STATE OF NEW JERSEY

BOARD OF PUBLIC UTILITIES

In the Matter of Joint Petition of United Telephone	)	
Company of New Jersey, Inc. d/b/a Sprint and LTD	)	Docket No. TM05080739
Holding Company for Approval Pursuant to	)	
N.J.S.A. 48:2-51.1 and *N.J.S.A.* 48:3-10 of a	)	
change in Ownership and Control	)	

DIRECT TESTIMONY OF SUSAN M. BALDWIN
ON BEHALF OF THE
NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE

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REDACTED VERSION

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1 # I. INTRODUCTION

2 **Qualifications**

3 **Q: Please state your name, position, and business address.**

4 A: My name is Susan M. Baldwin. I am a consultant, and my business address is 17 Arlington
5 Street, Newburyport, Massachusetts, 01950. I specialize in telecommunications economics,
6 regulation, and public policy, and consult to public sector agencies.

7 **Q: Please summarize your educational background and professional experience.**

8 A: I have prepared a Statement of Qualifications, which is included as Attachment A.

9 **Q: Have you previously testified before the New Jersey Board of Public Utilities ("Board")?**

10

11 A: Yes. On July 8, 2005 and August 19, 2005, I filed testimony in Docket No. TM05030189, on
12 behalf of the Division of the Ratepayer Advocate ("Ratepayer Advocate"), in which I analyzed
13 the proposed merger between Verizon Communications Inc. ("Verizon") and MCI, Inc.
14 ("MCI"). On May 4, 2005 and June 1, 2005, I filed testimony in Docket No. TM05020168 on
15 behalf of the Ratepayer Advocate, in which I analyzed the proposed merger between SBC
16 Communications, Inc. ("SBC") and AT&T Corporation ("AT&T"). On January 10, 2005 and
17 February 4, 2005, I filed testimony in Docket No. TO01020095, on behalf of the Ratepayer
18 Advocate, in which I analyzed Verizon's request to classify business local exchange service
19 offered to customers with two to four lines as competitive. On December 22, 2004 and January
20 18, 2005, I filed testimony on behalf of the Ratepayer Advocate in Docket No. TT04060442

1 in which I reviewed Verizon's petition for a rate restructure. On February 4, 2004, in Docket
2 No. TO03090705, I submitted testimony rebutting Verizon's assertion of non-impairment for
3 mass market switching, high capacity loops, and transport in certain geographic areas in New
4 Jersey.[1] On January 23, 2004, in Docket No. TO00060356, I submitted testimony analyzing
5 Verizon's proposed use of financial lives in computing depreciation costs in its recurring and
6 nonrecurring total element long run incremental cost ("TELRIC") studies. Also, in 1992, I
7 testified on behalf of the New Jersey Cable Television Association in Docket No. T092030358,
8 regarding the Application of the New Jersey Bell Telephone Company for Approval of its Plan
9 for an Alternative Form of Regulation.

10 **Assignment**

11 **Q: On whose behalf is this testimony being submitted?**

12 A: This testimony is being submitted on behalf of the Ratepayer Advocate.

13 **Q: What is the purpose of your testimony at this time?**

14 A: The Ratepayer Advocate asked me to review the petition of United Telephone Company of
15 New Jersey ("United" or "United New Jersey" or "United NJ") and LTD Holding Company
16 ("LTD") (together, "Joint Petitioners") for approval of a change in ownership and control from
17 Sprint Nextel Corporation ("Sprint Nextel") to LTD.[2] The Ratepayer Advocate also asked me

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1/ In October 2004, I sponsored an affidavit on behalf of the Ratepayer Advocate, which was submitted to the Federal Communications Commission in CC Docket No. 01-338, regarding network unbundling.

2/ Joint Petition of United Telephone Company of New Jersey, Inc. d/b/a Sprint and LTD Holding Company for Approval Pursuant to *N.J.S.A.* 48:2-51.1 and *N.J.S.A.* 48:3-10 of a Change in Ownership and Control, Verified Petition , August 26, 2005, ("Joint Petition").

1 to recommend specific conditions to protect residential and small business consumers from
2 potential harm and to increase the possibility of benefits flowing to consumers, should the
3 Board approve the Joint Petition.

4 **Summary of testimony**

5 **Q: Please summarize your testimony.**

6 A: The Joint Petition raises numerous issues, which merit scrutiny by the Board. Among the areas
7 of concern that I have identified based on my review of the Joint Petition, supporting
8 documents and direct testimony, and responses to discovery are the following:

9

10 • *Incomplete information:* First of all, there are many unanswered questions and
11 numerous outstanding data requests that bear directly on the Board's assessment of the
12 merits of the proposed transaction. As I demonstrate below, it is premature for many
13 reasons for the Board to deliberate on the merits of the proposed spin off of Sprint's
14 local operations. I reserve the right to supplement my testimony based on my review
15 of responses to outstanding data requests.

16

17 • *Absence of S-1:* The Joint Petitioners have yet to provide a copy of their S-1 either in
18 final or draft form. It is important for regulators to be able to compare the analysis
19 prepared for *regulatory* purposes with that prepared for *investment* purposes, as the S-1
20 reflects the most realistic assessment of risks related to the spin-off.

1

2 • *Reverse Merger Savings*: Sprint Nextel's proposed divestiture of its local operations
3 represents a "reverse merger." Indeed, the divestiture constitutes a sale of assets with
4 proceeds that should be shared with consumers. The Board should direct the sharing
5 of the proceeds from this divestiture and require the Petitioners to credit ratepayers, or,
6 in the alternative, to commit to specific levels of investment in New Jersey's
7 infrastructure. As the transaction is presently structured, consumers do not share in the
8 proceeds.

9

10 • *Adequate Compensation to consumers:* The filing does not address the post spin-off
11 treatment of such key issues as (1) Yellow pages, (2) the use of the name of Sprint by
12 Sprint Nextel (*e.g.,* will Sprint Nextel compensate the local spun-off company for the
13 use of the name?); (3) the cost of rebranding the local operations that are spun off (*e.g.,*
14 what is the rationale for the local company being obliged to rebrand rather than Sprint
15 Nextel?). In 2003, Sprint sold its highly profitable directory publishing for $2.3 billion,
16 yet has not yet compensated New Jersey consumers. New Jersey consumers are
17 entitled to $65,000,000 as a result of the sale.

18

19 • *Inter-company transactions:* The Joint Petitioners do not explain adequately the
20 treatment of shared assets and the transaction services agreements that relate directly

1 to the relationship between Sprint Nextel and the spun-off local company, and the
2 ability of LTD to succeed.
3
4 • *Capital Structure:* The reduction in dividend payments and increase in interest
5 expenses that the Joint Petitioners have planned may alter investors' view of the
6 financial attractiveness of the spun off company, which, in turn, would affect the
7 financial soundness of the spun-off company.
8
9 • *Guarantee by Sprint Nextel:* Sprint Nextel should guarantee the debt obligations that
10 LTD assumes and should also guarantee all pension obligations for LTD.
11
12 • *Modification of debt instruments to protect consumers:* The debt instruments should
13 be modified to remove any requirement that excess earnings must be applied to the
14 debt obligations.
15
16 • *Declining Capital Expenditures:* The Joint Petitioners' fail to explain adequately the
17 rationale for the projected trend of declining capital expenditures. Other than a
18 "keeping up with the Joneses" approach to mimic the capital expenditure patterns of
19 other incumbent local exchange carriers ("ILECs"), the Joint Petitioners fail to justify
20 their plan to dramatically decrease investment in their network.

1

2 • *Declining Service Quality:* The trend of declining service quality in United
3 Telephone's New Jersey territory, particularly when considered in the context of the
4 Joint Petitioners' plans for reducing their capital investment, jeopardizes consumers
5 of safe and adequate basic local exchange service.

6

7 • *Declining Subscribership:* Recently released data from the Federal Communications
8 Commission ("FCC") shows a declining trend in subscribership in New Jersey, which
9 the Joint Petitioners have not yet addressed.

10

11 • *Absence of showing of positive benefits:* The complex transaction could harm
12 consumers and yet would fail to yield positive benefits.

13

14 • *Risk to New Jersey consumers:* By jeopardizing the financial viability of LTD, the
15 divestiture would jeopardize the reasonableness of the rates and the adequacy of the
16 service quality of United NJ's local telecommunications services.

17

18 • *High executive compensation coupled with uncertain outcome for employees and*
19 *pension:* Executives clearly would be compensated generously, but any positive
20 impact of the transaction on employees' pensions and on employment levels is less

1 certain.

2

3 • *The Joint Petition is filed by the wrong party.* The real owner of the wireline business
4 is presently Sprint Nextel. The Joint Petition also fails to contain the necessary
5 information required by applicable Board regulation. Therefore the Joint Petition
6 should be dismissed.

7

8 • *Payphones:* Sprint Payphone has not yet submitted a cost analysis that demonstrates
9 that its revenues exceed its expenses, and, therefore, the Board cannot determine
10 whether Sprint Payphone has complied with various FCC orders.

11 **Q: Did the Ratepayer Advocate raise concerns about the spin off when Sprint and Nextel**
12 **sought approval of their proposed merger?**

13 A: Yes. At the time, the Ratepayer Advocate stated, among other things:

14 According to the Communications Workers of America ("CWA"), Sprint's
15 Local Division, which mainly serves rural customers, has for several years
16 effectively subsidized its wireless business. One feature of the proposed
17 merger is a spin-off of this division into an independent ILEC.
18 Communication Workers of America encourages the FCC to require the
19 assets and debts to be divided equitably to ensure the viability of the
20 spun-off ILEC.

1

2 The Ratepayer Advocate echoes the concerns of the CWA that rural landline
3 customers might be disadvantaged following the spin-off of the Sprint ILEC
4 if the assets and liabilities are not equitably assigned and allocated between
5 the new merged entity and the local spin-off. The FCC should take the steps
6 necessary to ensure that the spin-off occurs fairly.

7

8 The Applicants contend that the CWA's concerns are premature, and that the
9 FCC can address them when the Applicants, at a later date, seek approval to
10 spin off the local operations. However, the Applicants have squarely raised
11 this issue by announcing their intent to spin off the local operations, and,
12 therefore, it is entirely appropriate for the FCC to assess at least some aspects
13 of the implications of such a transaction at this time. Accordingly, in
14 anticipation of this spin-off, the FCC should require the Applicants to maintain
15 comprehensive records of costs and revenues, subject to an outside audit, to
16 facilitate any future regulatory review.

17

18 Also, recognizing the anticipated net $12 billion in merger synergies, the FCC
19 should require the Applicants to: (1) record in detail all components of the
20 merger synergies as they occur (e.g., reduced costs, enhanced revenues, and

1 transaction costs) so that, if and when, the local operations are spun off, the
2 timing is not such that the local business bears a disproportionately high share
3 of the one-time integration costs (which occur in the early years) and a
4 disproportionately low share of the recurring savings (which occur into
5 perpetuity); (2) agree to pay for an independent audit of the Applicants'
6 operations as an integral component of its request for regulatory approval of
7 any spin-off of the local operations; and (3) commit to sharing the merger
8 synergies with the spun-off local operations based on the net present value of
9 the synergies. Without this last commitment, it is entirely possible that the
10 Applicants, relying on the most recent year of financial information (and one
11 which might reflect the high one-time, nonrecurring merger transaction costs)
12 will shortchange the local spin-off. The concern is that, in the context of
13 seeking regulatory and investor approval, merger applicants express confidence
14 in their ability to achieve synergies, but in the context of assigning merger
15 synergies to ratepayers (or likely to spinoffs), these same synergies will
16 suddenly become speculative, not "known and measurable." The spin-off
17 should not occur in such a way as to saddle the local operation with merger
18 costs and no merger benefits.[3]

[3]/ Applications of Nextel Communications, Inc., and Sprint Corporation, for Consent to the Transfer of Control of Entities Holding Commission Licenses and Authorizations Pursuant to Sections 214and 310(d) of the Communications Act, WT Docket No. 05-63, Comments of the Division of the Ratepayer Advocate, April 18, 2005, at 6-7.

Q: How did the FCC address the various concerns raised about the anticipated spin off?

A: The FCC stated,

> Commenters suggest that, to the extent that our benefits analysis is predicated on the spin-off of Sprint's Local Division, we must also consider any potential harms to Sprint's wireline consumers that might result from the spin-off, and that the merger must be conditioned upon the approval of the Applicants' commitment to a "fair and equitable allocation" of corporate assets and debt at the time of the separation of the Sprint's Local Division, which is Sprint's local exchange business.
>
> Even though our benefits analysis in this transaction is not dependent on the announced future spin-off of Sprint's Local Division, we note that Sprint and Nextel have submitted a letter in this proceeding specifically addressing CWA's comments. Gary D. Forsee, Sprint's Chairman and CEO, and Timothy M. Donahue, Nextel's President and CEO, submitted a letter to the Commission on August 2, 2005, stating that the new local company, LTD Holding Company, "will receive an equitable debt and asset allocation at the time of its proposed spin-off so that the company will be a financially secure, Fortune 500 company." They state that "[i]ts stock is expected to be traded on the New York Stock Exchange; and it anticipates having a level of equity, debt and other financial characteristics consistent with those of companies that have been rated 'investment grade' by major ratings agencies." Furthermore, Mr. Forsee and Mr. Donahue state that, as part of the state commission approval process for this spin-off and resulting change of control of its local telephone operations, Sprint Nextel "will demonstrate that the New Local Company will possess the requisite financial strength, in addition to managerial and technical capability, to fully perform its public service obligations." We find that these statements represent commitments by Sprint Nextel that the new local wireline company, LTD Holding Company, will receive an equitable debt and asset allocation at the time of its proposed spin-off so that the company will be a financially secure, Fortune 500 company, and that Sprint Nextel will demonstrate that the new local company will possess the requisite financial strength, in addition to managerial and technical capability, to fully perform its public service obligations. In addition, these statements are presumably made in accordance with the Commission's requirements of candor and truthfulness, and, for this reason, we award them substantial weight.[4]

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[4]/ *Sprint Nextel Order*, paras. 182-183.

1 **Q: Did the FCC raise issues that may bear on the Board's deliberations in this proceeding?**

2 A: Yes. Commissioner Adelstein, in his separate statement, raised, among other things, the goal
3 of wireless broadband deployment, as the following excerpt indicates :

4 In this vein, I am very pleased that the companies have committed to specific
5 milestones in the deployment of services in the 2.5 GHz band. I initially had
6 concerns about Sprint Nextel amassing such a wide swath of spectrum in this
7 band without providing any clear plan for deployment. I raised these issues
8 with the companies, and have been encouraged by their response. They met my
9 concerns head on by providing a specific schedule of implementation
10 milestones that will ensure wireless broadband services will be deployed to at
11 least 30 million Americans across a number of markets, both large and small.
12 And, just as important, they put their money where their mouth is by agreeing
13 to be subject to enforcement action in the event Sprint Nextel fails to meet
14 these commitments for reasons of circumstances within the company's control.[5]

15 The Board should seek information about Sprint Nextel's plans in New Jersey, and also
16 specific milestones for deployment of broadband wireless in New Jersey.

17 **Q: Please elaborate on other issues that are relevant to consumers in New Jersey.**

18 A: Commissioner Copps raised issues pertaining to 911:

19 I believe we should have conditioned approval of this merger on Sprint Nextel
20 either meeting its 911 deadline, or having a waiver or consent decree in place.
21 We should have insisted that Sprint Nextel immediately get itself on a path to
22 full public safety compliance. I am disappointed that we do not do more today
23 to ensure compliance with our public safety deadline. I hope that we do not pay
24 a price for this decision, because Nextel's efforts to comply with our rules do
25 not seem to be working. I am pleased, however, that the company is
26 considering stepping up its efforts to comply with our public safety rules by, for
27 example, offering cash incentives to spur necessary upgrades. But whatever
28 efforts Sprint Nextel now takes, unless the company has a waiver or consent
29 decree approved by the FCC, it must still meet its December 31, 2005 deadline.
30 If it does not do so, and if there is no acceptable waiver or consent decree in

---

5/ *Id.*, Statement of Commissioner Adelstein.

1 place, today's Order states explicitly that the Commission "will not hesitate to
2 take enforcement action."[6]

3 **Q: What is the significance of this issue to the Board?**

4 A: Sprint Nextel should inform the Board about its progress in meeting the December 31, 2005
5 deadline.

6 **Q: Does FCC Commissioner Copps raise other issues about the divestiture?**

7 A: Yes. Commissioner Copps states, among other things:

8 Finally, I want to commend my colleague Commissioner Adelstein for his hard
9 work on this item, particularly on issues related to the 2.5 GHz band and the
10 wireline spin-off. I was pleased to support his effort to obtain a condition that
11 the merged entity must meet wireless broadband deployment milestones using
12 its 2.5 GHz holdings. This is vitally important spectrum that needs to be
13 utilized fully. I hope that these milestones will bring consumers some much
14 needed broadband competition. I am also happy to support the condition
15 related to the merged entity's wireline spin-off. This will help ensure that the
16 spin-off company is not weighted down by misallocations that could inhibit its
17 ability to compete. The merged entity has committed that the "LTD Holding
18 Company will receive an equitable debt and asset allocation at the time of its
19 proposed spin-off so that the company will be a financially secure, Fortune 500
20 company." The continued strength of this company is critically important to
21 its workers and its customers. The Commission will monitor this commitment
22 when we review the merged entity's application to effectuate this spin-off.[7]

23 **Q: Please elaborate on the significance of this excerpt from Commissioner Copps' statement**
24 **in the FCC's Sprint Nextel Order.**

25 A: The Board should direct Sprint Nextel to inform the Board about Sprint Nextel's plans, if any,
26 to deploy wireless broadband in New Jersey. Also, of even greater relevance to this

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6/ *Id.,* Statement of Commissioner Copps.

