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 DR. BRIAN K. STAIHR

ON BEHALF OF
SPRINT NEXTEL CORPORATION

FEBRUARY 13, 2006

Q. Please state your name.

A. My name is Brian K. Staihr.

Q. Are you the same Brian K. Staihr who filed rebuttal testimony in this proceeding on January 6, 2006 and supplemental rebuttal testimony on February 6, 2006?

A. Yes, I am.

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

A. The purpose of this testimony is to respond to the Supplemental Testimony of Mr. Michael L. Brosch, filed on behalf of Public Counsel on February 6, 2006. In this testimony I explain why Mr. Brosch's rationale regarding the allocation of the gain from the sale of Sprint's directory publishing business is flawed.

Q. In his Supplemental Testimony does Mr. Brosch continue to claim that shareholders should be completely excluded from sharing in any gains from the sale of Sprint's directory publishing business?

A. Yes, he does. On page 3 of his testimony Mr. Brosch makes that claim and, in doing so, presents an interestingly worded justification on lines 21-23. He writes, "ratepayers in Washington have borne all of the historical risks and costs associated with United's involvement in directory publishing in Washington." The reason this phrase is noteworthy is because, even if it were true, it does not justify excluding shareholders. This is discussed below.

Q. Is this the same rationale that Mr. Brosch presented in his earlier testimony as to why shareholders should be completely excluded from realizing any gain?

A. No. In his earlier testimony, on page 13, his argument was that shareholders were not the source of value of the directory publishing business. In this more recent testimony, his argument is that shareholders did not incur the risk or the cost of the directory publishing business.

Q. Are these two related?

A. They may or may not be. For example, if a new business owner takes her personal savings to open a store, she obviously incurred the cost of the business. She has also incurred the associated risk of the business (because either she will earn a return on her investment or will not). She has also contributed to the value of the business. But assume she hires a very effective, very personable store manager who attracts customers and builds the store's reputation. The manager clearly becomes a source of value, yet the manager is not bearing the costs of the business. Nor is the manager incurring the risk of the business, unless the manager has also invested in the business which makes him an owner.[1] In the case of directory publishing, it was shareholders who bore the primary risk of the business, and it was people buying ads (the *demanders* of advertising) who bore the costs. Value was created from many sources, some related to United's status as an incumbent LEC, and some not.

[1] The risk of the manager losing his job if the store goes out of business is not the same thing as incurring the risk of the business. See discussion of risk further below in the testimony.

Q. Please explain why Mr. Brosch's statement, "ratepayers in Washington have borne all of the historical risks and costs associated with United's involvement in directory publishing in Washington" does not justify excluding shareholders.

A. To see why this is so, it is easier to (momentarily) set aside the reference to "historical risks" and focus on "costs," so the statement would read "ratepayers in Washington have borne all of the …costs associated with United's involvement in directory publishing in Washington." If we examine this statement, we see that Mr. Brosch is *not* saying that ratepayers bore all the costs associated with directory publishing in Washington. Instead, he is saying that ratepayers bore all the costs associated with *United's involvement in* directory publishing in Washington. Let us assume, for the moment, that this is true. If so, then the next question that must be asked is: Are there any costs associated with the directory publishing business in Washington that are separate and distinct from *United's involvement in* directory publishing? The answer, of course, is yes. When a Sprint Publishing and Advertising ("SPA") salesman makes a call on a potential advertiser, and spends four hours convincing the buyer to buy a larger ad, the costs of the salesman's time and his expenses have nothing to do with United. They do not show up on the books of United and, more importantly, there is nothing in any local service rate charged to any Washington ratepayer that has anything to do with covering these costs. In my example, the salesman's time and his expense are undeniably costs associated with the directory publishing business in Washington. But they are—also undeniably—in no way related to United.

Even if we accept Mr. Brosch's claim that ratepayers in Washington have borne all of the costs "associated with United's involvement" in directory publishing in Washington, it is clear that there are costs of directory publishing that are *beyond* those reflecting United's involvement. Washington ratepayers did not bear those costs. If Mr. Brosch would have this Commission use the notion of "allocation of the cost burden" as a mechanism for determining "allocation of the gain" from the sale, there is no justification for allocating 100% to ratepayers.

