

**BEFORE THE WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

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

MICHAEL L. BROSCH (MLB-12T)

ON BEHALF OF PUBLIC COUNSEL

RESPONSE TO SUPPLEMENTAL TESTIMONY

FEBRUARY 13, 2006

1 **Q. Please state your name and business address.**

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

4 **Q. Are you the same Michael L. Brosch who previously submitted Direct and**
5 **Supplemental Testimony in this docket on behalf of the Washington Attorney**
6 **General's Office, Public Counsel Section (Public Counsel)?**

7 A. Yes. My qualifications are set forth in my Direct Testimony that was filed on November
8 30, 2005.

9 **Q. What is the purpose of your Supplemental Testimony?**

10 A. This testimony is responsive to the Supplemental Rebuttal Testimony of Sprint Nextel
11 witnesses Ms. Nancy L. Judy and Messrs. Richard G. Pfeifer and Brian K. Staihr with
12 regard to quantification and regulatory treatment of the gain on sale of the Sprint
13 Publishing and Advertising ("SPA") business in 2003. I also respond to Staff witness
14 Ms. Paula M. Strain's stated objections to Public Counsel's proposed one-time credit to
15 customers.

16 **Q. With regard to the Supplemental Rebuttal Testimony of Mr. Pfeifer, what issues are**
17 **resolved and what issues are still disputed?**

18 A. Mr. Pfeifer's testimony and his Exhibit No.__(RGP-14HC) and Exhibit No.__(RGP-
19 15HC) appear to reflect concurrence with my proposed quantification and allocation to
20 Washington of the gain on sale from the SPA transaction. Specifically, the amount
21 shown on line 13, Exhibit No.__(RGP-14HC), p.1 ties to the amount shown in line 14 of
22 my Revised Exhibit No. __(MLB-5HC).

1 All amounts shown on lines 14-20 of page 1 and all of page 2 of Exhibit
2 No__(RGP-14HC) are disputed. In other words, Sprint Nextel's proposed 50/50 sharing
3 of the gain on sale,¹ 10-year amortization period² and discount rate³ remain in dispute. I
4 understand that the Company's new 50/50 sharing position is sponsored by Dr. Staihr, so
5 I will respond to that position separately below.

6 **Q. Should the Commission use Mr. Pfeifer's proposed discount rate of 7.88% instead**
7 **of the higher discount rate of 8.5% you sponsor?**

8 A. No. At page 6 of his Supplemental Rebuttal, Mr. Pfeifer states, "...this [Sprint proposed
9 7.88%] rate does not reflect a proper analysis of United's cost of capital and, therefore, is
10 inadequate to predict United's cost of capital at the time of any future rate change.
11 However, it is the best information available at this time." Indeed, there is no fully
12 developed cost of capital available in this record for any future rate change. As my earlier
13 testimony shows, however, the higher discount rate I employed was quantified for use in
14 rate cases and was reviewed and accepted by the Commission. Brosch Direct Testimony,
15 Exhibit No. ____ (MLB-1THC), pp. 32-33. Additionally, given historically low capital
16 cost rates at the present time, it is reasonable to expect that the cost of capital at the time
17 of any future rate change may be higher. It should be noted that Sprint has not
18 committed to any limitation upon its requested cost of capital in future rate cases at the
19 relatively low percentage being employed by Mr. Pfeifer as a discount rate. In other
20 words, Mr. Pfeifer does not explicitly agree to be locked into this lower rate for the
21 future.

¹ Line 14, Exhibit No.__(RGP-14HC), p. 1.

² Line 16, Exhibit No.__(RGP-14HC), p. 2.

³ Line 17, Exhibit No.__(RGP-14HC), p. 2.

1 **Q. Should the 10-year amortization period Mr. Pfeifer supports be accepted in place of**
2 **the 16-year period you sponsor?**

3 A. No. Mr. Pfeifer proposes to start his 10-year amortization period as of January 1, 2003.⁴
4 This starting date, along with a shorter amortization period, would leave ratepayers
5 exposed to potentially higher rates in any future rate case using a test period or
6 adjustment period reaching past 2012. While I agree that the period should commence in
7 January 2003, I have proposed a longer customer benefit period, with imputation credits
8 that would extend through the year 2018. This would protect ratepayers from the loss of
9 imputation for an additional 6 years. Moreover, my proposed amortization period is
10 consistent with the Qwest Dex Settlement previously approved by the Commission.⁵

11 **Q. With the longer amortization period you advocate, how can your recommended**
12 **imputation credit amount in each year be larger than the amount Mr. Pfeifer has**
13 **calculated?**

14 A. Mr. Pfeifer has proposed no more than 50 percent of the SPA gain on sale be credited to
15 ratepayers, citing Dr. Staihr's supporting testimony.⁶ This "sharing" proposal causes the
16 significantly lower annual imputation credits being proposed by Sprint Nextel, with a
17 modest additional downward impact caused by the somewhat lower discount rate being
18 used by Mr. Pfeifer. If the Commission were to adopt either the Staff or Public
19 Counsel's recommendation that 100 percent of the SPA gain be attributed to ILEC

⁴ Exhibit No. ____ (RGP-13T), p. 5.