7/ *Id.*

1 proceeding, Commissioner Copps states that "[t]he Commission will monitor this commitment
2 [*i.e.,* "to an equitable debt and asset allocation at the time of its proposed spin-off so that the
3 company will be a financially secure, Fortune 500 company"] when we review the merged
4 entity's application to effectuate this spin-off." The FCC, apparently, intends to review the
5 financial viability of the spun off company. The Board should require the Joint Petitioners to
6 submit copies of any and all materials that they submit to the FCC to the Board as well, and
7 to explain the intended timing of the Joint Petitioners' application for FCC approval of the
8 divestiture.

9 **Q: What significance do you recommend that the Board afford the FCC's determinations?**

10 A: A plain reading of the FCC's order indicates that the FCC has not yet scrutinized the
11 implications of the spin off but rather relied on Sprint's and Nextel's statements, and deferred
12 their final approval to a future, unspecified date. Therefore, as I understand the FCC's order,
13 state public utility commissions are the first regulators to conduct an investigation of the
14 ramifications of the spin off.

15 **Q: How have you organized your testimony?**

16 A: Section I is the introduction to my testimony. In Section II, I summarize my understanding of
17 the regulatory context for this proceeding. Section III presents my analysis of the Joint Petition.
18 Section IV addresses payphone issues. Section V provides the Board with preliminary
19 recommendations for merger conditions should the Board approve the merger. Section VI
20 concludes my testimony.

1 **II. BACKGROUND**

2 **The Joint Petitioners have not yet demonstrated that the proposed spin off would yield positive**
3 **benefits.**

4 **Q: Please summarize your understanding of the statutory requirements governing the**
5 **Board's merger reviews.**

6 A: Under *N.J.S.A.* 48:2-51.1, acquiring companies must request and receive the Board's written
7 approval. When evaluating a request for approval of transfer of control, the Board must
8 consider the merger's impact on the following:

9 • competition;

10 • the rates of ratepayers affected by the acquisition of control;

11 • the employees of the affected public utility or utilities; and

12 • the provision of safe and adequate utility service at just and reasonable rates.[8]

13 The Board is also charged with producing a "written report detailing the basis for its decision,
14 including findings of fact and conclusions of law."[9]

15

16 Under *N.J.S.A.* 48:3-10, the Board must authorize a sale or transfer of stock of a public utility
17 to another public utility. The Board must ensure that public utility is able to meet its
18 obligations with respect to employee pension benefits.

8/ *N.J.S.A.* 48:2-51.1.

9/ *Id.*

1 **Q: How does the Board evaluate the merits of requests for approval of a change in control?**

2 A: Most recently, in an order on the appropriate standard of review issued by the Board in the
3 pending investigation of the joint petition of Public Service Electric and Gas Company
4 ("PSE&G") and Exelon Corporation ("Exelon"), the Board unambiguously departed from the
5 "no harm standard." The Board stated that it "shall utilize a positive benefits standard of
6 review. Pursuant to the positive benefits standard, in order for the proposed acquisition of
7 control and transfer of stock to be approved by this Board, the Joint Petitioners must show and
8 the Board must be satisfied that positive benefits will flow to customers and to the State as a
9 result of the proposed change in control, and, at a minimum, that there are not adverse impacts
10 on any of the criteria delineated in *N.J.S.A.* 48:2-51.1."[10]

11 **Q: In your view, is a positive benefits standard appropriate in this proceeding as well?**

12 A: Yes. As I demonstrate in detail below, based on the information available, the divestiture
13 would present significant risks to consumers yet provide negligible benefits. The significant
14 risk presented by the complex transaction warrants a standard of positive benefit.

15 **Q: What approvals do the Petitioners require in move forward?**

16 A: As discussed above, the FCC, apparently, intends to review the transaction.[11] Also, numerous

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[10]/ In the Matter of the Joint Petition of Public Service Electric and Gas Company and Exelon Corporation for Approval of a Change in Control of Public Service Electric and Gas Company, and Related Authorizations, *Order on Standard of Review*, November 9, 2005, at 25. The Board also indicated its intention to undertake a rule making proceeding and to propose a regulation to govern petitions to the Board for the acquisition of control of public utilities. *Id.*, at 26.

[11]/ In his statement in the Sprint Nextel Order, Commissioner Copps states that "[t]he Commission will monitor this commitment when we review the merged entity's application to effectuate this spin-off."

1 state public utility commissions ("PUCs") are investigating the divestiture. Exhibit SMB-1
2 summarizes the pending proceedings in other states.

3 **Background of this proceeding**

4 **Q: Please describe generally your understanding of this proceeding.**

5 A: In December 2004, Sprint Corporation ("Sprint") and Nextel Communications ("Nextel")
6 announced their intention to merge into a single company ("Sprint Nextel"). After receiving
7 the necessary approvals,[12] Nextel merged with a subsidiary of Sprint on August 12, 2005. As
8 part of the merger agreement, Sprint and Nextel agreed to separate Sprint's local incumbent
9 wireline services as an outside company. Toward this end, a subsidiary of Sprint Nextel, LTD
10 Holding Company ("LTD"), was created. Pending regulatory approval and a favorable tax
11 ruling, LTD is intended to become the parent company of Sprint's ILECs. Sprint Nextel then
12 intends to spin-off LTD to Sprint Nextel shareholders. On August 26, 2005, United Telephone
13 Company of New Jersey ("United" or "United NJ"), which is Sprint's New Jersey incumbent
14 local exchange carrier ("ILEC"), and LTD (together, "Joint Petitioners") filed a joint petition
15 for approval of a change in ownership and control of United's licenses with the Board ("Joint
16 Petition").

12/ Applications of Nextel Communications, Inc. and Sprint Corporation for Consent to Transfer Control of Licenses and Authorizations, WT Docket No. 05-63, File Nos. 0002031766, et al., Memorandum Opinion and Order, FCC 05-148 (rel. Aug. 8, 2005).

1 In support of its petition, the Joint Petitioners submitted the testimony of Mark A. Gast
2 (Director - Regulatory Analysis and Reporting for Sprint Nextel, addressing the financial
3 capabilities of LTD), Richard A. Hrip (Vice President - External Affairs for Sprint/United
4 Management Company, testifying in support of the Joint Petition), Kevin P. Collins (Managing
5 Director at Houlihan, Lokey, Howard & Zukin Financial Advisors, Inc. ("HL"), addressing
6 certain financial aspects of the proposed transaction, and sponsoring HL's "Sprint Report"),
7 and John W. Mayo (consultant, addressing the public policy merits of the proposed spin off).[13]

8 **Q: Please describe the general parameters of the proposed transaction.**

9 A: Under the proposed transaction and pending necessary approvals, Sprint Nextel will transfer
10 the licenses, assets, and liabilities of United New Jersey (and other Sprint ILECs) to LTD
11 Holding Company. LTD will then be spun-off to Sprint Nextel shareholders. LTD will issue
12 raise capital in the financial markets in order to compensate Sprint Nextel and to acquire the
13 desired debt/equity mix. After LTD assumes control of United NJ, the shares of LTD will be
14 issued to the existing shareholders of Sprint. LTD Holding Company proposes also to assume
15 control of Sprint Payphone Services, Inc. and Sprint Long Distance Inc., a switchless reseller
16 of long distance services.[14] As described by Mr. Gast, "[o]wnership in the stock of United
17 NJ will simply transfer from Sprint's balance sheet to the new LTD Holding Company's

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13/ On October 11, 2005, the Joint Petitioners provided the Ratepayer Advocate with a compact disk labeled "Highly Confidential CD" containing reports from investment analysts and credit rating agencies, the Houlihan Lokey workpapers, and pension analysis workpapers.

14/ Joint Petition at 3; Hrip Direct (Joint Petitioners) at 4.

1 balance sheet."[15]

2

3 The LTD Holding Company will include the following management: Daniel R. Hesse will be
4 the chief executive officer; Michael B. Fuller, the Chief Operating Officer; Gene Betts, the
5 Chief Financial Officer; Tom Gerke, the General Counsel; and James A. Hansen the senior
6 officer leading the network and Customer Service Organization.[16]

7

8 Sprint Communications Company L.P., which has been the long distance provider for United
9 NJ's customers who selected Sprint, will remain a subsidiary of Sprint, and LTD Long
10 Distance, a newly formed company, will be the long distance entity that is affiliated with the
11 LTD Holding Company. LTD long Distance intends to purchase wholesale long distance
12 services from Sprint Communications Company L.P.[17]

13 **Q: Is Sprint Nextel one of the petitioners in this proceeding?**

14 A: No. The Joint Petitioners consist solely of United NJ and LTD. However, as the parent
15 company, Sprint Nextel is clearly involved in, and indeed, presumably directing the terms of
16 the spin off. By contrast, LTD, at this point, is a "shell" that is not yet up and open for
17 business. Sprint Nextel owns LTD, and, as the parent company, is issuing stock. Therefore,

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[15]/ Gast Direct (Joint Petitioners) at 5.

[16]/ *Id.* ,at 7-8.

[17]/ *Id.*, at 8-9.

1 Sprint Nextel, not LTD, is the legal entity that should be supporting the Joint Petition.

2 **Q: Is the proposed divestiture a straightforward transaction?**

3 A: No. The divestiture raises numerous complicated accounting and public policy issues. As
4 described by Mr. Hesse to investors, the spin off is a "resource-intensive and complex
5 endeavor."[18] Among the fundamental questions that I urge the Board to consider is whether
6 the complexity of this transaction is justified, *i.e.,* whether Sprint Nextel is properly
7 compensating ratepayers for the significant risk that the divestiture would create.

8 **Q: Have the Joint Petitioners finalized their "S-1"form?**

9 A: No. Sprint Nextel has not finalized or filed its "S-1'form with the Securities and Exchange
10 Commission ("SEC"). The SEC form S-1, which is used by public companies to register their
11 securities with the SEC, contains the basic business and financial information on an issuer with
12 respect to a specific securities offering. Because investors may rely on the prospectus to
13 consider the merits of an offering, the prospectus is an important document that should be
14 available also for the Board's review. However, the S-1 has not yet been finalized and even
15 a draft has not yet been provided to the Ratepayer Advocate and to the Board.[19] In its
16 presentation in October 2005 to investors, Sprint Nextel indicated that it anticipated finalizing
17 SEC filings at the end of 2005."[20]

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[18]/ Sprint Nextel Third Quarter 2005 Investor Relations Webcast; http://www.sprint.com/investors/webcasts/

[19]/ Response to RPA-5.

[20]/ Sprint Nextel Third Quarter 2005 Investor Relations Webcast; http://www.sprint.com/investors/webcasts/

1 **Q: Has the proposed spin-off been subject to careful financial scrutiny by Sprint's financial**
2 **advisors?**

3 A: This is unclear. As recognized in the joint proxy statement by Sprint Nextel when they sought
4 shareholder approval of their merger:

> 5 There are significant operational and technical challenges that will need to be
> 6 addressed in order to successfully separate the assets and operations of the local
> 7 telecommunications business from the rest of the resulting company. ... In
> 8 addition, the subsidiary to be spun off is expected to incur substantial
> 9 indebtedness before the spin-off, the proceeds of which will be distributed to
> 10 Sprint Nextel in exchange for the assets contributed to the subsidiary to be spun
> 11 off. [21]

12

13 **Q: Did either of Sprint's two financial advisors, engaged in connection with its merger with**
14 **Nextel, analyze the implications of the spin-off?**

15 A: No. Sprint's financial advisors in connection with its merger with Nextel were Lehman
16 Brothers and Citigroup.[22] The proxy statement clearly states that "Lehman Brothers was not
17 requested to opine as to, and its opinion does not in any manner address, the contemplated
18 spin-off, including the underlying business decision to proceed with or effect the contemplated
19 spin-off."[23] Similarly, "Citigroup was not requested to opine as to, and its opinion does not in
20 any manner address, the contemplated spin-off, including the underlying business decision to

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[21]/ NJ010623-NJ010624 (pages 30-31 of the Sprint Nextel Joint Proxy Statement, dated June 10, 2005), provided in response to RPA-237.

[22]/ *Id.,* at NJ010542.

[23]/ *Id.,* at NJ010643.

proceed with or effect the contemplated spin-off."[24]

Q: What are the implications for the Board of the fact that Sprint Nextel has not yet finalized its S-1 statement for potential investors?

A: The Board should not be expected to render a regulatory decision before the Joint Petitioners have prepared an S-1 for potential investors and, if shareholder approval is required for the spin-off, an S-4 for shareholders. The way that Sprint Nextel represents the transaction to regulators (as reflected in the HL report) may differ from the way that Sprint Nextel represents the transaction to its investors and shareholders.

Q: How does Sprint Nextel intend to monitor LTD's financial information in anticipation of the proposed spin off?

A: **<<<BEGIN HIGHLY CONFIDENTIAL**

"[25] **END HIGHLY CONFIDENTIAL>>>** Sprint Nextel explained to investors that it is "[t]argeting to 'operate' internally as a 'separate' company by 1Q06."[26] The implications of

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24/ *Id.,* at NJ010646.

25/ "SpinCo Blueprint, Work in Progress," July 1, 2005, pages NJ007322 - NJ007363, at NJ007359.

26/ "Sprint together with Nextel Investor Update, October 26, 2005, revised November 9, 2005, http://www.sprint.com/investors/earnings/qe/3q05pres.pdf, at 28.

1 this "separate" operation are unclear and merit further explanation. In any event, the Board
2 should require Sprint to submit financial documents that correspond with these financial
3 tracking plans so that the Board can assess whether Sprint is compensating LTD adequately.

4 **Q: What services will the spun off company offer?**

5 A: United NJ's ability to continue to offer long distance service will be based on a combination
6 of commercial agreements, including sales agency and wholesale long distance agreements
7 entered into between LTD (or a subsidiary) and Sprint Communications Company L.P.[27]
8 Among the provisions of the commercial long distance wholesale agreement is a Most Favored
9 Nation ("MFN") component that entitles LTD to wholesale prices for long distance voice and
10 data product at prices equal to or lower than those provided under contract to other similarly
11 situated non-affiliate purchasers of services from Sprint.[28] LTD will offer wireless services
12 through a combination of commercial sales agency and Mobile Virtual Network Operator
13 ("MVNO") resale agreements between LTD (or a subsidiary) and Sprint.[29] When asked about
14 any new products or services that LTD will offer post spin-off, the Joint Petitioners simply
15 indicate that LTD intends to offer long distance and wireless service under its own brand
16 name.[30] LTD is expected to include North Supply. The Joint Petitioners objected to providing

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27/ Gast Direct (Joint Petitioners) at 15.

28/ Gast Direct (Joint Petitioners) at 18.

29/ Gast Direct (Joint Petitioners) at 19-20.

30/ Response to RPA-103.

1 copies of all third party agreements for long distance and wireless, and to documents relating
2 to the negotiations between Sprint and third parties.[31]

3 **The Petitioners' explanation of the rationale for the spin off is not persuasive.**

4 **Q: What is your understanding of the rationale for the proposed LTD Spin-off?**

5 A: A document titled <<<**BEGIN HIGHLY CONFIDENTIAL**

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[31]/ Response to RPA-144.

[32]/ NJ007467-NJ007475, provided in response to RPA-60 (and also to RPA-61, RPA-62, RPA-63, RPA-64, and RPA-78). From henceforth, the reference will be solely to RPA-60. The "update" document is dated July 15, 2005. Because the Joint Petitioners did not specify the "cut-off" date for providing documents responsive to the information request, it is unclear whether more recent versions of the update have been prepared in the past four months.

[33]/ *Id.*, at NJ007469.

[34]/ *Id.*

[35]/ *Id.*

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[36] *Id.*, at NJ007471.

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3 [37] **END HIGHLY CONFIDENTIAL>>>**

4 **Q: Have your reviewed other internal documents concerning the proposed spin-off?**

5 A: Yes. Among others, I reviewed **<<<BEGIN HIGHLY CONFIDENTIAL**

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[37]/ *Id.,* at NJ007473.

[38]/ In response to RPA-60 through RPA-64 and RPA-78, the Joint Petitioners provided voluminous documents, including, among others, at least three versions of a document, "SpinCo Blueprint." In order by page number, these documents are dated May 1, 2005, "Work in Progress" beginning on page NJ007258; a comparable "Work in Progress" document, beginning on page NJ007322, which is dated July 1, 2005; and also "Work in Progress," dated June 10, 2005, beginning page NJ007396.

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12 [40] **END HIGHLY CONFIDENTIAL>>>**

13 **Q: How does the Joint Petitioners' policy witness depict the transaction?**

14 A: Among other things, Dr. Mayo states:

15-21
> The merger of Sprint and Nextel in the wireless arena will have created a very large and national company whose strategic interests are distinctly "wireless" and "national." In contrast, LTD Holding Company, including United NJ, will have the opportunity to focus its competitive energies on providing value for, and securing the business of, consumers within its local geographic footprint. This heightened focus and reliance on its local customers for its financial success means

[39]/ "SpinCo Blueprint, Work in Progress," July 1, 2005, pages NJ007322 - NJ007363, at NJ007324.

[40]/ *Id.*, at NJ007327.

1 that the company will have maximal incentives to create valued and
2 innovative services for these customers. The re-organization, then,
3 neatly aligns the firm's self-interest and those of consumers.[41]

4 **Q: Has Dr. Mayo conducted any analyses of United NJ and/or of the impact of the proposed**
5 **divestiture on the financial health of United NJ?**

6 A: No.

7 **Q: The local focus would seem to benefit New Jersey's customers. Please comment.**

8 A: Although the logic is compelling because LTD, apparently, rather than pursuing large business
9 customers around the globe, will focus on its local operations in New Jersey, as I discuss
10 elsewhere in this testimony, other aspects of the proposed transaction are troubling. Although
11 LTD purportedly seeks to focus locally, it is also planning to scale back its network investment,
12 has not addressed declining service quality and apparently is not addressing declining
13 telephone subscribership in New Jersey. Furthermore, the rhetoric regarding local focus
14 neglects to address the likelihood that LTD may be readying itself to be acquired, to round out
15 another carrier's portfolio, or alternatively is readying itself to acquire another company.