Q. With the understanding that there are costs beyond those associated with United's involvement, does Sprint believe that Washington ratepayers bore all the costs that *were* associated with United's involvement with directory publishing in Washington?

A. Sprint is unsure exactly what the phrase "all the costs associated with United's involvement with directory publishing" means. For example, consider the expenses being incurred right now by participating in this phase of this proceeding. These expenses are clearly "costs that are associated with United's involvement with directory publishing." (If United was not involved with directory publishing we would not be filing this additional testimony.) To the extent that these expenses were not incurred last year (when there was no directory-related proceeding) these represent an actual year-over-year increase in costs associated with United's involvement in directory. Yet there was no corresponding increase in what ratepayers paid this year to cover these costs, and no adjustment to the corporate overhead expense component of the revenue requirement.

More important, though, is the simple fact that there are a wide variety of costs associated with the directory publishing business in Washington. Some of these reflect “United’s involvement” and some do not. Some may have been borne by ratepayers, others were not. Therefore, if the Commission decides to use “allocation of the cost burden” as its criteria, the resulting allocation cannot be 100% to ratepayers.

Q. But on pages 3-4 of his supplemental testimony doesn’t Mr. Brosch claim that, because revenue imputation was based on actual earnings, if the costs associated with directory publishing went up, the imputation amount would be affected as well? And therefore, in a sense, ratepayers *were* bearing the burden of these costs?

A. Mr. Brosch does make such a claim on pages 3-4 of his testimony, and it is completely wrong in many ways. He states that “whenever additional costs were incurred to produce directories … the amounts of directory imputation would be negatively impacted.” Setting aside the fact (discussed below) that United has not made – or attempted to make – any imputation adjustment in over fifteen years, Mr. Brosch’s logic is simply incorrect: Using actual revenues and actual earnings to calculate an imputation does *not* mean that any increase in cost is borne by ratepayers. Below I provide some examples of how the logic is flawed.

The existing imputation was calculated by applying an authorized rate of return to the directory publishing investment base and assuming that all directory publishing net operating income over that level constituted "excess" earnings, and therefore was available for imputation (after allocating a portion for Washington). Consequently, an increase in costs could only affect an imputation amount if it caused these "excess" earnings to decrease. A decrease in "excess" earnings *could*, if a complex series of conditions was met, potentially cause a decrease in the imputation. But the fact is that not every cost increase causes this decrease in excess earnings; there are many situations in which costs might increase but the imputation amount is never adjusted.

For example, if publishing costs increase by 5% but directory revenues, driven by the increased efforts of the sales force, increase by 6%, there may be no negative impact on directory publishing net operating income. In such a case, there would be no adjustment to any imputation – even if such an adjustment was sought – because "excess" earnings (the source of the imputation amount) would not have decreased. Clearly the 5% cost increase is a very real increase; it is just being covered by funds from ad-purchasers, rather than ratepayers. Mr. Brosch is simply incorrect when he claims on page 4 that "whenever" additional costs would be incurred, the costs would affect the imputation and thus, ratepayers.

Similarly, consider a second hypothetical situation where costs increased by 5% and revenues only increased by 4%. In this case there *might* be a negative impact to directory publishing net operating income and, as a result, “excess” earnings might decrease. But an adjustment would only be made to an imputation if a rate case was filed, and if the overall return had fallen below the allowed rate, and if the Commission granted relief in the form of an imputation adjustment. And even in that unlikely case, the adjustment would not reflect a 5% increase in costs because the change to directory publishing net operating income would reflect the change in earnings, not the change in costs. Clearly it is the case that not “all” costs are borne by ratepayers, as Mr. Brosch claims on page 3, and clearly using actual costs and earnings does not “transfer all cost burdens associated with directory publishing to ratepayers” (page 4).