⁵ See Tenth Supplemental Order Approving And Adopting Settlement Agreement; Docket No. UT-021120; August 1, 2003, at ¶ 47.

⁶ Exhibit No. ____ (RGP-13T), p. 5.

1 customers, approval of the 10-year amortization period advocated by Mr. Pfeifer would
2 produce much larger annual credits than I have proposed.

3 **Q. Turning next to the Supplemental Rebuttal Testimony of Dr. Staihr, at page 1 we**
4 **find the statement, “It is a clear fact that local ratepayers in Washington incurred**
5 **no risk associated with Sprint’s directory publishing business, and they bore no**
6 **financial burden associated with it either. The shareholders incurred all of the risk**
7 **and bore all of the financial burden, and thus according to economic principles, the**
8 **shareholders should receive all of the gain from the sale of Sprint’s directory**
9 **publishing business.” Has Dr. Staihr identified or quantified any specific “risk” or**
10 **“financial burden” that can be attributed to Sprint’s directory publishing business?**

11 A. No. Dr. Staihr appears eager to assume that some burden or risk was absorbed by
12 shareholders, but he provides no evidence or quantification to establish this assumption.
13 In my experience, the ILEC directory publishing opportunity is so valuable that little risk
14 or burden attaches to an enterprise that is given the market opportunity to produce official
15 directories on behalf of the local exchange carrier.

16 **Q. Does any historical action taken by Sprint reveal an inconsistency with respect to**
17 **the notion that only shareholders bore any risk or burden and should receive all of**
18 **the value associated with directory publishing?**

19 A. Yes. In 1989, at the time of the last Washington rate case involving UTNW, the affiliate
20 contract between DirectoriesAmerica, Inc. (SPA’s predecessor) and United Telephone
21 Company of the Northwest provided for annual compensation to UTNW in the form of a
22 “base fee” in the amount \$595,000. I have attached as Exhibit No. ____ (MLB-13) a
23 copy of Sprint’s supplemental response to Public Counsel Data Request No.15 containing

1 a copy of this contract as Attachment PC 15b.⁷ While Commission Staff did not accept
2 this base fee as adequate compensation for the UTNW official publisher opportunity in
3 the Docket No. U-89-3067-S1 rate case, the mere existence of the base fee indicates that
4 Sprint has historically recognized some UTNW entitlement to the directory publishing
5 income stream. This could not occur if, as suggested by Dr. Staihr, only shareholders
6 have borne risks and costs and only shareholders should participate in economic benefits
7 associated with directory publishing.

8 **Q. Dr. Staihr states, at pages 7 and 8 of his Supplemental Rebuttal, that the**
9 **Washington Supreme Court case you reference is distinguishable from the facts**
10 **surrounding the SPA sale because, “...ratepayer funds had nothing to do with the**
11 **development of Sprint’s directory business.” How do you respond?**

12 A. As I explained in my Supplemental Testimony, through earnings-based ratemaking
13 imputation adjustments, ratepayers in Washington have been exposed to all of the
14 historical risks and costs associated with United’s involvement in directory publishing in
15 Washington.⁸ While Dr. Staihr claims that “United’s ratepayers bore no financial burden
16 associated with Sprint’s directory publishing business,” he completely fails to show that
17 there was, in fact, any financial burden incurred by shareholders or anyone else in
18 connection with entering the business or growing the publishing business.

19 **Q. Dr. Staihr also states at page 11, “the Sprint brand was developed years before it**
20 **was ever associated with the Sprint ILECs such as United. The Sprint brand—**
21 **including the famous “pin drop” which even now exists in a stylized version in the**

⁷ Exhibit No. ____ (MLB-13), p. 8 defines the “base fee” and p. 37 contains the “base fee” amount of \$595,000.

⁸ Exhibit No. ____ (MLB-6T) pp. 3-4.