16 **Q: Are there any other potential weaknesses in the purported benefit of a "local focus"?**

17 A: Yes. Sprint Nextel management will continue to control LTD as a result of their significant
18 ownership of stock in the spun off company. This stock ownership will give them *de facto*
19 control of the new company, thus undermining the purported benefit of independence and local
20 focus.

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[41]/ Mayo Direct (Joint Petitioners),a t 8-9.

1 **Q: Have you had adequate opportunity to review the various documents filed by the Joint**
2 **Petitioners in support of their application?**
3 A: No. Numerous voluminous documents were provided November 23, 2005 and November 25,
4 2005, which this testimony does not fully address.

III. JOINT PETITION

The Joint Petitioners' descriptions lack sufficient detail about the markets they serve and consumer benefits.

Q: Please describe Sprint Nextel.

A: In its order approving the Sprint Nextel merger, the FCC described Nextel and Sprint (pre-merger) as follows:

> Today, Nextel is the fifth largest provider of mobile telephony service in the United States based on subscribership. As of December 31, 2004, Nextel provided service to over 16.2 million subscribers, which consisted of 15.0 million subscribers of Nextel-branded service and 1.2 million subscribers of Boost Mobile, a Nextel affiliate, and reported $13.4 billion in operating revenues for 2004. Nextel together with its affiliate, Nextel Partners, currently utilize the iDEN technology to serve 297 of the top 300 U.S. markets where about 260 million people live or work.[42]
>
> Currently, Sprint is the third largest provider of mobile telephone voice and related data services in the United States in terms of subscribership. Sprint PCS had 24.7 million customers as of December 31, 2004: 17.8 million direct, postpaid subscribers, 3.2 million through affiliates, and 3.7 million wholesale subscribers. Sprint reported $14.6 billion in revenues for 2004. Sprint's CDMA network is now available in 99 percent of the major metropolitan areas in forty-eight states, the Virgin Islands, and Puerto Rico. Sprint, together with third party affiliates, operates PCS systems in over 350 metropolitan markets, including the 100 largest U.S. metropolitan areas, and reaches approximately 250 million people. Sprint has been able to increase its coverage area by entering into roaming agreements with various carriers throughout the United States.[43]

42/ *Sprint Nextel Merger Order,* para. 7, cites omitted.

43/ *Sprint Nextel Merger Order,* para. 10, cites omitted.

1 Sprint provides wireless, long distance, and local communications services. Sprint's ILECS
2 offer local, long distance, data, wireless and video services.[44] LTD Holding Company would
3 be the largest independent local exchange carrier in the nation, with revenues in 2004 that
4 exceed $6 billion.[45]

5 **Q: Please describe United NJ's operations.**

6 A: United NJ's original parent company was United Telecommunications, Inc. ("United
7 Telecom"), which acquired multiple telephone companies including New Jersey Telephone
8 Company in 1931, Sussex Telephone Company in 1953, West Jersey Telephone Co. In 1976,
9 the Hillsborough and Montgomery Telephone Company in 1979, and Continental Telephone
10 Company of New Jersey in 1984. The merger of five United Telecom companies, approved
11 by the Board in Docket No. TM8704290, effective July 1, 1987, led to United NJ as the
12 surviving corporation.[46]

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14 United NJ serves 213,031 access lines in New Jersey.[47] United NJ serves **<<<BEGIN**
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[44]/ Joint Petition, at 3.

[45]/ *Id.*, at 14.

[46]/ Hrip Direct (Joint Petitioners) at 6.

[47]/ *Id.* ,at 3.

REDACTED VERSION

END CONFIDENTIAL>>>.[48] United NJ serves **<<<BEGIN HIGHLY CONFIDENTIAL**

END HIGHLY CONFIDENTIAL>>>.[49]

Q: What is the geographic distribution of United NJ's customers?

A: **<<<BEGIN HIGHLY CONFIDENTIAL**

[50] **END HIGHLY CONFIDENTIAL>>>** Confidential Exhibit SMB-C-2 shows the location of United NJ's residential and business customer by wire center and by designation of either urban, suburban, or rural.

Q: Please describe briefly Sprint Nextel's national operations.

A: Florida, North Carolina, Nevada, and Ohio represent the vast majority of all LTD access lines.[51] Exhibits SMB-3 summarizes major financial information for the years 2001 through

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[48]/ Responses to RPA-21, S-4.

[49]/ Response to S-48.

[50]/ Responses to RPA-21 and RPA-22. For the purposes of HL's analysis, urban areas are defined as wire centers with more than 300 access lines per square mile; suburban areas as those with between 100 and 300 access lines per square mile, and rural areas as those wire centers with fewer than 100 access lines per square mile. Response to RPA-22.

[51]/ "SpinCo Blueprint, Work in Progress," July 1, 2005, pages NJ007322 - NJ007363, at NJ007326. See confidential response to S-5 for a listing of access lines by state. The total shown in this response (at NJ003106) is significantly less than the 7.5 million access lines reported elsewhere by Sprint, possibly because they include only residential lines.

REDACTED VERSION

1 2003 for Sprint's Local Division, PCS Group, and Global Markets Division. More recent
2 data shows that operating income from wireless operations continues to increase significantly.
3 Between 2004 and 2005 (from September to September), wireless operating income increased
4 from $1.146 billion to $1.661 billion.[52] During the same time period, net income from the
5 local operations increased from $1.281 billion to $1.351 billion.[53]

6 **Q: Does the HL Report include an estimated balance sheet for LTD?**

7 A: Yes. Sprint Nextel provided HL with an actual balance sheet as of December 31, 2004. HL
8 then made various adjustments to estimate LTD's balance sheet as of June 1, 2006.[54] The
9 estimated adjustments correspond anticipated transactions such as new bank debt, cash
10 distribution from LTD to Sprint Nextel, and changes in assets.[55] Highly Confidential Exhibit
11 SMB-HC-4 summarizes HL's estimate of LTD's pro forma balance sheet as of June 1, 2006.
12 Highly Confidential Exhibit SMB-HC-5 summarizes the various adjustments that HL
13 anticipates and that HL incorporates in the estimate of the June 1, 2006 balance sheet for LTD.

14 **Q: Please comment generally on the use of data from December31, 2004 as the basis of the**
15 **projection.**

16 A: The use of data from almost one year ago means that the estimate provided by HL is based on

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52/ Sprint Nextel Form 10-Q, filed November 9, 2005 for the period ending September 30, 2005, provided in response to RPA-83.

53/ *Id.*

54/ HL Report at 16-17.

55/ *Id.*

1 a foundation that is so old as to render the projection dubious.

2 **Allocation of shared assets**

3 **Q: How would Sprint Nextel allocate and assign the shared assets?**

4 A: According to the Joint Petitioners, 96 percent of the gross property, plant, and equipment of
5 LTD will remain with the local telephone division of Sprint, including United NJ, after
6 separation.[56] The remaining 4 percent represents shared assets, which will be transferred from
7 the existing management company, Sprint United Management Company, to the management
8 company to be associated with LTD. The transfer will occur at net book value, and, according
9 to Sprint, the "fair market value of these shared assets is not known and therefore the impact
10 of the transfer using fair market value cannot be determined."[57] I have included as SMB-HC-6,
11 Sprint's analysis of its shared asset assignment, which it provided as a highly confidential
12 attachment to its response to RPA-74.

13 **Q: Please describe how LTD Holding Company and LTD will obtain services from Sprint.**

14 A: LTD holding Company will obtain certain services on an interim basis pursuant to "transition
15 services agreements."[58]

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[56]/ Response to RPA-74.

[57]/ *Id.*

[58]/ Joint Petition, at 10.

1 **Q: What benefits do the Joint Petitioners identify for consumers and small business**
2 **customers?**

3 A: The Joint Petitioners assert that the separation of Sprint's incumbent local wireline operations
4 from its parent company will benefit United NJ's residential and business customers, and that
5 the spun off company's "primary strategic focus will be building upon its local wireline
6 capabilities by providing a full portfolio of quality services to residential and business
7 customers in its local territory."[59]

8 **Q: How does Sprint Nextel portray the spin off to its investors?**

9 A: In its annual report, Sprint Nextel states:

> 10 Strategically, our plan to spin off our local business makes a lot of
> 11 sense. First, our growth strategy is focused on integrated solutions; so
> 12 in recent years we've invested heavily in our wireless and IP platforms.
> 13 Second, the local spin-off will help the combined company clarify its
> 14 growth strategy - including eliminating potential conflict with our
> 15 strategy of enabling the cable operators to deliver video, data and voice
> 16 service nationwide, as well as eliminating potential tension from the
> 17 combined company's strategy to displace local access lines through
> 18 wireless substitution. Finally, we believe the spin-off will put a
> 19 spotlight on the underlying value of Sprint's local exchange assets. This
> 20 new freestanding enterprise will rank as the largest non-RBOC local
> 21 company, providing service in 18 states to 7.6 million access lines.
> 22 Based on 2004 revenues of more than $6 billion, it will be a Fortune
> 23 300-level company with a strong financial profile. We expect the
> 24 spin-off of our local business to occur in 2006.[60]

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[59]/ *Id.*, at 2.

[60]/ Sprint Corporation 2004 Annual Report and Form 10-K, May 2005, page 7.

1 **Q: Please summarize your preliminary assessment of the purported benefits of Sprint**
2 **Nextel's proposed spin off of its local operations.**
3 A: As I understand the transaction at this time, the spin off would *at best,* leave consumers no
4 worse off than they are. The purported benefit of more local focus and clarity do not outweigh
5 the risk to consumers of the fundamental restructuring of the local operations. The spin off
6 poses risks to consumers, that the Joint Petition does not sufficiently address.

7 **The impact of the proposed spin off on competition is unclear, and, in any case, would not**
8 **increase competitive alternatives for customers of basic local exchange service.**
9
10 **Q: Would Sprint Nextel's spin off of its local division affect competition in New Jersey?**
11 A: Yes. Sprint Nextel would compete directly with LTD for local customers. Both companies
12 would offer bundled services to customers, although the make-up of the bundles would likely
13 differ.
14 **Q: Would the presence of two carriers, where now there is only one, enhance competition**
15 **in the local market?**
16 A: At this point, there is no evidence that the competition would enhance competitive prospects
17 for customers in rural areas and customers with low to moderate needs for telecommunications
18 services. Furthermore, the divestiture could make it less likely that Sprint Nextel or LTD will
19 compete beyond their footprint.

1 **Q: What is the status of competition by competitive local exchange carriers ("CLECs") in**
2 **United NJ's territory?**
3 A: There is minimal CLEC presence in United NJ's territory. **<<<BEGIN HIGHLY**
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8 **CONFIDENTIAL>>>**[61] See also the Joint Petitioners' response to RPA-86, which is
9 included with the exhibits to my testimony, and which shows CLECs' presence by wire center
10 and by mode of entry.
11 **Q: Have the Joint Petitioners provided data about consumers' actual present demand for**
12 **intermodal alternatives?**
13 A: No. The HL Report includes projected demand for competitive suppliers' services. Among
14 other assumptions, the HL Report is based on the following predictions:**<<<BEGIN HIGHLY**
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[61]/ Response to RPA-85.

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7 **END HIGHLY CONFIDENTIAL>>>**[62]

8 **Q: How much weight should the Board afford to intermodal alternatives in United NJ's**
9 **territory?**

10 A: Minimal. First, to use VoIP, one needs broadband access, which less than a quarter of
11 households have.[63] Furthermore, the vast majority of households use wireless to *supplement*
12 their primary basic local exchange service, not to *substitute* for basic landline service. The
13 FCC recently stated that "[e]vidence indicates that, overall, approximately 6 percent of
14 households have chosen to rely upon mobile wireless services for all of their communications
15 needs."[64]

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[62]/ HLdata41.ppt, "Local Telecommunications Division, 2005 – 2007, Business & Financial Plan"

[63]/ In October 2003, approximately 20% of U.S. households subscribed to a broadband service. A Nation Online: Entering the Broadband Age, U.S. Department of Commerce (Sept. 2004), at 1.

[64]/ *In the Matter of Verizon Communications, Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-75, *Memorandum Opinion and Order*, Rel. November 17, 2005 ("Verizon/MCI Merger Order"), at para. 91.

1 **Q: But didn't the FCC also determine that facilities-based VoIP and wireless should be**
2 **included in an analysis of concentration in the local market?**
3 A: Yes, but it is important to recognize that the FCC's quantitative analysis, although it includes
4 intermodal alternatives, incorporates measures of *actual* demand, and does not include
5 *projected or speculative* demand.
6 **Q: Please explain.**
7 A: First, the FCC stated in its recently issued decision in the Verizon/MCI merger proceeding that,
8 "[b]ased on the record in this proceeding, we identify three relevant product markets for our
9 mass market analysis: (1) local service; (2) long distance service; and (3) bundled local and
10 long distance service.[65] The FCC further explains that "[b]ased on record evidence, we define
11 the market for local service to include not only wireline local service, but also certain types of
12 VoIP service *to the extent that consumers view them as close substitutes for wireline local*
13 *service*. In addition, the record evidence suggests that for certain categories of customers,
14 mobile wireless service is viewed as a close substitute to wireline local service."[66]
15 **Q: How did the FCC recently describe the role of VoIP and wireless services in the local**
16 **market?**
17 A: The FCC stated that "the record indicates that mass market consumers view facilities-based
18 VoIP services as sufficiently close substitutes for local service to include them in the relevant

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65/ *Id.*, at para. 83.

66/ *Id.*, at para. 86 (emphasis added).

1 product market."[67] The FCC elaborated that "[w]hile we recognize that facilities-based VoIP
2 services may not be available ubiquitously in Verizon's territory, our product market analysis
3 does not require that all mass market consumers would be willing or able to substitute VoIP
4 service for wireline local service, or even that it be widely available for it to be included in the
5 relevant product market. Rather, our product market definition analysis only requires evidence
6 of sufficient demand substitutability in those geographic markets where facilities-based VoIP
7 service is available."[68]

8 **Q: Does the FCC include so-called "over-the-top" VoIP in the relevant market?**

9 A: No. FCC excludes "over-the-top" VoIP from the relevant product market analysis for local
10 services.[69] Over-the-top VoIP "includes those providers that require the end user to obtain
11 broadband transmission from a third-party provider, and such VoIP providers can vary in terms
12 of the extent to which they rely on their own facilities."[70]

13 **Q: How does the FCC characterize wireless service?**

14 A: The FCC stated, "[b]ased on the factors discussed in this section, we conclude that mobile
15 wireless services should be included within the product market for local services to the extent
16 that customers rely on mobile wireless service as a complete substitute for, rather than

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67/ *Id.*, at para. 87.

68/ *Id.*, at para. 88 (note omitted).

69/ *Id.*, at para. 89.

70/ *Id.*, at para. 87.

1 complement to, wireline service."[71] The FCC also noted it agreed "with commenters who note
2 that the record does not present credible evidence that mobile wireless services have a price
3 constraining effect on all consumers' demand for primary line wireline services."[72]

4 **Q: Please elaborate.**

5 A: The key element in the FCC's analysis of intermodal alternatives is that the FCC only included
6 those instances in its market concentration calculations where evidence suggests that
7 consumers actually use wireless and VoIP as substitutes. The *Verizon/MCI Merger Order*
8 contains the following explanation of the FCC's methodology:

> 9 We estimate total residential local access lines in each relevant
> 10 geographic market by summing the number of wireline local access
> 11 lines (i.e., residential resold lines, residential UNE-P lines, non-Verizon
> 12 residential E-911listings, Verizon's residential access lines) and an
> 13 estimate of the number of residential wireless-only lines. We estimate
> 14 residential wireless-only lines in two steps. First, we assume that the
> 15 total number of all local access lines is the number of landline
> 16 residential lines in Verizon's franchise areas divided by 94% (100%
> 17 minus that 6% of residential customers that rely solely on wireless).
> 18 Second, we estimate the number of wireless-only lines by taking the
> 19 difference between the estimate of the total number of local access lines
> 20 and the total number of wireline local access lines. We estimate
> 21 Verizon's share of the residential wireless-only lines by multiplying the
> 22 estimate of residential wireless-only lines by an estimate of Verizon
> 23 Wireless's share of mobile wireless based upon mobile wireless lines
> 24 in the NRUF database. Facilities-based VoIP lines will be captured in
> 25 the E-911 listings. We note that, although we do not intend to include
> 26 over-the-top VoIP subscribers in our market share calculations (because
> 27 we are unable to determine which services fall within our relevant

[71]/ *Id.*, at para. 91.

[72]/ *Id.*, at footnote 276.

1 product market), subscribers to some of these services may be included
2 in the E-911 listings, and thus included in our market share
3 calculations.[73]
4
5 **Q: Please summarize your analysis of the impact of the proposed spin off on competition.**

6 A: Although the spinning off Sprint Nextel's local division would seem to enhance competition
7 (by creating two carriers competing for the same customer base), it is unlikely that the
8 competition will be focused on rural customers or on low and moderate income customers.

9 **The financial report, prepared on behalf of the Joint Petitioners, appears to be designed for**
10 **regulatory purposes, but not for investors' use.**
11
12 **Q: Please describe the purpose and content of the report prepared by Sprint Nextel's**
13 **financial advisors that the Joint Petitioners submitted to the Board in support of their**
14 **request for approval of the proposed change in ownership and control.**

15 A: The Joint Petitioners engaged Houlihan Lokey Howard & Zukin ("Houlihan Lokey" or "HL")
16 to perform an independent valuation of LTD Holding Company and to evaluate the financial
17 health and capitalization of LTD Holding Company following the spin-off from Sprint Nextel.
18 Houlihan Lokey utilizes financial information and projections provided by the Joint
19 Petitioners' management teams, and assumes that economic, market, and financing conditions
20 remain constant through the projected date of separation, June 1, 2006. In addition, Houlihan
21 Lokey extends some financial projections through the period 2008 to 2010. This analysis
22 culminates in a document, "Report to Sprint Nextel Corporation, Analysis of LTD Holding

73/ *Id.*, at footnote 307.