Finally, consider the hypothetical where costs increase by a very significant amount, an amount greater than the dollar amount of the imputation. And assume that, because of these cost increases, “excess” earnings were reduced to zero (or less). In this case there would be no “excess” earnings at all, and adjusting the imputation would essentially have the effect of eliminating the entire imputation amount. Yet such an adjustment would still not cover all costs incurred (since they exceeded the imputation amount), unless it somehow raised local rates, or the rates of some other service, to cover the difference between the cost increase and the imputation. Conservatively stated, such a scenario (raising local rates to subsidize non-regulated directory publishing) is extremely unlikely: It is Sprint’s experience that regulators do not generally allow regulated operations to cross-subsidize non-regulated operations. Such a scenario demonstrates again that Mr.

Brosch is simply wrong to claim that using actual costs or actual earnings has the effect of transferring "all cost burdens associated with directory publishing to ratepayers."

So, to summarize, even though imputation is calculated using actual figures, this does not – contrary to Mr. Brosch's claims – mean that ratepayers incurred (or would incur) the cost burdens associated with directory publishing. If it did, if ratepayers were indeed responsible for covering all the costs of directory publishing, then every single dollar that was earned from ad sales would be 100% profit, since all of directory publishing costs were being covered by ratepayers.

Q. Does Sprint believe that looking at which parties bore the costs of directory publishing is the correct way to establish the allocation of the gain from the sale? That is, should the "allocation of the costs" determine the "allocation of the gain"?

A. Not necessarily. As discussed in my earlier rebuttal testimony filed January 6, 2006, the principles contained in *Democratic Central* dictate that the proper way to determine an ownership claim over the gain from the sale of an asset is to first determine who bore the risk of the asset. Then, if that is not possible, determine which party bore the financial burden of the asset. The "allocation of cost" approach correlates to the financial burden criteria. It should only be applied if the "allocation of risk" criteria cannot be.

Q. So, can we apply the "allocation of risk" criteria in this case?

A. Absolutely. As detailed in my Rebuttal Testimony filed January 6, 2006, shareholders bore the risk associated with directory publishing. As explained in that testimony, risk is the potential difference between an expected return on an asset and the actual return. The greater this potential difference, the greater the risk. Assets where the actual return does not deviate from the expected return as considered "risk-free" assets. Any stock price, including Sprint's, reflects the expected cash flows from the business. If these cash flows are less than expected, the stock price reflects this and declines. Owners of the stock – the shareholders – are the ones who experience the loss. Ratepayers do not.

Q. Does Mr. Brosch, in his testimony, explain why he believes shareholders did not incur risk?

A. Yes he does, and interestingly, if the Commission accepts his logic then it must also conclude that ratepayers bore no risk as well. On page 5 of his Supplemental Testimony Mr. Brosch writes the following: "Sprint's shareholders were never exposed to any serious risk of losing its [sic] investment because the incumbent directory business is <u>not</u> capital intensive and achieves most of its value from its exclusive relationship with the local telephone company …." (emphasis in original). We must consider this statement carefully: Mr. Brosch is suggesting that shareholders did not incur risk for two reasons: because the business is not capital intensive, and because the source of the value of the business (according to him) was someone else. A shareholder's investment is the price paid for a share of stock and, as I mentioned above, the price of a stock reflects expected cash flows. If cash flows are less than expected, the price declines and shareholders lose on their investment. If Mr. Brosch honestly believes that shareholders were never exposed to any risk of losing on their investment then he is saying that there was never a chance that cash flows would be less than expected. If that is so, then there was never a chance that any imputation adjustment would ever take place, and ratepayers never incurred any risk either.

Q. Is it correct to state that shareholders never incurred any risk?

A. No, and Mr. Brosch's rationale for suggesting such a thing is massively flawed. He claims that shareholders incurred no risk because directory publishing is not a capital intensive business. That statement is completely unrealistic; many industries, from the financial services industry to the in-home nursing care industry, are not capital intensive. That does not mean that shareholders incur no risk. I am sure the shareholders of Citicorp and Kelly Services would take little comfort in Mr. Brosch's conclusion that they are at no risk of losing on their investment, and that their share prices will only go up in the future.

With regard to the second part of the statement – shareholders incurred no risk because they were not (according to Mr. Brosch) the primary source of value – this claim is equally unrealistic. Returning to the example I presented earlier in this testimony (the small-firm owner starting a new business who hires the effective manager who adds value), the store's owner is a source of value but obviously the manager is a source of great value as well. In fact, the manager may contribute more to the value than the owner. But the fact that the owner is not the primary source of value does not remove the risk from the owner. If the business fails, for whatever reason, it is the owner who incurs a loss on the investment.

