

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Staff Investigation Regarding Agreements
for Directory Services Between VERIZON
NORTHWEST INC. and IDEARC MEDIA
CORP., formerly Verizon Information
Services Inc.

DOCKET NO. UT-061777

NARRATIVE SUPPORTING
SETTLEMENT AGREEMENT

I. Preliminary Matters

1 This Narrative Supporting Settlement Agreement (“Narrative”) is filed by the Staff of the Washington Utilities and Transportation Commission (“Staff”) on behalf of itself and the other signatories to the Settlement Agreement filed in Docket No. UT 061777 (“Agreement”), which are: Verizon Northwest Inc. (“Verizon NW”), Public Counsel Section of the Office of the Washington Attorney General (“Public Counsel”), the Washington Electronic Business and Telecommunications Coalition (“WeBTEC”), and the United States Department of Defense and all other Federal Executive Agencies (“DOD/FEA”). Staff, Verizon NW, Public Counsel, WeBTEC, and DOD/FEA may hereinafter be referred to, each individually as a “Party” and collectively as the “Parties.” This Narrative summarizes the Agreement, and is not intended to modify any terms of the Agreement.

II. Scope of the Underlying Dispute

2 On November 17, 2006, Verizon Communications Inc. (“Verizon Communications”) spun off the directory business formerly operated by Verizon Information Services and its subsidiaries (collectively, “VIS”), to Verizon Communications shareholders to form the independent company Idearc Media Corp. (“Idearc”) (the transaction referred to herein as

the "Spin-Off"). On November 22, 2006, Verizon NW filed agreements related to the Spin-Off with the Washington Utilities and Transportation Commission ("Commission"), and the Staff opened Docket UT-061777 to commence an investigation into the matter. The Parties subsequently engaged in discussions regarding the impact of the Spin-Off on the intrastate retail rates of Verizon NW in Washington (if any).

3 Verizon NW believes that the Spin-Off is not subject to the Commission's jurisdiction and should have no impact on its intrastate retail rates in Washington. Verizon NW further believes that even the question as to whether the Spin-Off should have an impact on its rates is premature, as it can only be decided in the scope of a general rate case. The other Parties disagree with the views of Verizon NW, and believe that the Commission has jurisdiction over the Spin-Off. Their position is that the potential ratemaking implications of the Spin-Off should be addressed now through development of an amortized revenue figure to be used in financial reports to the Commission and in future earnings reviews, such as rate cases and petitions for an alternative form of regulation ("AFOR").

4 Even assuming it is appropriate to develop an amortization figure, Verizon NW and the other Parties disagree on how it would be derived. Disagreements include threshold issues, such as: (i) how an overall number to be amortized would be calculated; (ii) what portion of the derived figure would be attributable to ratepayers in Washington; and (iii) the appropriate length of the amortization period.

5 The Parties engaged in an informal process to address the concerns of Parties other than Verizon NW on developing an amortized figure to be used in future rate cases, AFOR petitions and financial reporting. After lengthy negotiations and Verizon NW's provision of information to the other Parties in an informal discovery process, the Parties reached an

agreement on an amortization figure and time period over which the figure can be used in future rate cases, AFOR petitions and financial reports of Verizon NW that are submitted to the Commission. The Agreement was reached as a compromise (without waiver of any Party's positions on all matters, with the express reservation to revert to such positions should the Agreement not be approved in full), and would render moot the threshold disagreements of the Parties that would otherwise likely be resolved only through protracted litigation. Accordingly, the Parties seek Commission approval of the Agreement without change.

III. Overview of the Proposed Settlement Agreement

6 The Agreement, without waiver of any respective position(s) of the Parties, produces an amortization figure to be used in future rate cases and/or AFOR filings, as well as to be included in the financial reports of Verizon NW that are submitted to the Washington Commission for a specified time period. The amortization figure and time period are confidential until they are approved by the Commission and become effective, and are provided in the confidential copy of the Agreement filed with the Commission.

IV. Statement of Parties' Views

7 This Narrative, as envisioned by WAC 480-07-740(2), includes a "statement of parties' views about why the proposal satisfies both their interests and the public interest." Each Party has contributed the following separate statements:

Verizon NW.

8 Verizon NW's position is that: (i) the Commission does not have jurisdiction over this transaction, and the transaction has no impact on Verizon NW's intrastate retail rates in Washington; (ii) even if there were an impact on such rates, that impact cannot be

determined outside the scope of a general rate case and (iii) even if development of an amortization figure were appropriate at this point, the overall figure to be developed would be much lower than the number claimed by the other Parties, and would result in a much shorter amortization period than as set forth in the Agreement.