1 Company," August 15, 2005, provided as Exhibit B to the Collins Direct Testimony
2 ("Houlihan Lokey Report" or "HL Report"), which the Joint Petitioners submit in support of
3 their Petition.

4 **Q: Did the Joint Petitioners engage any other advisor regarding the proposed transaction?**

5 A: Yes. Sprint engaged numerous other advisors in connection with the transaction, including
6 KPMG (to conduct an independent audit of LTD Holding Company to support the filing of
7 SEC Form 10), Deloitte & Touche, Salt (regarding brand development), Dean & Co. (for "cost
8 profile" consulting), John Mayo (expert testimony), InCode (to assist with wireless strategy,
9 operations, and launch), Visage, TWG and CXO Advantage, and Watson and Wyatt (regarding
10 the planning and design of retirement program).[74] Although the Ratepayer Advocate requested
11 the documents prepared and reviewed by these advisors, the Joint Petitioners have not yet
12 provided responsive information except for documents provided by HL, Mayo, and Watson
13 Wyatt.[75]

14 **Q: How did HL determine the fair market value of LTD?**

15 A: HL used three different methodologies to determine the fair market value of LTD:

16 - market multiple methodology;
17 - comparable transaction methodology; and

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[74]/ Sprint response to RPA-65.

[75]/ *Id.*

1 • discounted cash flow methodology.[76]

2 **Q: Please briefly describe each of these three methodologies.**

3 A: The market multiple methodology considers a company's enterprise value in relation to certain
4 metrics of its operations. In this case, HL analyzed multiples of earnings before interest, taxes,
5 depreciation, and amortization ("EBITDA") and access lines for a group of purportedly
6 comparable companies. The results of this comparison were then applied to the EBITDA and
7 access lines metrics available for LTD.[77]
8
9 The comparable transaction methodology seeks to estimate the value of a company by
10 considering the enterprise value per access line implied by the market value established in
11 previous similar transactions. The range of enterprise value per access line is then applied to
12 the number of access lines served by LTD.[78]
13
14 The discounted cash flow ("DCF") methodology estimates the value of a company by
15 calculating the present value of the projected stream of cash flows. In this case, HL summed
16 the discounted future cash flows through 2010 and a terminal value of the company in 2010.[79]

76/ HL Report, at 38.

77/ *Id.*, at 39-40.

78/ *Id.*, at 41, 58-59.

79/ *Id.*, at 42-43.

Various factors affect the reasonableness of a DCF, including, among other factors, the assumptions about costs and revenues. For example, to assess the reasonableness of revenue forecasts, one would need to analyze demand data (*i.e.*, billing determinant data) and price information.

Q: What were the results of HL's application of these methodologies?

A: Highly Confidential Exhibit SMB-HC-7a summarizes the low and high ends of HL's valuations, using each of the three methodologies. The estimates range from <<<**BEGIN HIGHLY CONFIDENTIAL** >>>**END HIGHLY CONFIDENTIAL**>>[80] After taking into consideration LTD's projected debt, the estimated equity value ranges between <<<**BEGIN HIGHLY CONFIDENTIAL** >>>**END HIGHLY CONFIDENTIAL**>>[81]

Q: Ms. Baldwin, please elaborate on the HL Report's estimate of the value of LTD Holding Company using the market multiple approach.

A: The Houlihan Lokey report provides an estimate using this approach in the section entitled "Comparable Companies Analysis." The authors started with a universe of 26 publicly-traded telecommunications companies, 22 Rural Local Exchange Companies ("RLECs"), and 4 Regional Bell Operating Companies ("RBOCs"). The authors narrowed the universe of comparable companies according to size, exposure to the rural market, and non-core assets

[80]/ *Id.*, at 50.

[81]/ HL Report, at 50.

1 (wireless businesses, partnerships, etc).[82]

2 **Q: What companies did HL remove from the universe of comparable companies, and why?**

3 A: The authors first removed from comparison all of the RBOCs, and those RLECs with an
4 enterprise value of less than $1 billion. From the remaining RLECs, the authors of the report
5 removed ALLTEL, Telephone and Data Systems, and Cincinnati Bell Telephone, due to the
6 large wireless component of their businesses. [83]

7 **Q: What companies remained for the Comparative Companies Analysis?**

8 A: The six remaining companies were Citizens Communications, CenturyTel, Valor
9 Communications Group, Fairmont Communications, Iowa Telecommunications, and
10 Commonwealth Telephone.[84]

11 **Q: How similar is LTD Holding Company to the group of "comparable" companies utilized**
12 **in HL's analysis?**

13 A: LTD is not at all similar to companies in the group. For example, Houlihan Lokey cites the
14 2004 revenues for each company, as well as 2004 revenues for LTD. While LTD had 2004
15 revenues of over $6 billion, the largest of the "comparable" companies reported revenues of
16 just $2.5 billion. Four of the six companies reported revenues well under $1 billion. The
17 smallest, Iowa Telecommunications, reported revenues of just $221 million. In addition, while

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[82]/ *Id.*, at 20-21.

[83]/ *Id.*, at 21-24.

[84]/ *Id.*, at 25.

1 LTD served over 7.6 million access lines in 2004, the largest of the allegedly comparable
2 companies served less than one-third the number of lines served by LTD, or 2.3 million. Four
3 of the six companies served fewer than 600,000 lines and Fairpoint Communications served
4 only 239,274 access lines.[85]

5 **Q: Are there other reasons why the comparable group of companies may not be**
6 **appropriate?**

7 A: Yes. The HL Report also compared LTD with other companies on the basis of credit ratios.[86]
8 Again, comparing the other companies in the group on the basis of credit ratios shows that
9 LTD is not very similar to any of the companies in the group. For example, LTD's
10 Debt/EBITDA leverage ratio is <<<**BEGIN HIGHLY CONFIDENTIAL**
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14 **END**
15 **HIGHLY CONFIDENTIAL**.[87]

16 **Q: What credit ratings do the purportedly comparable companies have?**

17 A: One company, Commonwealth Telephone, is not rated by any of the three rating agencies. Four

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85/ *Id.*

86/ *Id.*, at 26.

87/ *Id.*

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1 of the six companies are rated "speculative" or "highly speculative." One company,
2 CenturyTel, received a "lower medium" credit rating from all three agencies.[88]

3 **Q: Sprint Nextel sought indicative credit ratings from Fitch Ratings and Moody's Investors**
4 **Service.[89] What credit ratings did they assign to LTD Holding Company?**

5 A: Fitch assigned the company a rating of <<<**BEGIN HIGHLY CONFIDENTIAL**
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9 **END HIGHLY CONFIDENTIAL>>>**

10 **Q: Have you reviewed the credit ratings that LTD solicited in anticipation of issuing debt?**

11 A: Yes. LTD is expected to issue debt in order to facilitate the separation and to reach the target
12 capital structure for the company. In order to access capital markets, Sprint Nextel solicited
13 preliminary credit ratings for the proposed spin-off entity from Fitch Ratings and Moody's
14 Investors Service. Sprint Nextel did not seek an indicative rating from Standard and Poor's.[91]
15 Fitch and Moody's developed credit ratings for LTD Holding Company (referred to in Fitch

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[88]/ *Id.*

[89]/ Sprint Nextel's introductory remarks to the document "Indicative Ratings for Sprint" contained on Highly Confidential CD provided in Sprint response to RPA-2.

[90]/ Exhibit SMB-7b summarizes ratings for long-term bonds.

[91]/ Sprint Nextel's introductory remarks to the document "Indicative Ratings for Sprint" contained on Highly Confidential CD provided in Sprint response to RPA-2.

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and Moody's documents as "Sprint Local") based on Sprint Nextel's projection that LTD will issue $7.25 billion of debt and will pay shareholders an annual dividend of $300 million.[92]

Q: What comments did Fitch have regarding the spin-off?

A: Among Fitch's findings were the following: **<<<BEGIN HIGHLY CONFIDENTIAL**

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[92]/ Highly Confidential Letter to Sprint Corporation, Fitch Ratings Inc., July 12, 2005, page 1, and Highly Confidential Letter to Sprint Corporation, Moody's Investors Service, July 13, 2005, page 1, from the document "Indicative Ratings for Sprint" contained on the Highly Confidential CD provided to the Ratepayer Advocate on October 11, 2005.

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6 **END HIGHLY CONFIDENTIAL>>>**[93]

7 **Q: What credit rating did Fitch assign to LTD Holding Company?**

8 A: Fitch assigned the LTD Holding Company a credit rating of <<<**BEGIN HIGHLY**
9 **CONFIDENTIAL END HIGHLY CONFIDENTIAL>>>.**

10 **Q: Did you review Moody's analysis?**

11 A: Yes. Among Moody's findings were the following:

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93/ *Id.*

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11 **END HIGHLY CONFIDENTIAL>>>**[94]

12 **Q: What rating did Moody's assign to LTD Holding Company?**

13 A: Moody's rated the company **<<<BEGIN HIGHLY CONFIDENTIAL END HIGHLY**
14 **CONFIDENTIAL>>>**

15 **Q: What kind of credit risk is represented by the ratings assigned by Fitch and Moody's?**

16 A: Both of these ratings correspond to the <<<**BEGIN HIGHLY CONFIDENTIAL**
17 **END HIGHLY CONFIDENTIAL**>>> credit rating of

[94]/ Highly Confidential Letter to Sprint Corporation, Moody's Investors Service, July 13, 2005, pages 2-3, from the file "Indicative Ratings for Sprint.pdf" found on the Highly Confidential CD provided to the Ratepayer Advocate on October 11, 2005.

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1 investment-grade bonds. Exhibit SMB-* illustrates the full range of credit ratings.

2 **Q: Did Sprint Nextel seek an indicative rating from Standard and Poor's?**

3 A: No, Sprint Nextel opted not to seek an indicative rating from Standard and Poor's service.

4 **Q: Did Sprint Nextel provide any information from Standard and Poor's?**

5 A: Yes. Sprint Nextel provided a Standard and Poor's Ratings Direct Research Update dated

6 August 4, 2005. Among the comments of Standard and Poor's are:<<<**BEGIN HIGHLY**

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2 **The proposed spin off, as presently structured, fails to compensate consumers adequately for the**
3 **sale of assets, and, therefore, the rates, post spin-off, cannot be considered just and reasonable.**
4
5 **Q: One of the four criteria requires an examination of the proposed transaction on rates.**[96]
6 **What are some of the ways that the Board should undertake this analysis?**

7 A: In order to make such an evaluation, it is essential to examine the financial implications of the
8 spin off. Among other things, if consumers are not adequately compensated, if shared assets
9 are not fairly apportioned, and if transactions between the spun off company (LTD) and Sprint
10 Nextel are not properly structured, then rates cannot be considered to be reasonable. The
11 soundness of the capital structure of the spun off company, the tax implications of the
12 transactions, and the consequences for pensions from the spin off also affect the ability the
13 financial strength of LTD and therefore its ability to offer service at reasonable rates.

14 **Q: How does the Board presently regulate United NJ's rates?**

15 A: United NJ is regulated under traditional rate of return regulation, but its revenue requirement
16 and rate design have not been examined since 1991.[97] An examination of United NJ's revenue

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[95]/ Standard and Poor's Rating Direct, "Research Update: Sprint Corp Ratings Remain On Creditwatch Positive, With Those Of Nextel, Pending Merger Case," August 4, 2005, pages 1-2, from the file "Indicative Ratings for Sprint.pdf" found on the Highly Confidential CD provided to the Ratepayer Advocate on October 11, 2005.

[96]/ *N.J.S.A.* 48:2-51.1.

[97]/ In the Matter of the Petition of United Telephone Company of New Jersey, Inc. For Approval to Increase, Decrease or Restructure Rates, Approval of Revised Depreciation Rates, and Approval of an Incentive Regulation Plan, BPU Docket No. TR90070726J, Telecommunications Decision and Order, March 26, 1991. As part of the stipulation, which the Board approved, United NJ withdrew its proposed incentive regulation plan. *Id*., at 2.

1 requirement, rate design, and service quality is long overdue. Among other things, as I discuss
2 below, Sprint sold off its highly profitable yellow pages operations for more than $2 billion and
3 yet, unlike in Qwest-served states, where ratepayers were compensated as a direct result of
4 Qwest's sale of its publishing operations, New Jersey ratepayers have not yet been
5 compensated. Also, as I discuss below, United NJ's service quality has been deteriorating and
6 the standards that apparently apply are unduly and inexplicably lenient.

7 **Q: Do the Joint Petitioners propose to credit consumers for the proceeds of the spin-off?**

8 A: No. The proceeds from the sale of assets associated with the proposed transaction should be
9 shared with New Jersey consumers, either in the aggregate or individually. The lack of such
10 a proposal is a fundamental deficiency in the Joint Petition.

11 **Q: Ms. Baldwin, are you aware of any prior legal case findings that relate the sharing of**
12 **proceeds of the sale of a utility with ratepayers?**

13 A: Yes. The holding in the *District of Columbia v. Washington Metropolitan Area Transit*
14 *Commission*[98] states that where ratepayers have borne the burden and had provided the capital
15 by which a utility financed the purchase of real property and other capital expenditures,
16 ratepayers should share in the proceeds of gains from the sale of such property. Specifically,
17 the Court stated that they "perceived no impediment, constitutional or otherwise, to recognition
18 of a ratemaking principle enabling ratepayers to benefit from appreciations in value of utility
19 properties accruing while in service…[a]nd doctrinal considerations to the contrary have lost

98/ *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 51 P.U.R. (NS) 193, 64 S.Ct. 281, 88 L.Ed. 333 (1944).

1 all vitality." In *Democratic Central Committee*, the D.C. Court directed the Washington
2 Metropolitan Area Transportation Commission to give the ratepayers the benefit of an
3 appreciation in value of land transferred from operating to non-operating status.[99]

4 **Q: Has the FCC made any determinations with respect to this issue?**

5 A: Yes. An FCC Order in 1980 states "….Thus, the ratepayers bear the risk both in terms of the
6 return they pay the investors for the use of their capital and in the reimbursement of the
7 investors for the decline in value (depreciation) of the assets used to provide service…Thus
8 when such a piece of property is retired and disposed, a gain results, the equities of the
9 situation would suggest that the ratepayer should receive the benefit of the gain."[100]
10 Furthermore, in 1983, the FCC concluded that the rule announced in the case of *Democratic*
11 *Central Committee* is that "neither the investors nor the ratepayers have a vested right to the
12 gains from the sale of appreciated utility property. Rather, our task in this matter is properly
13 to balance the investor and the ratepayer interests so as to apportion gains and losses in the
14 most equitable manner."[101]

99/ *Id.* 485 F.2d at 811.

100/ Federal Communications Commission Order (Docket No. 20188, 11-6-1980). *See also*: *California Public Utilities Commission Order Instituting Rulemaking Regarding Allocation of Gains on Sale By Energy Utilities, Incumbent Local Telecommunications Carriers and Water Companies*, Rulemaking 04-09-003, dated September 2, 2004; www.cpuc.ca.gov/

101/ *In the Matter of Procedures For Implementing The Detariffing Of Customer Premises Equipment And Enhanced Services (Second Computer Inquiry) American Telephone and Telegraph Company, Request For Approval To Supplement The Capitalization Of AT&T Information Systems In Connection With The Transfers Of Embedded Customer Premises Equipment*, FCC CC Docket No. 81-893, *Report and Order*, Rel. December 15, 1983, at para. 58.

1 **Q: Have state commissions also determined that ratepayers should share in the proceeds of**
2 **the sale of utility assets?**
3 A: Yes. It is my understanding that numerous state regulators have also determined that
4 ratepayers are entitled to recover gains on the sale of property. Among the different examples,
5 is Qwest's sale of its Yellow Pages publishing business, Dex, which I discuss in more detail
6 below.
7 **Q: Please discuss the relationship of Sprint's local operations and its wireless pursuits.**
8 A: Sprint's enormous success in expanding its wireless line of business can be attributed in part
9 to its access to virtually risk-free source of revenues from its local operations. Therefore,
10 Sprint Nextel, as part of its proposed divestiture, should compensate local customers for the
11 value of its wireless operations. As Exhibit SMB-8 shows, Sprint's PCS Group/Wireless
12 business segment reported operating losses for the years 1998 through 2001, while Sprint's
13 local, wireline division consistently posted substantial operating income. The stability that
14 Sprint's local wireline operations provided enabled Sprint to enter the wireless business,
15 which, in the first years, was not profitable.
16 **Q: Are New Jersey ratepayers entitled to share in the proceeds of the reverse merger?**
17 A: Yes. Although I cannot address the legal aspects of such a determination, as a matter of public
18 policy, United's ratepayers, which have provided the historic, virtually risk-free source of
19 revenues for United, are clearly entitled to the proceeds of the sale of assets that is occurring
20 with the proposed spin off of Sprint's local operations. The reverse merger should lead to a

credit for New Jersey consumers, either in the aggregate or individually. Highly Confidential Table SMB-HC-2 below summarizes the results of my calculation of the credit to which consumers are entitled. I have computed a consumer credit based on six alternative methodologies. First, I apply two different approaches for computing New Jersey's share, relative to the other states that Sprint local operating companies serve: the use of access lines and the use of revenues. Also, to compute the premium associated with the sale, I use three approaches: (1) the new debt that the spin off company is anticipate to incur; (2) HL's "low end" equity valuation of the spun-off company; and (3) HL's "high end" equity valuation of the spun-off company.

Q: What were the results of this analysis?

A: <<<**BEGIN HIGHLY CONFIDENTIAL**

END HIGHLY CONFIDENTIAL>>> The results of my analysis are very similar whether one uses a revenue or access line approach. The results are included in the table below:

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Calculations and sources for the above results are included in Highly Confidential Exhibit SMB-HC-9. The Board should assign appropriately, 100 percent to consumers.

Q: Ms. Baldwin, Sprint states that as "the transaction does not involve a sale of assets, there is no compensation involved."[102] Please respond.