1 **new Sprint Nextel brand—was developed to reflect the clarity associated with**
2 **Sprint’s long distance fiber optic network. Sprint’s ILEC operations played no role**
3 **in establishing the brand; consequently there is nothing about the Sprint brand that**
4 **derives its value from Sprint’s ILEC operations.” How do you respond?**

5 A. I have attached copies of Sprint Nextel’s responses to Public Counsel Data Request 94 as
6 Exhibit No. ____ (MLB-14). Sprint’s responses and the attached documents explain that
7 UTNW and the other Sprint ILEC’s were not given an option with regard to adopting and
8 promoting the “Sprint” brand name. It is reasonable to expect that Sprint and UTNW
9 incurred significant initial and ongoing costs in every year since the mid 1990’s to
10 promote the shared Sprint brand through advertising, signage on buildings and vehicles,
11 uniforms, event sponsorship, and through customer billings and customer contact made in
12 the normal course of business.⁹ There has been no showing by Sprint Nextel that it
13 charged the costs associated with promoting the Sprint brand to below-the-line accounts,
14 to be absorbed entirely by shareholders, or that ratepayers would not have borne costs
15 associated with brand advertising and brand promotion in UTNW rate cases.

16 **Q. Dr. Staihr also states at page 11 that shareholders are entitled to some of the value that**
17 **is reflected in the SPA gain on sale because, “It is the efforts of these SPA employees**
18 **that produced the relationships that Donnelly valued, and these SPA employees were**
19 **not acting as agents of the incumbent LEC, nor were they negotiating on behalf of the**
20 **incumbent LEC.” How do you respond?**

⁹ In its confidential response to Staff Data Request No. 15, Sprint provided an estimate of the initial costs incurred in Washington to effect the name and logo changes, but no estimate was provided of the ongoing costs.

1 A. The employees of SPA and its predecessor directory publisher, DirectoriesAmerica, Inc.,
2 received compensation that was recorded in the financial reports of these affiliated
3 publishing entities. As a result, when imputation calculations were performed in rate
4 cases, the Washington share of the publishing affiliate's employee wage and benefit costs
5 was borne by ratepayers. Contrary to Dr. Staihr's conclusion, because of imputation
6 accounting policies of the Commission, SPA employees actually were serving indirectly
7 as agents of UTNW and its ratepayers, because the effectiveness of their efforts in
8 building relationships with customers and in selling advertising directly impacted the
9 amount of directory earnings that would be subject to imputation in Washington.

10 **Q. At page 5 of his Supplemental Rebuttal, Dr. Staihr states that Public Counsel's and**
11 **Staff's recommendation to attribute all of the gain on sale of SPA to ratepayers,**
12 **"...flies in the face of economic fundamentals: If the owner of an asset is denied the**
13 **ability to gain from the asset, what exactly is the point of owning the asset?" How**
14 **do you respond?**

15 A. I would respond to Dr. Staihr by noting that the "point of owning the asset" is that
16 shareholders are allowed to earn a regulated rate of return on their actual directory
17 publishing investment, much like the return allowed on all other regulated telephone
18 company assets included in rate base.

19 The imputation procedures employed by the Commission have allowed affiliated
20 publishing companies to earn a reasonable return on whatever capital investment was
21 actually made by shareholders in the publishing business. This can be seen in the
22 imputation calculations last applied to UTNW in a rate case, where the publishing
23 affiliate's invested capital was quantified and allowed to earn a fair rate of return by

1 retaining some earnings beyond the amount imputed to UTNW customers. The
2 documentation for this step of the imputation process can be observed at page 8 of my
3 Exhibit No.__(MLB-11C), where a “Rate Base” was calculated based upon United’s
4 actual investment in directory publishing assets for Washington. That Exhibit shows that
5 United was allowed to earn a double digit “rate of return” on its investment.

6 Another “point of owning the asset” is the fulfillment of management’s
7 responsibility to take economic advantage of the directory publishing opportunity that
8 arises from ILEC operations.¹⁰ It would be grossly imprudent, in my view, for an ILEC
9 to not exploit the opportunity to publish directories to generate advertising revenues that
10 can be used to offset the costs associated with operation of the ILEC business. It is no
11 coincidence that the major ILEC holding companies; Verizon, SBC, Qwest, Bellsouth
12 and Sprint, and their predecessors built valuable directory publishing businesses because
13 they were positioned favorably to do so and regulators expected these entities to not
14 squander the publishing opportunity.

15 I would also urge the Commission to consider that the “asset” in question is not a
16 power plant, a parcel of land or a central office – but rather is a business enterprise where
17 most of the value arises from intangible assets that required little at-risk capital
18 investment by shareholders. These intangible assets include the publishing agreement
19 granting official publishing rights to the buyer of SPA and the related non-competition
20 agreement, the existing business relationships with advertising customers and the

¹⁰ Rather than conceding that the right to publish an ILEC official directory is an opportunity, Sprint witness Dr. Staihr characterizes directory publishing as a “mere obligation” in apparent reference to WAC 480-120-251. Exhibit No.__(BKS-3T), p. 6. Whether characterized as an opportunity or an obligation, directory publishing is immensely profitable and Sprint would prefer to retain the value of this business in whole or part for its shareholders.

