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

SUPPLEMENTAL REPLY TESTIMONY OF

RICHARD G. PFEIFER

ON BEHALF OF
SPRINT NEXTEL CORPORATION

February 13, 2006

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

[REDACTED VERSION]

Q. Please state your name and business address.

A. My name is Richard G. Pfeifer and my business address is 330 South Valley View Boulevard, Las Vegas, Nevada 89107.

Q. Did you file direct, rebuttal and supplemental rebuttal testimony previously in this proceeding?

A. Yes, I filed direct, rebuttal and supplemental rebuttal testimony with the Washington Utilities and Transportation Commission (the "Commission") in this docket on August 26, 2005, January 6, 2006 and February 6, 2006, respectively, on behalf of Sprint Nextel Corporation ("Sprint") and the Washington operations of United Telephone Company of the Northwest ("United" or the "Company").

Q. What is the purpose of your supplemental reply testimony?

A. I am presenting supplemental reply testimony to respond to the supplemental testimony of Paula M. Strain filed on behalf of the Commission Staff on February 6, 2006. Specifically, I will discuss the flaws in Staff's recommendation for the treatment of gain on the directory stock purchase transaction.

Q. Please generally describe your objections to Staff's proposal, as set forth in Ms. Strain's testimony.

A. Staff proposes that the Commission require, as a condition of approval of the separation transaction, that Sprint Nextel transfer **$[redacted]** cash to United upon the close of the separation. This amount represents an assignment of gain from the directory stock purchase to United, which she proposes be allocated in total to United's local telephone ratepayers. As part of this recommendation, Staff also proposes that United establish a regulatory liability (i.e., a deferred revenue account) by recording the entire amount of the theoretical gain on United's books. Through the deferred revenue account, the **$[redacted]** cash would be required to fund an ongoing revenue credit of **$[redacted]** on an annual basis. In order to replenish the cash reserve on an ongoing annual basis until the time of United's next rate case, Staff applies an 8.15% carrying charge, which supposedly represents the rate that United can earn on the cash asset. Ms. Strain states in her testimony that use of an 8.15% rate would get to a result that would approximate the annual level of imputation currently in rates and would assure that the regulatory liability is preserved until United's next rate proceeding.

United strongly objects to this proposal. It is not only unprecedented but also flawed because it would not achieve the results that Staff has assumed, as I will further explain. United also opposes an assignment of 100% of the gain to ratepayers, as discussed in the testimony of Dr. Brian Staihr.

Q. Please explain why Staff's recommendation is flawed.

A. First of all, Staff is proposing the actual transfer of cash from Sprint Nextel to United to reflect the assignment of gain on the stock purchase to United's operations. Based on my many years of experience in telecommunications finance and regulation, imputations based on directory transactions are not realized by the actual transfer of cash but, rather, through theoretical accounting entries utilized for ratemaking purposes only. In contrast, Staff's proposal would require United to book entries to reflect the actual transfer of cash. A required transfer of cash – which is the transfer of a *real* asset – transforms what normally would be a theoretical ratemaking calculation to an event with real financial implications.

I also understand that this type of proposal is unprecedented in the state of Washington. Thus, Staff's proposal would treat United in an unfair manner, by singling it out with an arbitrary requirement that has not been imposed on any other similarly situated company. In summary, Staff's proposal is not only unprecedented, but its flaws also would result in a number of consequences that may not have been intended by the Staff and that are, in any event, unreasonable.

Q. Please explain the flaws in more detail.

A. First, Staff's proposal that Sprint Nextel be ordered to transfer cash to United to replicate United's share of the gain fails to recognize that there were income tax consequences associated with the transaction. Sprint Corporation already paid taxes on the gain, but United would have been responsible for paying taxes on gain if it had actually experienced one or if Sprint Corporation had allocated a portion of the gain to United like the Staff wanted it to do. In fact, United's after tax portion of the gain would have been only **$[redacted]** (**$[redacted]** at a 35% tax rate.) Staff's entire proposal is based on a starting point of **$[redacted]**. Because that number is wrong, it would be impossible for United to realize the results contained in the remainder of Staff's proposal.

Q. If there will be no income tax consequence to United, does it matter that the allocation of gain to United in Staff's proposal does not reflect a post-tax amount?