A: The critical question for the Board in this proceeding is an assessment of the bearing of the risks. Ratepayers have borne the risk, provided United NJ with a largely captive, embedded customer base, accumulated customer loyalty, contributed significantly to Sprint's brand name recognition, and subsidized Sprint's now, highly lucrative wireless business. Under this transaction, they would be required to bear yet more, and highly unpredictable risk associated

[102]/ Sprint response to RPA-99.

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1 with the divestiture of the local operations from the parent company.[103] Furthermore, in
2 addition to the fact that the market valuation of LTD vastly exceeds the book value of assets,
3 Sprint is inheriting substantial and valuable intangible assets, such as the right to the branding,
4 work force, customer loyalty and inertia, possibly the use of access to customer lists, etc. For
5 these reasons, Sprint Nextel should credit LTD consumers.

6 **Q: You have computed the consumer credit on both a statewide basis and on a per-line**
7 **basis. If the Board does not direct Sprint to provide a credit on customers' bills, is there**
8 **an alternative by which the Board could return the amount of the consumer credit to**
9 **consumers?**

10 A: Yes. The Board should direct United to make investments in its operations to provide for:
11 (1) adequate operations and maintenance of the basic local network to achieve the
12 statutory objective of "the provision of safe and adequate utility service at just and
13 reasonable rates."[104] As I discuss below, United's trend of declining service quality
14 underscores the importance of ensuring that LTD allocates adequate expenditures to
15 provide service at an acceptable level of quality.
16 (2) fiber to the home or to the curb: it is unlikely that rural and/or low and moderate
17 income communities will be served absent a commitment by the Joint Petitioners.
18 (3) stand-alone DSL throughout its operating territory in New Jersey.

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[103]/ See document entitled **<<<BEGIN HIGHLY CONFIDENTIAL**

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[104]/ *N.J.S.A.* 48:2-51.1.

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1 **Q: Have other PUCs addressed ILECs' deployment of broadband technology?**

2 A: Yes. Community groups and regulators in California are raising similar concerns about
3 consumers' access to broadband technology. A recent press release issued by the California
4 Public Utilities Commission states:

> 5 As a condition of approving the mergers, the PUC also required both
> 6 companies to contribute a combined total of $60 million to an infrastructure
> 7 fund for emerging broadband technologies. The California Emerging
> 8 Technology Fund (CETF) would be established by the PUC as an independent
> 9 non-profit entity that would focus on building broadband networks in areas
> 10 with limited access to high-speed Internet service. The PUC established a
> 11 similar fund for emerging energy technologies (The California Clean Energy
> 12 Fund) as a condition of approving the Pacific Gas and Electric Company
> 13 reorganization plan in 2003.
> 14
> 15 CETF funds will be used to attract matching funds from other non-profit
> 16 organizations, corporations, and government entities. It is anticipated that the
> 17 initial endowment of $60 million ($45 million from SBC and $15 million from
> 18 Verizon) will be matched with funds from other sources to reach a total goal
> 19 of $100 million over five years. The purpose of the CETF is to fund
> 20 deployment of broadband facilities in underserved communities, defined as
> 21 communities without broadband service, communities with access to only one
> 22 broadband service provider other than satellite, or below average broadband
> 23 adoption rates. Communities with below average adoption rates primarily
> 24 include low-income households, ethnic minority communities, disabled
> 25 citizens, California Public Utilities Commission 11/18/05 seniors, small
> 26 businesses, and rural or high-cost geographic areas. The CETF will also focus
> 27 on deployment of broadband facilities to bring critical advanced services to
> 28 high cost and rural areas, such as telemedicine and online education.
> 29
> 30 "This Commission is committed to 100 percent access in the next five years,"
> 31 President Peevey said. Commissioner Kennedy added, "This fund is aimed at
> 32 building those last mile connections that are the hardest to reach, and tend to
> 33 be uneconomical for the private sector to serve. It won't replace private sector
> 34 investment – it will supplement it. With the right combination of funding, we

1 can bring key services such as telemedicine to the far reaches of the state."[105]
2
3 **Q: Is there other evidence implying that the Board should affirmatively set policy to ensure**
4 **broadband access by all socioeconomic groups?**
5 A: Yes. National studies demonstrate that access to the Internet and the use of broadband
6 technologies declines as income declines. Absent any state-specific information, the Board
7 should assume that demand characteristics in New Jersey mirror national statistics. As I
8 discuss in more detail below, a Department of Commerce study suggests that as income
9 declines, access to the Internet declines, and, furthermore, that as income declines, the use of
10 broadband declines.[106] Absent access to broadband technology, VoIP is not an alternative to
11 wireline telecommunications for consumers. Thus, as income declines, competitive
12 alternatives also decline. The FCC recently stated, "[t]he availability of the Internet has had a
13 profound impact on American life. This network of networks has fundamentally changed the
14 way we communicate."[107]

105/ California Public Utilities Commission News Release, Docket Nos: SBC/AT&T: A.05-02-027 and Verizon/MCI: A.05-04-020, "PUC Approves Telecom Mergers, Approval Addresses 'Digital Divide'" released November 18, 2005.

106/ Information about consumers' access to broadband, including tables with various demographic breakdowns are discussed in more detail below. See, also, *e.g.*, footnote 3 on page 3 of the NTIA report detailed below, which states: "This report focuses primarily on broadband usage. Tables covering a variety of demographic breakdowns of overall computer and Internet use for September 2001 and October 2003, such as income, education, race/ethnicity, disability, and age, are provided in the Appendix and on the web at www.esa.doc.gov and www.ntia.doc.gov."

107/ In the Matters of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, CC Docket No. 02-33, Policy Statement, released September 23, 2005, cite omitted.

1 **Q: Has the FCC articulated goals regarding broadband access?**

2 A: Yes, the FCC clearly envisions a growing role for broadband in society. FCC Chairman
3 Martin recently described the significance of broadband to citizens throughout the country:
4 "Broadband deployment is vitally important to our nation as new, advanced services hold the
5 promise of unprecedented business, educational, and healthcare opportunities for all
6 Americans."[108] Commissioner Adelstein similarly recognized the importance of broadband to
7 society, as well as the goal of ensuring that no one is left behind, stating:

> 8 These technologies [wireline broadband Internet access services, the high-speed
> 9 DSL and fiber-to-the-home connections] are revolutionizing the way that
> 10 consumers connect, learn, work, and socialize through the Internet. ...
> 11 ...
> 12
> 13 Given the growing importance of broadband services for our economy, public
> 14 safety, and society, I hope that we can preserve our ability to support the
> 15 deployment of these services for consumers that the market may leave
> 16 behind.[109]

17 **Q: Please explain how your concerns about widespread access to broadband relate to this**
18 **proceeding.**

19 A: In order to provide an unambiguous positive benefit for New Jersey's consumers, Sprint Nextel
20 should commit to deliver broadband access, particularly to those rural and low to moderate
21 income communities that might not otherwise be served.

108/ In the Matter of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, FCC CC Docket No. 02-23, Report and Order and Notice of Proposed Rulemaking, Rel. September 23, 2005 ("NPRM"), Statement of Chairman Kevin J. Martin, at 123.

109/ *Id.*, Statement of Commissioner Jonathan S. Adelstein, at 130.

1 **Until the Board examines the treatment of yellow pages, the Board should not approve the**
2 **proposed spin-off.**
3
4 **Q: Does the Joint Petition explain how yellow page revenues are treated?**

5 A: No. I understand that a full-blown rate case is outside the scope of this proceeding.[110]
6 Nonetheless, it is important to examine the treatment of the highly profitable yellow pages that
7 are branded with Sprint's name and logo.[111] ILECs' yellow pages offering are highly
8 profitable and traditionally, state regulators have imputed the profits to intrastate regulated
9 operations.

10 **Q: Do the Joint Petitioners recognize that Sprint branding has implications?**

11 A: Yes. **<<<BEGIN HIGHLY CONFIDENTIAL**
12 **END HIGHLY CONFIDENTIAL>>>**[112] Although the document
13 does not elaborate on this point, nor do the Joint Petitioners explain in their filing to the Board
14 about the implications of the proposed spin-off for the yellow pages revenues, I urge the Board,
15 nonetheless, to address this important issue. At a minimum, the revenues from the highly
16 lucrative yellow pages operations should be imputed to ratepayers, by computing the net
17 present value of the future stream of yellow pages profits. As the Board has clearly articulated,
18 ratepayers should be no worse off as a result of a change in control, and, indeed, under the

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110/ *Prehearing Order and Order on Motion to Intervene,* October 26, 2005, at 3.

111/ Sprint provided a copy of its combined white and yellow pages for Sussex Countywide, as of July 2005 in response to RPA-126.

112/ Response to RPA-60, page NJ007505.

1 positive benefits standard, should be better off than if the transaction did not occur. United's
2 ability to offer yellow pages at, what likely, a very profitable level, is a direct consequence of
3 its historic monopoly position in local markets.

4 **Q: Have you examined how Sprint accounts for yellow page revenues?**

5 A: The information that the Joint Petitioners have provided does not provide a complete picture
6 of the accounting associated with yellow pages. The Ratepayer Advocate has issued follow-up
7 discovery that seeks more complete information regarding whether United's ratepayers (and
8 therefore, LTD's ratepayers) have been and are being adequately compensated for the
9 extremely lucrative line of business associated with the publishing of United's directories.

10 **Q: What is your general understanding of the way in which United's directories are**
11 **handled?**

12 A. RH Donnelly, Inc. ("Donnelly") provides yellow pages on behalf of United and "took over all
13 phonebook publications on January 1, 2003."[113] Being able to publish the yellow pages of an
14 incumbent local exchange carrier is an extremely valuable line of business, and one where the
15 value derives directly from the incumbent's long-standing relationship to its historic customer
16 base. However, the information provided by the Joint Petitioners thus far does not shed any
17 light on the financial transaction that occurred that resulting in Donnelly "taking over" the
18 phonebook. Until the Board can confirm that United NJ's ratepayers were compensated
19 properly for the transaction, it should not approve the pending Joint Petition.

[113]/ Responses to RPA-124-125.

1 **Q: Didn't the Joint Petitioners provide the directory services license agreement?**

2 A: Yes. Sprint provided the directory services license agreement "by and between" R.H. Donnelly
3 Publishing & Advertising, Cendon, R.H. Donnelly Directory Company, Sprint Corporation,
4 Sprint Directory Trademark Company and and Sprint Local Telecommunications Division.[114]
5 However, this document does not address the financial history of this new relationship.
6 Generally, there is insufficient information about the financial transactions associated with
7 Sprint LTD's decision to license the right to produce, publish, and distribute the Sprint LTD
8 directories under the terms set forth in the agreement provided in response to RPA-127 and in
9 the "other Commercial Agreements." For example, the Joint Petitioners failed to disclose
10 whether Sprint LTD received any compensation for granting the exclusive publishing right to
11 Donnelly.

12 **Q: What is your understanding of what Sprint granted to Donnelly?**

13 A: Sprint LTD granted to Donnelly an "exclusive license...to produce, publish and distribute on
14 behalf of Sprint LTD the physical media and non-physical media Sprint LTD Directories."[115]
15 The term of the agreement continues until 2052 and then renews automatically for successive
16 five year terms.[116] There is a separate subscriber listings agreement between Sprint and

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[114]/ Response to RPA-127.

[115]/ Response to RPA-127, NJ008382.

[116]/ Response to RPA-127, Section 8.1.

1 Donnelly, which the Joint Petitioners did not provide in response to RPA-127.[117]

2 **Q: Please describe the transaction further.**

3 A: As of January 3, 2003, Donnelley Publishing took over the publishing of Sprint's yellow pages
4 through a stock acquisition.[118]

5 **Q: Does Sprint's annual report provide information about this transaction?**

6 A: Yes. In the third quarter of 2002, Sprint reached a definitive agreement to sell its directory
7 publishing business to R.H. Donnelley for $2.23 billion in cash. The sale closed on January 3,
8 2003.[119]

9 **Q: Have you examined any historic data on the profitability of Sprint's yellow pages?**

10 A: Yes. Exhibit SMB-10, which summarizes data included in Sprint's Form 10-K for the years
11 1998 through 2000, shows that the operating income for this line of Sprint's business increased
12 by five percent from $231-million from 1998 to $242-million in 1999. Between 1999 and
13 2000, operating income increased by *seventeen percent* from $242-million to $284 million.

14 **Q: Have you examined data for 2001 and 2002?**

15 A: No. These data are not readily available. The Ratepayer Advocate has sought historic
16 information about Sprint's directory publishing from the Joint Petitioners as well as other
17 pertinent information to enable the Board to ensure that New Jersey consumers are adequately

117/ Response to RPA-127, Section 6.3.

118/ Response to RPA-127.

119/ Sprint Nextel Corp. Form 10-K, filed March 11, 2005, for period ending December 31, 2004, at 1.

1 compensated for Sprint's sale to Donnelly.[120] Based on my review of the Joint Petitioners'
2 responses to these, and any related interrogatories, I will supplement my analysis.

3 **Q: Ms. Baldwin, are you aware of any cases in which state utility commissions have dealt**
4 **with the sale of the incumbent's directory business?**

5 A: Yes. Just a few years ago, Qwest Communications International, Inc. ("QCI" or "Qwest")
6 entered into purchase agreements in August, 2002 to sell its Qwest Dex, Inc. ("DEX")
7 directory publishing business to an unaffiliated business, "Dex Holdings, LLC". Dex
8 Holdings, LLC was formed by two private investment firms (Carlyle Group and Welsh,
9 Carson, Anderson & Stowe) for the purpose of buying Qwest's directory business for $7.05
10 billion.[121] In its filings with state utility commissions regarding the sale, Qwest asserted that
11 to avoid bankruptcy, it had agreed to sell Dex.[122]

12 **Q: Were any of the state proceedings in that case relevant to the instant proceeding?**

13 A: Yes. For example, Qwest agreed to credit ratepayers as part of the sale. On August 1, 2003,
14 the Washington Utilities and Transportation Commission ("WUTC") approved a Stipulation
15 and Settlement Agreement that provided direct credits on customers' bills for a total of $67-

[120]/ *See e.g.,* RPA-337 through RPA-352.

[121]/ *In the Matter of the Application of Qwest Corporation Regarding the Sale and Transfer of Qwest Dex to Dex Holdings, LLC, a non-affiliate*, Washington Utilities and Transportation Commission Docket No. UT-021120, *Tenth Supplemental Order: Approving and Adopting Settlement Agreement; Granting Application and Accepting Notice, Subject to Conditions*, August 1, 2003, at paras. 10-11.

[122]/ *Id.*, at para. 40.

1 million which translated into $29.87 per access line.[123] In addition, the settlement included 15
2 years of revenue credits whereby in the first five years $110 million would be added to Qwest's
3 Washington intrastate regulated revenues and $103.4 million would be added for the following
4 ten years. Directory revenues would no longer be imputed for the purposes of rate cases.[124]
5 As part of the settlement, Qwest also agreed not to petition to remove customer-specific service
6 quality remedies contained in its tariffs for the period of two years[125] and to "improve customer
7 access" to Washington's Telecommunications Assistance Program and Lifeline/Link-Up.[126]
8
9 In Utah, the Public Service Commission ("Utah PSC") approved a stipulation between Qwest,
10 the Division of Public Utilities, and the Committee of Consumer Services that provided for a
11 one-time credit to retails customers totaling $22-million.[127] In addition, parties to the
12 stipulation agreed not to seek changes in the price cap index or consumer prices based on the

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123/ *Id.*, at para. 27.

124/ *Id.*, at para. 28.

125/ *Id.*, at para. 29.

126/ *Id.*, at para. 30.

127/ *In the Matter of the Petition of Qwest Corporation for Declaratory Ruling or, in the Alternative, for Approval of the Sale of the Utah Assets of Qwest Dex, Inc.*, Public Service Commission of Utah Docket No. 02-049-76, *Report and Order*, March 11, 2003, at 1. Consumers received $34.25 per account as a credit after the sale was final. Utah PSC Press Release: "Qwest Customers Will Receive Phone-Bill Credits," dated September 26, 2003.

1 sale.[128] The credit was estimated to translate to approximately $32.91 per customer account.[129]

2 **Q: Why are ratepayers entitled to a credit?**

3 A: As stated previously, the incumbents' directory businesses are a direct outcome of their historic
4 monopoly position in the telecommunications market. The courts, as well the state utility
5 commissions, have recognized this fact. The Washington Supreme Court, in 1997,
6 characterized Qwest's (at the time, US West) directories business in the following manner:

> 7 The fact is that the Company is different from other companies
> 8 competing for the business. The record shows that US West did not
> 9 develop this lucrative business by its initiative, skill, investment or risk
> 10 taking in a competitive market. Rather, it did so because it was the sole
> 11 provider of local telephone service, and as such owned the underlying
> 12 customer databases and had established business relationships with
> 13 virtually all of the potential advertisers in the yellow pages. Therefore,
> 14 the Commission reasonably concluded that the yellow pages business
> 15 is quite unlike businesses of other unregulated companies which were
> 16 developed in, or derive their profitability from, the competitive
> 17 marketplace. The record indicates that the billing and collection service
> 18 provided to US West Direct by US West is a valuable business
> 19 advantage to US West Direct. The record also indicates that in contrast
> 20 with potential publishing competitors, US West Direct's publishing
> 21 enjoys a unique and direct benefit by being associated with the
> 22 Company's regulated telecommunications services. The affiliated
> 23 transactions of US West's competitors do not present an analogous
> 24 public policy issue because competitors lack the formidable and
> 25 historical dominance in the local exchange market that US West
> 26 possesses.[130]

27

[128]/ *Id.*, at 6.

[129]/ *Id.*, at 5.

[130]/ *US West v. Utils. and Tranp. Comm'n* 134 Wn.2d 74, 949 P.2d 1337 (1997), at 99-100.