9 With regard to (i), the lack of Commission jurisdiction stems from fact that the directory business of Verizon Communications was always held through entities (VIS) separate and apart from Verizon NW, and the Spin-Off did nothing more than convert that separate business into an independently owned company. Thus, no regulatory assets of Verizon NW were transferred in the Spin-Off. Moreover, the agreements governing the dealings between Verizon NW and Idearc are commercial arrangements between two independent, unaffiliated companies and thus do not constitute “affiliated interest” agreements under the Commission’s rules. The structure of the Spin-Off and the independent history of VIS render this a materially different transaction than the sales of Qwest and Sprint directory businesses to third parties. Indeed, the discussions of “gain” from the sale of Qwest and Sprint business to third parties have no place in the context of a spin-off transaction such as this one.

10 Nevertheless, the Agreement is in Verizon NW’s interest because it resolves the matter without protracted litigation and provides regulatory certainty going forward on the treatment of an unprecedented transaction by the Commission. The avoidance of protracted litigation also places the Agreement in the public interest because without the settlement, there would have been lengthy disputes – both jurisdictional and methodological – about the Spin-Off in future rate cases and/or AFOR filings, as well as over financial reporting requirements.

Commission Staff.

11 The Staff has historically insisted upon recognition of the earnings arising from publication of telephone directories as an offset to the revenue requirement of Verizon NW in rate case proceedings. Staff has viewed the exclusive right of telephone company affiliates to engage in directory publishing to be a regulatory asset properly attributed to ratepayers. The Commission and the State Supreme Court have upheld this view as well as the propriety of the Commission's ratemaking adjustments to include directory publishing income in determination of telephone company earnings and revenue requirements. *US West v. Utilities and Transp. Comm'n*, 134 Wn.2d 74, 87-96, 99-102, 949 P.2d 1337 (1997).

12 As part of the Spin-Off, Verizon Communications, Inc., Idearc, and Verizon Services Corporation, on behalf of several operating companies including Verizon NW, entered into a publishing agreement under which Idearc receives exclusive official directory publishing rights for thirty years. Verizon Communications Inc. and Idearc also entered into a non-competition agreement which, among other things, restricts the directory publishing activities of Verizon NW and other Verizon telephone companies for thirty years. Staff believes the agreements constitute "arrangements" between Verizon NW and its affiliate Verizon Communications Inc that are jurisdictional to the Commission under the affiliated interest statutes codified under RCW 80.16.

13 However, when the directory publishing business is permanently separated from common ownership with Verizon NW, as occurred in November 2006 with the spin-off of Idearc, there is no longer an affiliated publishing business and it becomes extremely difficult to obtain directory publishing financial information or to assert corrective regulatory adjustments. Under these circumstances, it is necessary to secure a fixed amount of

directory income contribution for ratemaking purposes to recognize the Washington ratepayers' claim upon the value associated with the exclusive directory publishing rights that are being transferred.

14 The Settlement satisfies the need to secure a fixed amount of amortized directory revenue contribution in the event of any future Verizon NW rate case or alternative regulation proceeding, or any other matter in which the reported financial results of Verizon NW are being reviewed. The term and amount of amortized revenue credits was carefully analyzed by the Staff and its consultant and is consistent with the value of the business as of November 2006, with reasonable allocation of such value to Washington ratepayers. Agreement to a fixed directory revenue amortization eliminates the need to litigate the reasonableness of directory revenue attribution in future regulatory proceedings, while removing the risks of potentially reduced future directory revenues arising from the competition being faced by directory publishers.

15 Staff recommends approval of the Settlement as consistent with Staff's interests and the public interest, for the reasons stated above.

Public Counsel.

16 Public Counsel has maintained that the full value associated with the incumbent directory publishing rights enjoyed by regulated telephone company affiliates should be recognized when telephone rates are adjusted or the financial performance of the regulated ILEC carrier is evaluated, even though unreasonable affiliate contract arrangements have historically sought to transfer such directory revenues from the regulated business' books. This position has been adopted by the Commission in numerous previous proceedings where directory revenues from the corporate publishing affiliate were imputed in determining

revenue requirements, and is summarized in considerable detail within the "HISTORY" section of the Commission's Fourteenth Supplemental Order in Docket No. UT-980948. In Verizon's most recent Washington rate case (Docket No. UT-040788), one of the most contentious ratemaking issues surrounded directory publishing revenues and this issue was compromised only as part of a global settlement, effectively ensuring the issue would remain unresolved for litigation in any future proceedings that may occur.

17 Recently, telephone holding companies have reorganized and sought to monetize the value of these directory publishing rights, complicating the Commission's historical ratemaking approach to this affiliated interest problem. Verizon's spin-off of directory publishing into the newly created Idearc entity is consistent with similar transactions undertaken in recent years by Qwest Communications, Inc. and Sprint Corporation.