A. Yes, it matters significantly. It would be an inaccurate representation of value to require the allocation of a portion of the gain to United without an allocation of the associated portion of tax. Just as Staff allocated to United a portion of Sprint Corporation's gain on sale, it also should have allocated the proper proportion of Sprint Corporation's tax liability. This is exactly what would have occurred if United itself had experienced a gain or if Sprint Corporation had allocated a portion of the gain to United as Staff suggests it was obligated to do. By not doing so, Staff's proposal is overstating the value that would have accrued to United if United had actually experienced a gain on sale. To properly represent the cash value of the gain, Staff's starting number would have to be adjusted downward from **$[redacted]** to **$[redacted]** and further adjusted downward to recognize a proper sharing of gain between shareholders and ratepayers, as discussed by Dr. Staihr. As I also explain below, these necessary adjustments would make it impossible for United to achieve a replenishment of the reserve at the level proposed by Staff.

Q. Are there any other flaws in Staff's proposal?

A. Yes. Under Staff's proposal, United would be required to record **$[redacted]** per year of revenue and at the same time replenish the reserve on its books to "preserve" the reserve amount through the time of United's next rate case. The suggested means of replenishing the reserve is the application of an 8.15% carrying charge. In other words, Staff's proposal seems to assume that the transfer of cash will generate an asset for

United that can earn a return in the amount of 8.15% annually. First, as I described above, the amount designed to generate earnings has not been set in an accurate manner. Therefore, in order to be correct, it must be reduced from **$[redacted]** to **$[redacted]** and be further reduced to reflect a proper level of sharing. Additionally, Staff's proposed carrying charge of 8.15% does not realistically reflect an annual rate of return that United could achieve on excess cash. A lower rate of return applied to a reduced amount of cash would be severely deficient to enable United to replenish the reserve and fund the annual imputation in the amounts proposed by Staff. With the combination of these two factors, it would be impossible for United to generate enough cash to cover the booked liability.

Q. Why is the 8.15% not achievable on the excess cash balance?

A. United is a regulated utility that earns a return on its investment in telephone plant and equipment, and is not a financial institution. While United would have the opportunity to earn an 8.15% rate of return on its overall operations if the Commission established that level as a reasonable one, it is not in a position to generate an 8.15% level of return on an excess cash balance.

Q. Didn't Staff suggest a lower discount factor in its previous testimony in this proceeding?

A. Yes, it did. As Ms. Strain explains in her supplemental testimony, Staff changed its recommended discount rate in conjunction with its amended proposal for the treatment of gain. Staff increased the rate for no other reason than to get to a result that would approximately maintain the level of imputation currently in rates. Moreover, Staff's proposal would now require that United fund an ongoing revenue credit and replenish the cash amount that supports that credit. Staff's proposed 8.15% rate of return is highly arbitrary and unrealistic because it overstates the level that United would be able to earn on any cash reserve, as I discussed previously.

Q. What is your position on Staff's alternative proposal, set forth on page 5 of Ms. Strain's supplemental testimony, that United set up a regulatory liability account on its books for the amount of the gain, increase it each year to account for the time value of money, reduce it each year by the amount of the current directory amortization and determine the ratemaking treatment as part of United's next rate case?

A. This recommendation is an improvement in that it would not result in the unrealistic and unachievable consequences that I described previously. Also, it is more in line with other similar types of regulatory accounting and theoretical ratemaking concepts. However, there are still some problems which the Commission should address and rectify if it decides to adopt Staff's alternative approach. First, the Commission should reject Staff's proposal to assign 100% of the gain to ratepayers and consider carefully the testimony of Dr. Brian Staihr on this matter. Second, the Commission should reject the proposal to delay the start of the amortization until the time of a rate case, which could result in harmful financial impacts to United depending on how the amortization period is set in that case. Rather, the Commission should adopt an amortization period that would result in minimal impacts to customers and the Company alike. In my supplemental rebuttal testimony, I discussed that it would be fair and reasonable to begin any amortization of gain as of 2003 because that was the date on which the directory transaction closed. The current embedded imputation amount should remain for the years 2003, 2004 and 2005 because those time periods have passed and the current imputation amount was in place and absorbed during each of those years. I also discussed why it would be reasonable that any replacement imputation be incorporated on a going forward basis from the time of the close of the separation. Further, the length of the amortization period should achieve annual imputation amounts that are approximately equal to the current amount of annual imputation, again, to mitigate impacts. In connection with the amortization, the Commission should adopt a discount factor for the time value of money that has a reasonable basis for its use. The factors proposed by both Staff and Public Counsel are far too arbitrary. As I discussed in my supplemental rebuttal testimony, a discount factor of ** %**, the percentage of the weighted average cost of capital that Houlihan Lokey utilized in the valuation of LTD Holding Company, while not optimal, is the best information available at this time.

If the Commission decides to approve Staff's alternative proposal, I would ask the Commission to consider these and the related factors discussed in my prior testimony, to minimize impacts and achieve a fair and reasonable balance between United and its customers.

Q. Does this complete your supplemental reply testimony?

A. Yes, it does.