1 In its 1997 decision, the Washington Supreme Court cited the Colorado Supreme Court's
2 reasoning that:

> 3 The directory publishing business was developed over the past fifty years
> 4 within the protective shelter of Mountain Bell's monopoly of telephone service.
> 5 The assets were included in the base upon which Mountain Bell was permitted
> 6 to earn a return. Mountain Bell concedes that the Yellow Pages always have
> 7 generated 'supra competitive' profits. It is an exaggeration to say that Mountain
> 8 Bell's shareholders took any significant risk in developing the directory
> 9 publishing business, and we find the public interest in those assets to be beyond
> 10 dispute.[131]

11 Judge Greene concluded that the "assets used in the production of these printed directories will
12 accordingly have to be allocated to the Operating Companies." Modification of Final
13 Judgment, U. S. v. AT&T, 552 F. Supp. 131, 212 (D.D.C. 1982) ("MFJ").

14 In 2001, the Federal Communications Commission concluded:

> 15 Essential to a competitor's ability to provide directory assistance is
> 16 access to an accurate local directory assistance database. Because
> 17 incumbent LECs derive their local directory assistance database through
> 18 their service order processes, they continue to maintain a near total
> 19 control over the vast majority of local directory listings that form a
> 20 necessary input to the competitive provision of directory assistance.
> 21 Without nondiscriminatory access to the incumbents' directory
> 22 assistance databases, competing DA providers may be unable to offer
> 23 a competitive directory assistance product. This, in turn, may affect the
> 24 ability of both the DA providers and the CLECs that rely on them to
> 25 compete in the local exchange marketplace. The directory assistance
> 26 market will not be fully competitive as long as incumbent LECs have
> 27 the ability to leverage their monopoly control of their DA databases into

[131]/ *Id.*, at 100, citing *Mountain States Tel. & Tel. Co. v. Public Utils. Comm'n*, 763 P.2d 1020, 1027-28 (Colo. 1988) (citations omitted).

market dominance.[132]

Q: Should United NJ's customers be compensated for this sale?

A: Absolutely. New Jersey's share, based on access lines, is 2.8 percent, and multiplying this share by the $2.3-billion proceeds from the sale yields a consumer credit of $65-million.[133] Consumers are entitled to these funds and should be provided either with a one-time credit, computed on a per-line basis, or with a credit that is returned on over a twelve-month period.

The Board should examine the impact of the proposed transaction on LTD's capital structure to enable the Board to assess the impact of the proposed spin off on consumers' rates and the ability of LTD to provide safe and adequate service.

Q: What is your understanding of HL's analysis of LTD's capital structure?

A: HL performed several "capital tests" as follows:

1. HL examined whether the fair market value of LTD exceeded LTD's liability.[134] Using the results of its market valuation HL estimates that its assets exceed its projected debt by approximately **<<<BEGIN HIGHLY CONFIDENTIAL**

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2. HL also performed a cash flow test by examining the cash available at the end of each of the projected years 2006 through 2010. HL computed a "cash cushion" that is anticipated to increase steadily between a projected level of **<<<BEGIN HIGHLY**

132/ *Provision of Directory Listing Information Under the Telecommunications Act of 1934, as Amended*, FCC CC Docket 99-273, *First Report and Order*, Rel. January 23, 2001, at para. 3 (noted omitted).

133/ Response to RPA-21, HL Report at 50.

134/ HL Report, at 65.

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1 **CONFIDENTIAL** **END HIGHLY**

2 **CONFIDENTIAL>>>**

3 3. Also, HL performed a reasonable capital test by assessing whether LTD's equity as a

4 percent of the value of its assets was adequate. HL computed the equity value by

5 **<<<BEGIN HIGHLY CONFIDENTIAL**

6

7 **END**

8 **HIGHLY CONFIDENTIAL>>>**[135]

9 **Q: Do you have any preliminary observations about LTD's capital structure?**

10 A: Sprint Nextel does not include any short-term debt in the capital structure of the company, nor

11 does it explain the absence of such debt.[136] Sprint Nextel also asserts United's assets,

12 liabilities, revenues, and expenses will "primarily...remain the same," but neglects to describe

13 how they will differ.[137] Sprint indicates that the issuance of debt "is part of the process of

14 establishing an appropriate capital structure determined by Sprint's Treasury Department," but

15 does not provide any detail as to Sprint's Treasury Department's method of making such a

16 determination.[138]

135/ *Id.*, at 67.

136/ Exhibit MAG-2.

137/ Gast Direct (Joint Petitioners), at 5.

138/ *Id.*, at 10.

Q: Would the spin off affect United's interest expenses?

A: Yes. Presently, United Telephone carries a debt load of $57,896,000 and an interest expense of $1,323,000, which implies a debt cost rate of 2.3 percent.[139] However, LTD Holding Company is anticipated to incur interest expense of **<<<BEGIN HIGHLY CONFIDENTIAL**

END HIGHLY CONFIDENTIAL>>>[140] According to United, "this increased interest expense will be more than offset by the additional cash flow resulting from LTD Holding Company's new dividend plan.[141] The new dividend plan, which is slated to provide $300 million annually, differs significantly from the present dividend distribution of **<<<BEGIN HIGHLY CONFIDENTIAL END HIGHLY CONFIDENTIAL>>>**paid to shareholders in 2004.[142] The Petitioners fail to explain why this **<<<BEGIN HIGHLY CONFIDENTIAL END HIGHLY CONFIDENTIAL>>>** in dividends will be acceptable to investors. Similarly, the Petitioners fail to explain why either the increase in leverage or the reduction in dividends would not be an option except as a result of the proposed separation.

139/ *Id.*, at 11 and Exhibits MAG-1 and MAG-2.

140/ *Id.*

141/ *Id.*, at 11-12.

142/ *Id.*, at 14 and Exhibit MAG-6.

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1 **Q: What is United's existing dividend policy?**

2 A: **<<<BEGIN HIGHLY CONFIDENTIAL**

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5 **END HIGHLY CONFIDENTIAL>>>** Sprint indicates that

6 LTD intends to continue that dividend practice.[143]

7 **The Joint Petition lacks detail about the merger's impact on employees, yet executive officers**
8 **would benefit from substantial bonus.**

9 **Q: How does the Joint Petition address the impact of the merger on employees?**

10 A: The Joint Petitioners indicate that "the final structure and staffing of LTD Holding Company
11 and its subsidiaries is being developed."[144] They also indicate that United NJ will fulfill its
12 pension obligations. According to the Joint Petitioners, a new management company
13 subsidiary of LTD Holding Company (LTD Management Company), staffed with m any of the
14 same people that now provide the service, will provide such centralized functions as human
15 resource service, finance services, etc.[145]

16 **Q: How would the separation affect employees covered by bargaining units?**

17 A: United NJ intends to honor existing agreements: the IBEW agreements expire April 1, 2007

143/ Response to RPA-92.

144/ Petition at 11.

145/ Joint Petition at 11-12.

1 and January 12, 2007; the CWA contract expires April 1, 2006. The Joint Petitioners indicated
2 that existing Sprint employees that are employed by LTD Holding Company and United NJ
3 "are expected to have available to them a defined benefit pension plan, with terms and benefits
4 reasonably equivalent to the Sprint plan." Also, "LTD Holding Company will review its
5 pension benefit plan from year-to-year in order to remain competitive in the market for
6 employees."[146]

7 **Q: How many New Jersey employees are potentially affected by the divestiture?**

8 A: United NJ has 246 employees.[147]

9 **Q: Are Sprint Nextel executives likely to benefit from the spin off?**

10 A: Yes. Typically, the top executives of the acquiring company benefit significantly from mergers
11 through a combination of special retention bonuses, and other enhanced post-merger
12 compensation.[148] Although I have not analyzed all of the employment agreements, Hesse's
13 employment agreement is an example of the benefits flowing to top executives.
14 Among other things, this agreement includes the following provisions:
15
16 • On June 7, 2005 (the "effective date"), Hesse commences service as CEO of Sprint's

[146]/ *Id.,* 12-13

[147]/ Hrip Direct (Joint Petitioners) at 7.

[148]/ Gretchen Morgenson, "What Are Mergers Good For?" *New York Times Magazine,* June 5, 2005. The article states, among other things, that "the most compelling case for mergers may simply be the immense wealth that they generate. Executives began reaping big rewards from deals during the 1980's, when so-called golden parachutes were introduced." *Id*., at 58.

REDACTED VERSION

1 Local Telecommunications Division reporting directly to the CEO of Sprint.
2 Immediately following the spin-off, Hesse serves as President and CEO of SpinCo
3 reporting directly to the Board and shall be member of the Board. Kansas City, Kansas
4 greater metropolitan area shall be Hesse's principal job location. NJ006281.

5 • The original employment term is through June 30, 2008, with provisions for
6 termination or extension. NJ006282.
7

8 • Base salary starting on the effective date: $900,000. Bonus: eligible to participate in
9 "short-term incentive plan" - annual target bonus opportunity of at least 120% of base
10 salary and maximum bonus not exceed 200% of base (apparently a bonus ranging
11 between $1,080,000 and $1,800,000). NJ006282.
12

13 • For 2005, entitled to minimum annual bonus of $1,050,000, pro-rated for actual service
14 with LTD; required to relocate promptly to the greater Kansas City metropolitan area.
15 Entitled to sign-on bonus of $600,000 with initial grant of options to purchase 408,000
16 FON common stock at exercise price equal to fair market value on the grant date and
17 also an initial grant of 157,000 restricted stock units relating to shares of FON common
18 stock. Initial options vest in 25% "trances" on the first four anniversaries of grant date,
19 subject to continued employment. The restricted options vest on the third anniversary
20 of the grant date, subject to continued employment. NJ006277. See also NJ006283 for

1 more details about the initial and restricted stock options.

2

3 • $7-million Sign-on Bonus: "The first annual long-term equity award to Mr. Hesse in
4 2006 will be made not later than the earlier of (1) December 31, 2006 and (2) the first
5 to occur of the termination of Mr. Hesse's employment (a) without cause, (b) for good
6 reason or (c) for constructive discharge, and will have a grant date value of $7,000,000,
7 subject to Mr. Hesse's continued employment through the earlier of (A) the date on
8 which such grants are made to other executives designated to join the LTD Business
9 and (B) March 15, 2006." If Hesse's employment with Sprint is terminated by Sprint
10 without cause or by Hesse for "good reason," Hesse will receive pro-rata annual bonus
11 for the year of termination and a monthly severance. NJ006277. See also
12 NJ006284.[149]

13

14 The Joint Petitioners indicate that there is no divestiture agreement between Sprint Nextel and
15 LTD, stating that "[a] Separation and Distribution Agreement is contemplated to be completed
16 at or near the time of separation." RPA-66. The response further indicates that the LTD Board
17 of Directors will need to determine if the contracts between Dan Hesse, Gene Betts, Mike
18 Fuller, William Blessing, and Thomas Gerke "will remain intact or require changes." RPA-66

[149]/ See Form 8-K, June 10, 2005, provided in response to RPA-66. See discussion of employment agreement on pages NJ006277 through NJ006317.

1 **The Joint Petitioners have failed to demonstrate that consumers' rates will be more affordable**
2 **as a result of the proposed transaction and, also, have failed to demonstrate that they are**
3 **allocated sufficient resources to the provision of safe and adequate service.**

4 **Q: Does the Board need to assess the impact of the proposed merger on consumers' rates**
5 **and service quality?**

6 A: Yes. According to the statute, the Board must assess the impact of the proposed merger on the
7 rates of ratepayers affected by the merger and on the "provision of safe and adequate utility
8 service at just and reasonable rates."[150]

9 **Q: Have the Joint Petitioners adequately demonstrated that the merger will not jeopardize**
10 **the rates and quality of the merged entity's service?**

11 A: No. The Petition simply includes broad-brush statements about purported consumer benefits.

12 **Q: Could consumers actually be harmed in the Petitioners' course of achieving merger**
13 **synergies?**

14 A: Yes. The proposed spin off exposes consumers to two possible ill effects related to the
15 Petitioners' achievement of the predicted merger synergies:

16 • The Joint Petitioners' efforts to reducing operating expenses could jeopardize service
17 quality.

18 • The Joint Petitioners' efforts to *lower* capital investment could lead to declining service
19 quality.

[150]/ *N.J.S.A.* 48:2-51.1.

1 **Q: Please elaborate.**

2 A: Documents provided by Sprint Nextel in this proceeding clearly show that LTD plans to reduce
3 capital investment over the near term. More specifically, capital investment is projected to
4 **<<<BEGIN HIGHLY CONFIDENTIAL**
5 **END HIGHLY CONFIDENTIAL>>>**[151]

6 **Q: In what areas is the reduction in capital expenditure most apparent?**

7 A: The reduction in capital investment will be widespread. Documents provided by Sprint Nextel
8 show that investment is anticipated to decrease across all categories. Highly Confidential
9 Exhibit SMB-HC-11, a reproduction of a table provided by Sprint Nextel,[152] provides greater
10 detail about reductions in capital investment by category. Highly Confidential Exhibit SMB-
11 HC-12, provides additional detail.[153]

12 **Q: Do the capital spending plans detailed in the above referenced exhibits pose concerns for**
13 **consumers in New Jersey?**

14 A: Yes. Highly Confidential Exhibit SMB-HC-12 suggests that declining investment in several
15 categories will directly impact the quality of service that consumers in New Jersey receive from
16 United New Jersey. Some particular areas of concern to consumers include the following
17 categories: **<<<BEGIN HIGHLY CONFIDENTIAL**

151/ Sprint Nextel response to RPA-2, NJ000406.pdf, at 2.

152/ Sprint Nextel response to RPA-2, NJ000357.pdf, at 2.

153/ Sprint Nextel response to RPA-2, NJ000362.pdf, at 7-10.

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7 **END**

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9 **Q: Does Sprint Nextel provide any explanation as to why the reductions are necessary or**
10 **provide evidence that capital investment reductions will not harm New Jersey**
11 **consumers?**

12 A: No.

13 **Q: Does Sprint Nextel provide any evidence that LTD made substantial investments in these**
14 **categories in recent years, thus justifying a decrease in the near term?**

15 A: No.

16 **Q: Does Sprint Nextel provide a comparison of capital spending compared to other**
17 **companies?**

18 A: Yes. In response to RPA-2[154] Sprint Nextel shows that in 2002 and 2003, LTD's capital
19 expense as a percentage of revenues was **<<<BEGIN HIGHLY CONFIDENTIAL**

[154]/ Response to RPA-2, NJ000357.pdf.

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2 **END HIGHLY CONFIDENTIAL>>>**[155] Sprint

3 Nextel appears to be deliberately moving from a position of industry leader to that of an

4 industry laggard with respect to investment. Highly Confidential Exhibit SMB-HC-13 contains

5 additional detail.

6 **Q: What are the implications for consumers of this apparent change in investment strategy?**

7 A: It suggests that LTD is willing to sacrifice long-term competitiveness and service quality to

8 short-term gains in its bottom line. A footnote appearing on a document Sprint Nextel

9 provided in response to RPA-2, comparing LTD Capex to other companies reads: **<<<BEGIN**

10 **HIGHLY CONFIDENTIAL**

11 **END HIGHLY**

12 **CONFIDENTIAL>>>**[156] Economic theory suggests that a company pursuing long-term

13 viability will undertake projects that add positive net present value. **<<<BEGIN HIGHLY**

14 **CONFIDENTIAL**

15

16 **END HIGHLY CONFIDENTIAL>>>**

155/ *Id.*

156/ Sprint response to RPA-2, NJ000357.pdf, at 2.

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1 **Q: Does Sprint Nextel provide materials that suggest that despite reductions in capital**
2 **investment, it intends to make investments to improve customer service operations?**
3 A: No. In fact, spending on customer service operations **<<<BEGIN HIGHLY**
4 **CONFIDENTIAL END**
5 **HIGHLY CONFIDENTIAL>>>**[157]
6 **Q: Does Sprint Nextel provide information regarding its plans with respect to spending on**
7 **customer service operations in the future (*i.e.* after 2005) ?**
8 A: No.

9 **United NJ's service quality objectives lag significantly behind those applicable to Verizon New**
10 **Jersey, and, furthermore, United NJ's service quality has been declining for several years.**

11 **Q: What service quality measures does United NJ presently track and monitor?**
12 A: Exhibit SMB-14, which is a reproduction of Sprint's response to RPA-106, summarizes the
13 measurements that United NJ tracks and its objectives for those measurements.
14 **Q: Are the measurements sufficiently comprehensive?**
15 A: No. Among other things, several measurements that ILECs typically monitor are missing from
16 the list, such as the percentage of repairs completed within 24 hours and repeat trouble reports.
17 Sprint reports some of these to the FCC, but apparently does not monitor them for intrastate
18 purposes, which is surprising given that state regulators typically are more concerned with, and
19 directly involved with the regulation of, local operations than is the FCC.

[157]/ Sprint response to RPA-2, Document NJ000322.pdf, at 1.

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1 **Q: Do the objectives United sets for the measurements seem reasonable?**

2 A: No. An objective of only 75% for completing primary service orders within five days is
3 inexplicably low.[158] Also, United NJ's objective for meeting its commitments to install
4 primary basic local exchange service is only 88 percent.[159] By contrast, Verizon seeks to meet
5 a standard of 90 percent for completing installations within five days, and to meet 98 percent
6 of its installation commitments for residential and business local service.[160] Also, an objective
7 of 8 customer trouble reports per hundred access lines is entirely out of date and inappropriate.
8 The objective for Verizon, by contrast, is only 2.3.[161] Based on the deployment of digital
9 switches and the upgrading of outside plant, an objective of eight trouble reports per hundred
10 lines is inexcusably high.

11 **Q: How do United's and Verizon's service quality standards compare?**

12 A: Exhibit SMB-15 compares the standards applicable to Verizon with those that United
13 apparently seeks to achieve.[162] A United consumer is no less deserving of acceptable service

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158/ Response to RPA-106.

159/ *Id.*

160/ In the Matter of the Application of Verizon New Jersey Inc. For Approval (I) of a New Plan for an Alternative Form of Regulation and (ii) to Reclassify Multi-Line Rate Regulated Business Services as Competitive Services, and Compliance Filing, New Jersey Board of Public Utilities Docket No. TO01020095, Decision and Order, ("PAR-2 Order") August 19, 2003, Attachment B.

