's suggested approach is untenable.

16 Furthermore, Sprint is incorrect when it asserts that issues pertaining to the treatment of directory sale proceeds can be properly addressed "*only* in a rate case setting." *Rebuttal Testimony of Richard G. Pfeifer, Exh. No. __ (RGP-9THC), at 2* (emphasis in original). In fact, this Commission has addressed directory issues in stand-alone cases on multiple occasions. In Docket No. UT-980948, *In re the Petition of US West Communication, Inc., for an Accounting Order*, Fourteenth Supplemental Order; Order Denying Petition (July 27, 2000), the Commission denied US West's petition for an accounting order that would have ended the Commission's longstanding practice of imputing to US West, for ratemaking purposes, excess income earned by the regulated company's yellow page directory publishing affiliate. That issue was decided in a stand-alone case.

17 And in Docket No. UT-021120, *In the Matter of the Application of Qwest Corporation Regarding the Sale and Transfer of Qwest Dex to Dex Holdings, LLC.*, Tenth Supplemental Order (August 1, 2003), the Commission approved a settlement agreement providing for the sale of Qwest's directory publishing business. The settlement required Qwest to compensate ratepayers by providing customers an immediate credit of $67 million, together with additional revenue credits (effectively continuing the imputation of directory revenues) of $103-115 million per year for fifteen years. The Commission's order found that these remedies, as a condition of directory sale approval, would "ensure that ratepayers obtain immediate benefit in the form of a substantial bill credit, and gain a measure of protection, through the revenue credit mechanism, with respect to ratepayers' longer-term interest in stable rates." *Id.* at 22, ¶ 47. The Commission did not determine that it needed to defer questions regarding the appropriate treatment of directory revenues to a later rate case, as Sprint suggests here.

18 Furthermore, there can be no question that United's ratepayers have a substantial interest in the Sprint directory sale revenues that must be addressed in

this proceeding. As Ms. Strain explains in her testimony:

> As part of the [directory] sale, United was required to relinquish its rights to publish its own directories, or to negotiate appropriate fees with Donnelley for the exclusive publishing and distribution rights Donnelley received, and for United's 50-year commitment not to compete with Donnelley in the directory publishing business. While United never owned the physical assets that are used in producing the business, it did possess the right to decide who should publish and distribute its directories. The ability to publish and distribute the "official" directories to United's ratepayers, and to sell advertising in those directories, has value because of United's status as the dominant local service provider in its serving areas. United gave away its publishing rights only because it was required by its parent to do so. A stand-alone company acting in a reasonable manner would not have done so. Therefore, it is unreasonable to expect United's ratepayers to pay for its failure to obtain fair value for these rights. United's ratepayers should therefore be compensated when those rights are sold to a third party like Donnelley.

Response Testimony of Paula M. Strain, Exh. No. __ (PMS-1THC), at 10. The State Supreme Court has concurred with this analysis of the ratepayers' interests in, and rights to compensation for, directory revenues. In *US West v. Utilities & Transp. Comm'n,* 134 Wn.2d 74, 949 P.2d 1337 (1997), the Court affirmed the Commission's decision to impute directory revenues to US West after it transferred the directory business to its non-regulated affiliate for inadequate compensation. In doing so, the Court agreed with the Commission that:

> [T]he concern was that the utility not transfer the business—an asset created by ratepayer funds during the utility's de facto monopoly—to its own affiliate for an inadequate price, to the harm of the ratepayers. 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.

Id. at 96. The Court also cited with approval the Colorado Supreme Court's holding in *Mountain States Tel. & Tel. Co. v. Public Utils. Comm'n,* 763 P.2d 1020, 1027-28 (Colo. 1988):

> Mountain Bell argues that the publishing assets belong to its shareholders who took the risks to develop the publishing business . . . . The directory publishing business was developed over the past fifty years within the protective shelter of Mountain Bell's monopoly of telephone service. . . . 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.

134 Wn.2d at 100 (citations omitted). Contrary to the views expressed by Sprint witness Mr. Staihr, (*see Rebuttal Testimony of Brian K. Staihr, Exh. No. __ (BKS-1THC), at 30-39),* the ratepayers clearly do have an interest in the Sprint directory sale proceeds, as the courts have recognized.

19 Finally, Sprint contends that, unlike US WEST, its directory function has always been performed by a separate affiliate, and that this somehow negates any ratepayer interest in the directory proceeds that need be addressed in this proceeding. *Rebuttal Testimony of Nancy L. Judy, Exh. No. __ (NLJ-4THC),* at 23-24; *Rebuttal Testimony of Brian K. Staihr, Exh. No. __ (BKS-1THC),* at 29, 32. This contention, too, is clearly incorrect. The failure of Sprint to allow United to be

compensated for its publishing and non-competition rights doesn't mean that those rights don't exist or have value. In Cause No. U-9914, *Order Authorizing Tariff Revisions,* at 11-12 and Appendix A (December 24. 1970), a case involving GTE Northwest, the Commission ordered a reduction to GTE Northwest's revenue requirement (i.e., imputation of directory revenues) in the amount of the profits earned by the Directory company in excess of its cost plus a fair rate of return. This decision was affirmed by the Thurston County Superior Court (Case No. 44043, September 16, 1974). The Commission also approved a settlement of a general rate case involving Continental Telephone Company that included recognition of a gain on sale of the directory publishing affiliate. Significantly, neither GTE Northwest nor Continental ever owned or operated their own directory publishing businesses; in both cases the directory publishing functions were performed by an affiliate.

Response Testimony of Paula M. Strain, Exh. No. __ (PMS-1THC), at 14.

20 The California Public Utilities Commission also recently dismissed the contention that ratepayers have no compensable interest in the directory publishing business if that business has historically been performed by a separate company-created affiliate. In Rulemaking O1-09-001, *Order Instituting Rulemaking on the Commission's Own Motion to Assess and Review the New Regulatory Framework for Pacific Bell and Verizon California Incorporated,* Decision 03-02-073 (February 27, 2003), at 3

(copy attached as Appendix A), the California Commission noted that "although Verizon has conducted its directory operations through an affiliate since 1936, 'the lack of an arms-length relationship between Verizon and its Directory Affiliate has been a long-standing source of concern to the Commission.'" Furthermore:

> It is immaterial that the [Directory Affiliate] has been formed as a corporation separate . . . from [Verizon] . . . Nothing magical happens in relation to function when corporate papers are filed with the Secretary of State; it is the work and function that an entity performs that determines its regulatory treatment, rather than what lawyers put in incorporation papers.

Id. at 4 (ellipsis in original) (citation omitted). The California Commission concluded that the ratepayers had a substantial interest in the directory affiliate's revenues. That is likewise the case with Sprint.

21 In conclusion, the Commission needs to consider the appropriate treatment of Sprint's directory sale proceeds in this proceeding, in order to protect the interests of the ratepayers, and indeed, in order to determine whether the proposed spin-off and transfer of control of United is in the public interest.

DATED this 25th day of January, 2006.

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