18 The Settlement now offered for approval by the Commission is consistent in its design with other Commission-approved settlements involving Qwest Communications' sale of the Dex publishing business in 2003 in Docket No. UT-021120 and with Sprint Nextel Corporation's sale of its Sprint Publishing and Advertising affiliate to R.H. Donnelley in 2003, addressed in Docket No. UT-051291, the proceeding conducted to consider the spin-off of the Sprint local telephone operations into a separate entity, Embarq. Under the pending Settlement with Verizon, ratepayers served by Verizon NW will benefit from an assured directory revenue amortization credit in multiple future years in the confidential amount set forth in the Settlement, while avoiding any uncertainty surrounding potential litigation of this contentious issue and any risk associated with anticipated declines in future directory publishing income. By reflecting such amortization revenue credits within the Verizon NW Commission-basis financial statements that are submitted for Staff review, a

more accurate depiction of the Company's financial condition is continuously available to the Commission and its Staff for consideration in future regulatory proceedings. Public Counsel recommends approval of the Settlement as consistent with the public interest for the reasons stated herein.

DoD/FEA.

19 DoD/FEA's position is that (i) the Commission has jurisdiction to review the nature and terms of the Spin-Off as to the impact thereof on ratepayers in Washington; (ii) the Commission has the ability, based on a record, to determine to what extent and in what manner ratepayers have legitimate claims on the value of the directory operations to assure that ratepayers are not adversely affected by the Spin-Off, and to fashion relief as was done in Docket No. UT-021120, Qwest Communications' sale of the DEX publishing operations; and (iii) the Commission should ensure that Verizon NW's regulatory financial reports accurately reflect the relief accorded ratepayers in this regard.

20 As a large customer of Verizon NW's business telecommunications offerings, DoD/FEA has an interest in ensuring that Verizon's rates are determined in a manner that reflects appropriate regulatory adjustments to its operating results. One such adjustment that the Commission has traditionally made for telecommunications companies is the imputation of revenues from carriers' directory operations. In Commission Docket No. UT-040788, the 2004-2005 Verizon NW rate case, witnesses for Staff and Public Counsel filed considerable testimony supporting the imputation of revenue from Verizon NW's affiliated directory operations to augment regulated income for ratemaking purposes. Verizon NW opposed that treatment. Had that proceeding not been settled, DoD/FEA also would have urged the

Commission to adopt a revenue imputation as necessary to ensure that intrastate rates were just and reasonable.

21 The proposed settlement, a product of compromise, in this proceeding satisfies DoD/FEA's interests as a large telecommunications user and ratepayer, because it provides for an appropriate revenue imputation to help offset the need for future rate increases and to be reflected in future proceedings during the term of the imputation. Thus, the settlement is in the public interest by ensuring that ratepayers will receive a fair financial contribution, consistent with Commission practice, should Verizon NW's rates, regulatory scheme or financial results be reviewed during that period. The proposed settlement also is in the public interest because it eliminates the need for parties and the Commission to expend the considerable effort (as reflected by the previous extensive testimony in Docket No. UT-040788 on this point) necessary to resolve the directory revenue imputation issue. The proposed settlement will accordingly narrow issues in future proceedings, eliminate uncertainty, allow for a focus on other contested issues and conserve Commission's and parties' resources. For these reasons, DoD/FEA supports the approval of the proposed settlement.

WEBTEC.

22 Like DoD/FEA, WeBTEC members are large customers of Verizon and, as such, have an interest in seeing that Verizon NW's rates reflect appropriate adjustments to its operating results. WeBTEC concurs in the statements of the Commission Staff, Public Counsel, and DoD/FEA. WeBTEC believes that the proposed settlement is in the public interest because it ensures that ratepayers will receive the benefit of a fair, fixed amount of amortized directory revenue contribution in the event of any future Verizon NW rate case,

alternative regulation proceeding, or any other matter in which the reported financial results of Verizon NW are being reviewed. The proposed amortized revenue credit is consistent with prior Commission treatment of other directory publishing transactions. The proposed settlement also is in the public interest because it eliminates the need for parties and the Commission to expend the considerable effort necessary to resolve the directory spin-off issue. The proposed settlement is a true compromise, and WeBTEC recommends that it be approved.

V. Legal Points that Bear on the Agreement

23 The Parties do not believe that there are any legal points that require discussion under WAC 480-07-740(2)(a). By approving this Agreement without change, the Commission will avoid the need to address a number of threshold issues, including: (i) whether the Commission has jurisdiction over the transaction; (ii) whether the transaction may have any impact on the intrastate retail rates of Verizon NW in Washington; and (iii) the proper methodology for determining an amortization figure

VI. Conclusion

24 The Parties respectfully request that the Commission approve the Agreement in full.