161/ *Id.*

162/ For Verizon, the Board "updated and improved" three of the twelve metrics defined through the Rate Stability Plan in 1987 and approved under PAR-1. In addition, the Board adopted eight metrics utilized in the FCC's Automated Reporting Management Information System ("ARMIS") and created one new metric (BPU complaints per 10,000 lines). *Id.*, at 79.

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1 quality than is a Verizon consumer, and certainly faces similar or fewer opportunities for
2 competitive alternatives.

3 **Q: Complaints decreased between 2000 and 2004 for United NJ.**[163] **Can one assume that if**
4 **the number of complaints decline that service quality is improving, or at least adequate?**

5 A: Not necessarily. Customers alter their expectations based on previous experience. For
6 example, if the road one travels often is riddled with potholes, at some point, the pothole filled
7 road becomes the standard. A decline in complaints could simply parallel a decline in
8 expectations.

9 **Q: Didn't the FCC recently release a report concluding that its analysis "indicates the**
10 **presence of statistically significant long term trends … indicative of long-term**
11 **improvement?"**[164]

12 A: Yes. However, this report focuses largely on industry-wide trends. While the report does
13 discuss individual companies (including Sprint), the results are aggregated over the companies'
14 entire service areas. In the case of Sprint, no detail is provided for its New Jersey subsidiary,
15 United New Jersey.

163/ FCC ARMIS Report 43-05, Table V, Column(da), Rows 320, 322, 330, 332 (State Complaints per 1,000,000 Lines). The numbers for United NJ, Business and Residential, are 709 in 2000, and 106 in 2004.

164/ Industry Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission, Quality of Service of Incumbent Local Exchange Carriers (November 2005), pages 1-2.

1 **Q: What are the consequences of service quality deterioration in United's territory, whether**
2 **measured on a wire center, district, or statewide basis?**
3 A: When asked "[w]hat consequences, if any, ensue if service quality deteriorates," Sprint simply
4 indicated that "United NJ abides by the Board's Service Standards at NJAC 14:10-1.10(a) that
5 states 'When a utility fails to meet any of the minimum service levels listed below in a
6 reporting entity for three consecutive months the service data for the standard not met in that
7 entity shall be reported to the Board.'"[165] This response is troubling for two reasons. First, as
8 I explain above, the minimum service standard levels that presently apply to United are
9 woefully inadequate as is evidenced by actual performance by ILECs. Second, one would
10 expect some type of internal accountability if service quality deteriorates in a particular part
11 of United NJ's serving territory.
12 **Q: Are the existing consequences sufficient?**
13 A: No. If a competitive marketplace existed, regulatory oversight of the quality of United's basic
14 local exchange service would be unnecessary. However, precisely because mass market
15 consumers do not select providers in a "competitive marketplace," regulatory oversight is
16 essential. Where there is sufficient competition, customers can migrate to the provider with
17 the desired level of service quality. However, for the mass market basic customer, such
18 competitive options do not exist in New Jersey at this time. That United may not now for
19 business reasons choose to track its service quality performance at a disaggregated level and

165/ Sprint response to RPA-119.

1 at sufficiently rigorous standards simply underscores that as a dominant provider, it need not
2 be concerned with detailed service quality data. The fact that United does not track service
3 quality data or apparently have a system for internal accountability is evidence that it lacks the
4 economic incentive to track service quality. In the absence of effective competition, the
5 Board's intervention is essential in this regard. Therefore, I urge the Board, as a condition of
6 any approval granted for the proposed spin off, to establish meaningful service quality
7 standards and financial accountability. The "local focus" that Dr. Mayo touts is meaningless
8 absent greater accountability to customers, which have few competitive alternatives.

9 **Q: Do you have specific recommendations regarding financial accountability?**

10 A: Yes. As I discuss below with reference to Illinois, customer-specific accountability could be
11 instituted. In other words, rather than focus on the reporting mechanism, the Board could focus
12 on the customer and create financial accountability if United fails to meet specified standards.
13 The advantage of such an approach is that there would be a financial incentive for providing
14 service quality. The challenge of this approach, however, is that each and every customer of
15 basic local exchange service in New Jersey would need to be fully informed as to the
16 consequences of late installations or delayed maintenance of out-of-service lines. United
17 should commit to incurring financial consequences should service quality decline. The
18 financial consequences would not apply if United achieves those service quality standards
19 deemed appropriate by the Board. Yet, by establishing such financial consequences, a
20 safeguard could prevent a decline in the future. To the extent that competitive pressures

1 discipline a local service provider's service quality, the financial consequences would be
2 irrelevant.

3 **Q: Please describe the Illinois program you reference above.**

4 A: In Illinois, as a result of state-enacted legislation, telecommunications carriers are required to
5 provide customer credits for (1) out-of-service over 24 hours; (2) installation occurring after
6 five days; and (3) missed appointments.[166] The credits are as follows:

7 **Table SMB-3**

8 **Illinois Credits for Out of Service for more than 24 Hours**

9	24-48 hours	A pro-rate portion of the monthly recurring charges
10	48-72 hours	33% of monthly recurring charges
11	72-96 hours	67% of monthly recurring charges
12	96-120 hours	100% of monthly recurring charges
13	> 120 hours	Alternative telephone service or $20/day (customer option)

[166]/ 83 Ill.Adm. Code 732, effective August 1, 2001; Illinois Commerce Commission, Docket No. 98-0252, Illinois Bell Telephone Company Application for review of alternative regulation plan; Docket No. 98-0335, Illinois Bell Telephone Company petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates; Docket No. 00-0764, Citizens Utility Board and the People of the State of Illinois -v- Illinois Bell Telephone Company, Verified Complaint for a Reduction in Illinois Bell Telephone Company's Rates and Other Relief, Order, December 30, 2002 ("Illinois Order"), at 196.

1 **Table SMB-4**

2 **Illinois Credits for Delayed Service Installation**

3 After 5 business days	50% installation charges
4 After 10 business days	100% installation charges
5 Each day thereafter	Alternative telephone service or $20/day (customer option)

6

7 For missed installation and repair appointments, customers receive $50 per missed
8 appointment in the absence of 24 hours notice.

9 **Q: Please explain the relevance of the Illinois legislation to this proceeding.**

10 A: Although not required by legislation to do so, United could voluntarily commit to providing
11 its consumers with credits for failure to meet service quality benchmarks. Assuming that
12 United complies with the benchmarks, the financial consequences would never apply. By
13 agreeing to specific consequences, United could demonstrate its good-faith intention to
14 continue to maintain service quality for consumers.

15 **Q: Have other state regulators established service quality incentives to protect consumers?**

16 A: Yes. The Michigan Public Service Commission adopted new service quality rules for
17 telecommunications on August 1, 2005.[167] Among other requirements, the comprehensive
18 rules require providers to give customers a credit of $25 for a missed repair commitment and

[167]/ *In the matter, on the Commission's own motion, to promulgate rules governing the quality of telecommunications services*, Michigan Public Service Commission Case No. U-14435, *Order Adopting Telecommunications Service Rules*, August 1, 2005.

1 either a 50 percent or 100 percent waiver of installation fees, depending on the tardiness of the
2 installation.[168] Facilities-based providers are required to report to the commission any
3 disruption of service to a "substantial" number of customers (the lesser of 25% or 2,000 of the
4 access lines) in any exchange that lasts for one hour or more. The reporting must occur within
5 90 minutes of becoming aware of the disruption or within 90 minutes of the commencement
6 of the next business day (if after hours).[169] Upon request of the commission or its staff the
7 provider must undertake an analysis to determine the level of compliance with the service
8 quality rules.[170] Providers, must, within ten business days of receiving an oral or written
9 complaint must investigate and respond "fully and promptly."[171]
10
11 Also, the Virginia Corporation Commission also recently adopted new service quality rules for
12 all local exchanges carriers in Virginia.[172] New standards include a repeat trouble report rate
13 of 16% and 3 or fewer outside plant trouble reports within any thirty day period. In-service
14 trouble reports cleared within 72 hours must reach a rate of 90% and in-service trouble reports

[168]/ *Id.*

[169]/ *Id.*, at Exhibit A, page 5.

[170]/ *Id.*

[171]/ *Id.*, at 8.

[172]/ *Establishment of Rules for Service Quality Standards for the Provision of Local Exchange Telecommunications Services*, Virginia Corporation Commission Case No. PUC-2003-00110, *Final Order Approving Rules for Local Exchange Telecommunications Company Service Quality Standards*, September 30, 2005 ("Virginia Service Quality Order").

1 cleared within 96 hours must reach a rate of 95%.[173]

2 **Q: The Joint Petitioners assert that "the separation will have no adverse effect on the quality**
3 **of service customers enjoy, or on the ability of the company to meet all of its obligations.**
4 **Equally important, there will be no change in the high quality customer service**
5 **experience that the company provides."[174] Please comment.**

6 A: First, based on my analysis of the data that Sprint submits to the FCC, which I discuss below
7 and summarize in exhibits to my testimony, I am not persuaded that United NJ provides high
8 quality service, and therefore, it is not evident that the starting point is acceptable. Second, a
9 spin-off of the magnitude that the proposed transaction contemplates should yield a *positive*
10 *benefit*, not simply leave consumers with the same level of service as they now have. The spin
11 off creates risks for consumers that should be offset by clear benefits.

12 **Q: What service quality measures does Sprint report to the FCC?**

13 A: Exhibit SMB-16, which is a reproduction of the Joint Petitioners' responses to RPA-109 and
14 RPA-112, includes the definitions of six service quality measurements that Sprint reports to
15 the FCC. Sprint does not explain why the measures that it includes in response to RPA-106
16 (that is, the measures that Sprint presently measures) do not include all these measures that
17 Sprint submits to the FCC.

173/ *Id.*, at Attachment A.

174/ Hrip Direct (Joint Petitioners), at 9; Sprint response to RPA-120.

1 **Q: Have you analyzed these service quality data?**

2 A: Yes. FCC ARMIS data show that in several areas, Sprint's local service customers have
3 suffered a deterioration in service quality over the past decade.

4 **Q: Can you provide specific examples of this deterioration in service quality?**

5 A: One example is the metric "Out of Service Repair Intervals in Hours." The repair interval for
6 United New Jersey rose from 10.5 hours in 1995 to 22.8 hours in 2004.[175]

7 **Q: What impact does this have on New Jersey consumers?**

8 A: This means that customers who lose telephone service, often through no fault of their own,
9 must wait 22.8 hours, on average, for service to be restored. Every hour that a household must
10 wait for repair work to be completed is another hour that it is unable to call 911. Every hour
11 that a business is unable to utilize normal telephone service is another hour that productive
12 economic activity is impaired.

13 **Q: Can you provide other examples of service deterioration over the past decade?**

14 A: Yes. The "Repeat Out-of-Service Trouble Reports as a Percentage of Initial Out-of-Service
15 Reports" metric shows that United New Jersey has become less efficient at performing repairs.
16 As Exhibit SMB-17 shows, for United New Jersey this metric rises from 8.6% in 1995 to
17 20.4% in 2004.[176] The metric "Percent Local Installation Commitments Met" also suggests
18 declining service quality. In 1997 United New Jersey met 99.62% of its local installation

[175]/ FCC, ARMIS Report 43-05, Table II, Column (af), Rows 144, 145, 148, and 149.

[176]/ FCC, ARMIS Report 43-05, Table II, Column (af), Rows 144, 148.

1 commitments. In 2004, the percentage fell to 96.98%. As Exhibit SMB-18 shows, in contrast,
2 Verizon New Jersey met 99.27% of its local installation commitments in 2004.[177]

3 **Q: What is the impact on United's New Jersey customers?**

4 A: The rise in repeat trouble reports means that United New Jersey technicians increasingly
5 require multiple attempts to fix problems reported by customers. The declining percentage of
6 installation commitments met means that customers who are told that their telephone service
7 will be installed properly by a certain date are increasingly disappointed. Continuing and
8 projected reductions in spending on customer operations and in capital expenditures will only
9 serve to hasten the service quality deterioration noted above.

10 **Q: Has Sprint provided materials explaining the cause of declining metrics with respect to**
11 **service quality?**

12 A: The Ratepayer Advocate (in RPA-111) asked Sprint to explain why the percentage of repeat
13 troubles for households doubled over the past decade. The Joint Petitioners have not yet
14 responded to this data request. I urge the Board to seek a complete explanation of the cause
15 for the declining service quality in United NJ's service territory and also United NJ's proposed
16 remedies (including specific milestones and time frames).

177/ FCC, ARMIS Report 43-05, Table II, Column (af), Row 132.

1 **Q: Ms. Baldwin, this proceeding simply concerns a change in control and would not affect**
2 **the Board's oversight of the LTD. Why should the Board address service quality in this**
3 **proceeding?**

4 A: An investigation of United NJ's service quality is timely and appropriate for several reasons:

5 • Clearly an analysis of United NJ's service quality is long overdue as is evidenced by
6 its inferior (and declining) performance and inexplicably lax standards.

7 • Consumers should be better off after the transaction, based on the statutory criteria.
8 Clearly, acceptable service quality is one of the relevant factors for assessing whether
9 LTD offers "safe and adequate service."

10 • Sprint Nextel is eager to obtain requisite regulatory approvals to complete this major
11 transaction, and, therefore, at this time, is most likely to be responsive to Board
12 leadership on important policy objectives. Once LTD has been spun off, LTD's
13 incentives for increasing its service quality will diminish.

14 • Postponing the investigation of United NJ's service quality harms those customers with
15 the least recourse, particularly mass market consumers who cannot afford broadband
16 and the potential for competitive alternatives that broadband could offer.

1 **The Board should investigate the reasons for declining subscribership in New Jersey.**

2 **Q: Do you have any other concerns about LTD's provision of safe and adequate service**
3 **offered at just and reasonable rates to New Jersey consumers?**

4 A: Yes. In August 2005, the National Association of State Utility Consumer Advocates
5 ("NASUCA") sent a letter to FCC Chairman, Kevin J. Martin, seeking the commencement of
6 an inquiry "into the source (methodological and/or actual) of the decline in reported telephone
7 subscribership."[178] According to a FCC report issued in May 2005, nationwide telephone
8 subscribership had declined over the past two years from a high of 95.5% in March of 2003
9 to 92.4% in March of 2005.[179] This decline could not be be attributed to consumers "cutting
10 the cord" and opting to use wireless phones instead; the FCC study counts such households as
11 telephone subscribers.[180] NASUCA observed that this decline comes at a time when the
12 federal universal service fund "has reached its highest levels ever."[181] Exhibit SMB-19 shows
13 the trend of declining subscribership, and incorporates the FCC's most recent data.[182]

178/ National Association of State Utility Consumer Advocates, letter to Honorable Kevin J. Martin, Chairman, Federal Communications Commission, August 11, 2005 ("NASUCA Subscribership Letter"), at 2.

179/ Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Telephone Subscribership in the United States*, data through March 2005, released May 2005 ("FCC Subscribership Report"), at Table 1.The FCC report indicated that the percentage of households with a telephone in New Jersey fell from a high of 96.6% in July of 2003 to 93.9% in March of 2005.

180/ *Id.*, at 2.

181/ NASUCA Subscribership Letter, at 2.

182/ Telephone Subscribership in the United States (Data through July 2005), Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, Released November 2005, Table 3.

1 The Board should be even more concerned about affordability issues and access as it reviews
2 the proposed spin off. The Ratepayer Advocate concurs with NASUCA that the "apparent lack
3 of access of an increasing number of Americans to basic telephone services cannot be
4 overlooked as the nation moves to a broadband-based telecommunication system."[183]

5 **Q: What is the significance of subscribership to this proceeding?**

6 A: I urge the Board to use this proceeding as an opportunity to set the course to improve access
7 by all consumers to adequate telecommunications services at reasonable rates, and to ensure
8 that some consumers are not left behind. Among other things, Commissioner Copps recently
9 stated the following, in the context of approving Verizon's acquisition of MCI:

> 10 Looking beyond the transaction before us, it is obvious that the whole
> 11 telecommunications landscape continues to change dramatically. But despite
> 12 all of the advances in technology and efficiency over the last decade, local
> 13 phone rates have failed to decline. Household phone penetration is at the lowest
> 14 rate in 17 years. Surely being 16th in the world in broadband penetration is
> 15 nothing to crow to about. And, yes, we still have enormous digital gaps from
> 16 the inner city to the rural village, and there is a real threat that current policies
> 17 may widen rather than close those gaps. So there are already ample warning
> 18 signs something is not right. And it is long past time for the Commission to pay
> 19 heed.[184]

20

21 **Q: Does the FCC data show penetration levels separately by carrier?**

22 A: No. Subscribership data is not available separately, by carrier, and therefore, the Board should
23 require United to provide detailed information regarding subscribership in its territory, and
24 about Lifeline participation. The Ratepayer Advocate sought information regarding lifeline

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183/ NASUCA Subscribership Letter, at 2.

184/ *Verizon/MCI Merger Order*, Statement of Commissioner Michael J. Copps, concurring, at 145.

1 participation. However, in response to RPA-143, United NJ contends that it is unable to
2 determine the number of its customers that are eligible for the Lifeline program. As of
3 December 31, 2004, there were 960 United NJ customers participating in the Lifeline
4 program.[185]

5 **Q: Is there sufficient information to determine whether United NJ's outreach and education**
6 **efforts suffice for Lifeline?**

7 A: No. Without information about the quantity of eligible customers, the Board cannot determine
8 whether outreach and education efforts are sufficient. The Board has addressed Lifeline
9 participation as it relates to Verizon NJ, and should undertake similar efforts regarding United
10 NJ.