Q. But, in your example, doesn't the manager also incur a loss in the form of a lost job?

A. That is a very important question, and very applicable to the situation at hand because the manager, in my example, in this respect is exactly like ratepayers in Washington: The manager derives a benefit (his salary) from the income generated by the asset (the store). In this case, ratepayers derive a benefit (lower rates through imputation) from income generated by the asset (the directory publishing business). Losing that benefit is not the same thing as incurring a loss on the asset.[2] However, it is possible to view it as a loss *associated* with the asset (as described at length in my Rebuttal Testimony filed January 6, 2006). If we choose to view it this way, we must acknowledge that the risk of a loss in the

[2] In this example, although the manager bears the risk of a loss that is *related* to the asset, technically that does not mean that the manager shared the risk of loss *on* the asset. There are many parties that derive benefit from the income generated by the asset: the landlord who rents the store space, the suppliers to the store, the electric company who supplies power to the store, and the store's employees. If the store goes out of business, they all lose the benefit that they derive from the asset's (store's) income. But that does not mean they share the risk of loss on the asset. If it did, they would be in a position to seek recourse against the management for the loss caused by mismanagement of the asset, much like shareholders have the right to bring suit for mismanagement of the asset they own. Shareholders have this right because they have an ownership claim to the asset. The manager in the example does not have this ownership claim. And – returning to the case at hand – ratepayers do not have this ownership claim either.

directory business becomes two things: 1) the risk of a loss *on* the asset, which is borne by shareholders, and 2) the risk of a loss *of a benefit associated with* the asset, which (Mr. Brosch claims) is borne by ratepayers. And using this risk-based criterion, <u>again</u> we show that there is no justification for excluding shareholders, and no justification for allocating 100% of the gains from the sale to ratepayers.

Q. So the risk of a loss in the directory publishing business becomes two things: a risk of a loss on the asset itself (the business) to shareholders, and a risk of a loss of a benefit associated with the asset (the imputation) to ratepayers. Do these two things always happen together?

A. No. Simply stated, ratepayers would never experience a loss of their benefit (the imputation) unless shareholders have already experienced a loss on their asset. But the opposite is not true; it is very possible for shareholders to incur a loss on their asset and ratepayers to never experience a loss of their benefit. As I stated above, share prices are a function of cash flows, and when cash flows are less than expected, share prices decline and shareholders experience a loss. The only time that loss would translate to a loss of ratepayers' benefit (reducing the imputation) is if United pursued compensation for the lost cash flows by entering into a rate case.

Q. Has United, or any Sprint ILEC, ever entered into a rate case solely in pursuit of a potential imputation adjustment?

A. No.

Q. Please summarize your testimony.

A. Mr. Brosch, in his supplemental rebuttal testimony, continues to advocate that shareholders be completely excluded from sharing any of the gain from the sale of Sprint's directory publishing business. His original position was a value-based argument – that shareholders should be excluded because only ratepayers created the value of the business. As discussed in my Supplemental Rebuttal Testimony filed February 6, that argument is incorrect. Now, in Mr. Brosch's more recent testimony, his position is a risk- and cost-based argument: He claims that only ratepayers incurred costs, and that shareholders incurred no risk associated with directory publishing. Again, his arguments are simply incorrect. First, there are costs associated with directory publishing in Washington that have nothing to do with United's ratepayers, and were certainly not incurred by United's ratepayers. Second, the imputation process does *not* ensure that all directory-related costs are transferred to ratepayers. Third, the only time ratepayers could potentially incur risk by experiencing a loss associated with directory business is if a complex set of conditions was met, including United entering into a rate case in pursuit of an imputation adjustment – conditions that *never* existed in Washington. Every argument that Mr. Brosch makes for excluding shareholders is erroneous. In summary, there is simply no justification for completely excluding shareholders from a portion of the gain from the sale of Sprint's directory publishing business.

Q. Does this conclude your testimony?

A. Yes it does.