1 branded identity and public perceptions of Sprint’s directories as being the “official”
2 books. By contrast, the most significant tangible assets involved in directory publishing
3 tend to be short-term working capital investments associated with prepaid publishing
4 costs and accounts receivables for advertising.

5 **Q. At pages 2 through 8 of her Supplemental Rebuttal Testimony, Sprint Nextel**
6 **witness Ms. Nancy Judy discusses the treatment of sale of the Mast Directory**
7 **publishing business within a 1987 Continental Telephone Company of the**
8 **Northwest, Inc. (CTNW or Contel) Washington rate case, ultimately concluding**
9 **with the statement, “Mr. Pfeifer’s approach and proposed treatment is similar to**
10 **the way the Commission resolved the Contel sale of its Mast Directory business.”**
11 **How do you respond?**

12 A. The regulatory treatment afforded Contel’s gain on sale of the Mast business is not
13 similar to Mr. Pfeifer’s recommendation. While Ms. Judy is careful to note that the
14 circumstances of the sales were different and that there were several other important
15 differences between the Contel settlement agreement back in 1987 and the pending SPA
16 gain on sale issue, she seems to imply that some sharing of the Contel gain on sale was
17 accepted by Staff in 1987 and is comparable to Mr. Pfeifer’s 50/50 sharing proposal
18 today.¹¹

19 Ms. Judy explains in some detail how the Washington share on the gain was
20 calculated in the Mast sale, but she fails to discuss in any detail how the gain was
21 distributed between ratepayers and shareholders. Indeed, a thorough analysis of Ms.
22 Judy’s Supplemental Testimony at pp. 4-5 and careful review of her Exhibit No.__(NLJ-

¹¹ Exhibit No.__(NLJ-7T), p. 7.

1 8) reveals that there were several allocations involved, but that none of the gain on sale
2 for the Washington Contel/Mast operations was allocated to shareholders. Exhibit
3 No.____(NLJ-8), p. 7 shows allocations being performed to split the \$105.6 million “Pre-
4 Tax gain on sale of Mast” as follows:

- 5 • Between affiliates and non-affiliates on revenue basis, then
- 6 • Between CTNW and other non-CTNW affiliates on a revenue basis, and then
- 7 • Between CTNW Washington and other CTNW jurisdictions on a relative expense
8 basis.

9 None of these calculations, or the related transcript and schedules within Ms. Judy’s
10 Exhibit, suggest that shareholders of Contel were permitted to retain any of Washington’s
11 share of the Mast gain.

12 **Q. Staff witness Ms. Paula Strain lists, at page 8 of her Supplemental Testimony,**
13 **several objections to Public Counsel’s proposed one-time customer credits using a**
14 **portion of the SPA gain on sale. How do you respond to these arguments?**

15 A. Staff’s position is at odds with the Commission’s finding in Qwest’s Directory Sale
16 proceeding, that a “substantial bill credit,” together with future amortized distribution of
17 the gain on sale, ensures that ratepayers obtain “immediate benefits” and “gain a measure
18 of protection through the revenue credit mechanism, with respect to ratepayers’ longer-
19 term interest in stable rates.”¹² Public Counsel’s proposal for distributing the gain on sale
20 gives both an immediate benefit and a longer term benefit to ratepayers consistent with
21 the distribution provided for in Docket No. UT-021120.

¹² Docket No. UT-021120, 10th Supplemental Order dated August 1, 2003, at ¶ 47.

1 **Q. Does Public Counsel’s proposal give a disproportionate share to current ratepayers**
2 **through a one-time customer credit?**

3 A. No. Public Counsel’s recommended one time customer credit amount at closing
4 represents only a small percentage of the total value Washington ratepayers are entitled
5 to receive.¹³ This amount is very conservative in impact, leaving much higher imputation
6 credits for future years when rate cases may occur, which I believe is quite equitable to
7 future customers.¹⁴ As noted in my Direct Testimony, Exhibit No. ____ (MLB-1THC),
8 pp. 31-32, the proposed one-time credit is consistent with the disposition of the
9 Washington share of the Qwest Dex gain on sale approved in UT-021120.

10 **Q. Does this conclude your Response to the Supplemental Testimony?**

11 A. Yes.

¹³ See Exhibit No.__(MLB-5HC), line 19, where this percentage is stated.

¹⁴ *Id.*, at lines 20-32.