11 **Q: Please describe your understanding of the Board's directives regarding Verizon NJ's**
12 **efforts to increase subscribership in the Lifeline Program.**

13 A: In its "PAR-2" order, the Board stated:

14 However, as noted by the Advocate, at present there are less than 50,000
15 subscribers in this program, while the record indicates that 400,000 to 500,000
16 may be eligible. Therefore, we shall enhance the affordability of residential
17 basic exchange service by ordering improvements to the New Jersey Lifeline
18 program in the area of eligibility. While VNJ has proposed improvements to
19 Lifeline, we FIND that the Company's proposal must be modified in order to
20 satisfy the requirements of N.J.S.A: 48:2-21.18(a)(1). We DIRECT that these
21 modifications shall become effective as of March 1, 2003.
22
23 ...
24

---

[185]/ Sprint response to RPA-143.

1 The Board is keenly aware of New Jersey's low Lifeline participation rate. Less
2 than 50,000 subscribers is an unacceptably low rate for a program that is
3 intended to promote affordable telephone service for our neediest citizens, and
4 that has been in existence since December 1, 1997.[186]
5
6 The Board modified VNJ's proposed improvement to New Jersey's Lifeline program and
7 directed VNJ to make such modifications by March 1, 2003.[187] These modifications included
8 an expansion of eligibility; raising the level of Lifeline assistance "making New Jersey a 'full
9 assistance' state"; and the implementation of an automatic enrollment procedure.[188]

10 **Q: Didn't the Board more recently address Lifeline participation?**

11 A: Yes. In 2005, in its order issued in Docket No. TT04060442 (the investigation of Verizon NJ's
12 "revenue-neutral" tariff filing), the Board stated:

13 Nevertheless, the Board is aware of the need to ensure that all possible eligible
14 customers are enrolled in the Lifeline program. To that purpose, the Board
15 directs that the communications Lifeline working group, which includes BPU
16 Staff, VNJ, representatives from relevant State agencies and MRP, should meet
17 to develop solutions to the concerns about Lifeline enrollment raised by MRP
18 in this proceeding. The working group will address these issues as
19 expeditiously as possible, and shall report their proposed resolutions to the
20 Board by no later than April 29, 2005. The Board will take action on these
21 proposed resolutions as soon as possible, and expects to have them
22 implemented by late Spring, 2005.[189]

186/ *PAR-2 Order*, at 29, 31.

187/ *Id.*, at 29.

188/ *Id.*, at 30-31.

189/ Docket No. TT04060442 In the Matter of Verizon New Jersey Inc. For a revision of Tariff B.P.U. - No. 2 providing for a revenue neutral rate restructure, *Decision and Order*, March 24, 2005, at 17.

1 **Q: Are you aware of any similar efforts to increase Lifeline participation among United NJ's**
2 **customers?**
3 A: No.
4 **Q: Please summarize your recommendation regarding the Lifeline program in United NJ's**
5 **territory.**
6 A: The Board should ensure that United NJ is making a good faith effort to increase participation
7 in the Lifeline program.

8 **The Joint Petitioners should commit to deploying infrastructure to ensure that mass market**
9 **consumers are not left behind.**

10 **Q: Are you familiar with any studies regarding broadband access to the Internet as it relates**
11 **to household income?**
12 A: Yes. The US Department of Commerce's National Telecommunications and Information
13 Administration ("NTIA") included the following data in a 2004 report, based on a survey
14 conducted in October 2003:[190]

[190]/ "A Nation Online: Entering the Broadband Age," US Department of Commerce, Economics and Statistics Administration, National Telecommunications and Information Administration, September 2004, Appendix Table 1. http://www.ntia.doc.gov/reports/anol/NationOnlineBroadband04.doc

1 **Table SMB-5**
2

Percentage of U.S. Individuals Age Three and Older Living in a Broadband Household, by Family Income (as of October 2003)	
Family Income	Percentage Living in Broadband Household
Less than $15,000	7.5%
$15,000 - $24,000	9.3%
$25,000 - $34,999	13.4%
$35,000 - $49,999	19.0%
$50,000 - $74,999	27.9%
$75,000 and above	45.4%
$75,000 - $99,999	36.8%
$100,000 - $149,999	49.3%
$150,000 and above	57.7%
Source: US Dept. of Commerce, Economics and Statistics Administration, National Telecommunications and Information Administration, *A Nation Online: Entering the Broadband Age*, September 2004, Appendix Table 1.	

21
22 **Q: Did the NTIA also analyze the percentage of "non-Internet-using" households by**
23 **income?**

24 A: Yes. Table SMB-6 summarizes this information.

1 **Table SMB-6**
2

Percentage of U.S. Individuals Reported as Non-Internet Users, by Family Income (as of October 2003)	
Family Income	Percentage of Non-Internet Users
Less than $15,000	68.8%
$15,000 - $24,000	62.0%
$25,000 - $34,999	51.1%
$35,000 - $49,999	37.9%
$50,000 - $74,999	28.2%
$75,000 and above	17.1%
$75,000 - $99,999	20.2%
$100,000 - $149,999	14.9%
$150,000 and above	13.9%
Source: US Dept. of Commerce, Economics and Statistics Administration, National Telecommunications and Information Administration, *A Nation Online: Entering the Broadband Age*, September 2004, Appendix Table 2.	

21
22 **Q: Did the NTIA report include any analysis of the mode of access to the Internet by**
23 **household income?**

24 A: Yes. As the following excerpt from the NTIA report clearly demonstrates, among Internet
25 households, the use of dial-up access is relatively more prevalent among relatively lower
26 income households and the use of broadband access increases as household income increases.
27 Among other implications, the much-touted intermodal alternative of VoIP, which depends on
28 broadband access, is less likely to provide an economic substitute for low-income households.

1
2 **Table SMB-7**[191]
3

4

Internet Connection Types for U.S. Households (as of October 2003)							
Family Income	Total Internet Households (000s)	Dial-Up Telephone		Cable Modem		Digital Subscriber Line (DSL)	
		No.	%	No.	%	No.	%
	61,481	38,593	62.8%	12,638	20.6%	9,335	15.2%
Less than $15,000	3,681	2,555	69.4%	584	15.9%	477	13.0%
$15,000 - $24,000	3,839	2,786	72.6%	600	15.6%	418	10.9%
$25,000 - $34,999	5,855	4,137	70.7%	921	15.7%	694	11.9%
$35,000 - $49,999	8,867	6,213	70.1%	1,391	15.5%	1,138	12.8%
$50,000 - $74,999	12,429	7,918	63.7%	2,531	20.4%	1,814	14.6%
$75,000 - $99,999	7,774	4,440	57.1%	1,919	24.7%	1,321	17.0%
$100,000 - $149,999	5,811	2,726	46.9%	1,771	30.5%	1,207	20.8%
$150,000 and above	3,753	1,482	39.5%	1,242	33.1%	961	25.6%
Source: US Dept. of Commerce, Economics and Statistics Administration, National Telecommunications and Information Administration, *A Nation Online: Entering the Broadband Age*, September 2004, Appendix Table 4.							

18
19 **Q: What is the income distribution for New Jersey's households?**

20 A: Forty-five percent of New Jersey households have incomes below $50,000.[192] The survey
21 reported by the NTIA demonstrates clearly that as income declines, the probability of Internet

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[191]/ The NTIA report also includes data for the following categories: mobile/phone/PDA/pager, satellite, fixed wireless and other. For each of these categories, the percentages shown are less than one percent.

[192]/ U.S. Bureau of Census.

1 access declines, and, in those instances where households do have Internet access, as income
2 declines, the probability of broadband rather than dial-up access also declines.

3 **Q: What is the significance of these factors to this proceeding?**

4 A: The Joint Petitioners have an opportunity, as an integral component of their multi-billion dollar
5 transaction, to commit to *tangible, explicit* benefits for those consumers who might otherwise
6 be left behind. United NJ and other ILECs are clear winners from the FCC's recent ruling,[193]
7 which eliminated mandated sharing for wireline broadband Internet access. In this proceeding,
8 United NJ could help to "speed the deployment of affordable broadband services to all
9 Americans" and to "preserve our ability to support the deployment of these services for
10 consumers that the market may leave behind."[194]

11 **Q: How, specifically, do you recommend that United NJ assist in achieving this objective of**
12 **not leaving any consumers on the other side of the "digital divide"?**

13 A: United NJ should offer broadband access at POTS prices.

14

15 **The LTD divestiture will jeopardize the reasonableness of New Jersey consumers' rates.**

16 **Q: Has the Ratepayer Advocate engaged any other consultants to assist in examining the**
17 **impact of the LTD divestiture on New Jersey ratepayers?**

18 A: Yes. The Ratepayer Advocate has engaged Snavely King Majoros O'Connor & Lee, Inc.

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[193]/ "FCC Eliminates Mandated Sharing Requirement on Incumbents' Wireline Broadband Internet Access Services: Decision Places Telephone and Cable Companies on Equal Footing," FCC Press Release, August 5, 2005.

[194]/ *Id.,* Separate Statement of Commissioner Jonathan S. Adelstein, concurring.

1 ("Snavely King"). I discuss my understanding of their preliminary concerns in this section of
2 my testimony.

3 **Q: Will the spin off of LTD Holding Company adversely affect the rates of United NJ**
4 **ratepayers?**

5 A. It is very likely that the divestiture of LTD Holdings from Sprint Nextel will adversely affect
6 the rates paid by United NJ ratepayers, although one cannot predict the extent of this effect,
7 because Sprint has provided insufficient information.

8

9 LTD's filing lacks any meaningful demonstration of the effect of the divestiture accounting
10 entry - the debits and the credits. This is the most fundamental entry of all, and it is impossible
11 to hypothesize its impact. By contrast, for its divestiture, AT&T filed a thick book titled *Plan*
12 *of Reorganization* that described, in detail, the accounting entries to be booked in that
13 divestiture.

14

15 Sprint has filed nothing of the kind. Mr. Gast submitted a United New Jersey income
16 statement (MAG-1), balance sheet (MAG-2), and cash flow statement (MAG-3) all as of
17 December 31, 2004. Even if these were acceptable, they are not timely, but rather stale in
18 relationship to the anticipated date of the actual divestiture. Mr. Gast should have provided
19 some projections for United New Jersey. Sprint Nextel was able to provide LTD projections
20 through 2007 to Mr. Collins (see Collins Direct, pages 2 - 3); Sprint Nextel should have

1 provided similar projected data for United New Jersey to the Board.

2 **Q: Does the filing show the impact of the divestiture on United NJ?**

3 A: No. All of Mr. Gast's financial statements assume the divestiture occurred as of January 1, 4 2004. In other words, there is no United New Jersey balance sheet showing the effect of the 5 divestiture entry on United New Jersey. Furthermore, the United New Jersey financial 6 statements are all on an unseparated total company ARMIS basis. At a minimum, the Board 7 should be able to examine equivalent financial statements on a GAAP basis. There are 8 significant differences between GAAP and ARMIS financial statements that are relevant in this 9 proceeding. For example, Sprint's 2003 Form 10K states:

> 10 Adoption of SFAS No. 143 affected the cost of removal historically recorded 11 by the FON groups. Consistent with regulatory requirements and industry 12 practice, the local division historically accrued costs of removal in its 13 depreciation reserves. These costs of removal do not meet the SFAS NO. 143 14 definition of an ARO liability. Upon adoption of SFAS NO. 143, the FON 15 Group recorded a reduction in its historical depreciation reserves of 16 approximately $420 million to remove the accumulated excess cost of removal, 17 resulting in a cumulative effect of change in accounting principle credit of $258 18 million net of tax, in the Consolidated Statements of Operations. The impact 19 of this accounting change on income (loss) from continuing operations a 20 decrease to the FON Group's 2003 depreciation expense of approximately $40 21 million and an increase to 2003 expenses incurred for removal costs of 22 approximately $20 million recognized as incurred over the year. [195]

23 Thus, Sprint's FON Group took into its own corporate income $420 million of depreciation 24 it had previously charged to ratepayers, and then reduced its GAAP depreciation rates. This 25 accounting treatment is not explained in the Joint Petitioners' filing and its impact cannot be

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[195]/ Sprint 2003 10K, p. F-30 emphasis added.

1 determined without United New Jersey financial statements on both a GAAP and ARMIS
2 basis, for a relevant period. Based on the information available now, it is virtually impossible
3 to conduct a reasonable analysis and evaluation of the basic accounting entries associated with
4 this divestiture.

5 **Q: Are there other significant items of concern that a proper analysis and evaluation of**
6 **more relevant, specific divestiture accounting entries and numbers may highlight?**

7 A. Yes. A proper analysis and evaluation of the specific accounting entries and more relevant
8 numbers should highlight any instances in which Sprint or LTD may be attempting to take
9 other sources of ratepayers-provided funds into their corporate capital accounts. For example,
10 the Joint Petitioners have not provided any detail concerning the asset transfers relating to the
11 divestiture. Attachment B is a 1983 article by Michael J. Majoros, Jr. relating to the AT&T
12 divestiture. The article explains how AT&T's Plan of Reorganization, discussed above,
13 resulted in telephone companies taking ratepayer-provided deferred taxes into their equity
14 accounts as a component of the "midnight" divestiture entries. The Joint Petitioners have not
15 explained how Sprint Nextel will treat these transfers and have not provided any sense of the
16 amount of money involved. Apparently, Sprint Nextel seeks approval in advance and then will
17 make the entry. Instead, the Board should attempt to get United NJ's books right before
18 approving the divestiture. Another example of ratepayers-provided funds is the excessive
19 depreciation discussed above. Furthermore, over-funded pension plans are ratepayer-provided
20 funds. There may be other ratepayer-provided funds on United New Jersey's books, but they

1 are not identifiable with presently available information. Of greatest concern is the fact that
2 Sprint Nextel's intentions regarding those ratepayer-provided funds are unknown.

3 **Q. Why is likely that the divestiture will have an adverse effect of the rates of United New**
4 **Jersey?**

5 A. The principal effect has to do with the processes of the rate base/rate-of-return form of
6 regulation that now governs the setting of United NJ's rates. The capitalization aspects of this
7 transaction anticipate the conversion of all LTD (hence) United NJ equity into debt with a
8 repayment schedule. Current regulatory accounting principles generally provide a regulated
9 utility with the opportunity to receive a return on and return of its invested capital.
10 Depreciation is said to provide the return of capital, but realistically, there is no specific
11 requirement to provide utility investors a regular check for a return of their capital investment.
12

13 A complete conversion of equity into debt, however, creates a specific obligation for equity
14 repayment. Thus, debt service effectively becomes a component of the revenue requirement.
15 Unlike common equity, there is a requirement to make debt payments. In a period of
16 potentially declining revenues, the substitution of debt for equity will accelerate unnecessarily
17 upward pressure on rates. Indeed, the issuance of debt appears to serve no purpose other than
18 to strengthen Sprint Nextel's post-divestiture financial position by dramatically weakening the
19 financial positions of the local companies.

1 **Q: Mr. Collins states on page 7 of his testimony that the book value of equity capital has**
2 **little relevance in determining the capital structure and leverage risk of most operating**
3 **companies. Please comment.**
4 A: This statement does not apply to companies subject to rate base/rate-of-return regulation, such
5 as United NJ. For those companies, book value is of critical importance because regulation
6 makes it so. The earnings of such companies are determined by applying an allowed rate of
7 return to a rate base that is composed of the book value of the assets devoted to public utility
8 service. Conventionally, the rate base is the net book value of the plant in service, plus
9 allowances for working capital and less the accumulated deferred taxes. While this rate base
10 is drawn from the asset side of the balance sheet, it is necessarily matched on the liabilities
11 side. If the debt portion of the company's capital structure equals or exceeds the rate base, then
12 any allowed return on that rate base, no matter how generous, will flow principally to debt
13 service, leaving little in the way of earnings to the company's equity investors. In the case of
14 LTD Holdings, the forecast debt will exceed the entire book value of the company's assets.
15 (See Gast Exhibit No. MAG-5.) If regulation allows a return only on those assets at their book
16 value, then there will be little, if any, earnings left for the equity investors.
17 **Q: What is the possible effect on LTD Holdings?**
18 A: The extent of this regulatory effect of on LTD Holdings depends upon the portion of LTD's
19 operations that is subject to rate base/rate-of-return regulation. If most of LTD's operations
20 are regulated in this manner, then Houlihan Lokey's valuation of LTD's equity at multiples of

1 its book value is overstated. Consequently, it would be wrong to include any of the debt
2 service created by the overstated valuation in United of New Jersey's service rates. Otherwise,
3 ratepayers must be recognized and compensated in the distribution of the premium created by
4 the HL valuation, and further compensated for the additional risk manifested in the form of the
5 debt service they will be required to absorb, and any future revenues such as wireless that were
6 essentially subsidized by regulated operations as those markets developed.
7
8 Regardless of whether the extent of this problem pervades LTD's operations, there is little
9 question that United NJ will be regarded within LTD as a poor performer as long as it is
10 subject to rate base/rate-of-return regulation. This reputation can have only adverse effects on
11 United NJ's ratepayers. First, it will motivate LTD to reduce investment in United NJ, with
12 the consequent slow development of advanced services. Second, it will encourage LTD to cut
13 United NJ's expenses to the bone, resulting in a further decline in United's already poor service
14 performance. Finally, it will stimulate upward pressure on rates.
15 **Q: What might be the consequences of the upward pressure?**
16 A: Two courses of action suggest themselves. First, LTD will likely attempt to escape rate
17 base/rate-of-return regulation through regulatory or legislative action, possibly based on an
18 argument that inter-modal competition is now sufficient to control prices. If successful, this
19 strategy likely will result in inverse-elasticity pricing, wherein rates are reduced to customers
20 who actually have viable communications alternatives, but those reductions are more than

1 offset by rate increases to the most captive customers, principally the mass market subscribers
2 who do not have access to competitive alternatives for voice communications.
3
4 The second course of action may be to initiate a rate case - or a series of rate cases. In this
5 instance, LTD can be expected to employ every device available to inflate its revenue claim.
6 Among these devices may be the following:

7 • The retention by Sprint of the accumulated deferred taxes that United NJ's ratepayers
8 have paid in their rates but which Sprint has not paid to the IRS;
9 • The use of United NJ's capital structure with its 35%/75% debt/equity ratio;[196]
10 • The inclusion of extensive unregulated and unaudited service charges from LTD
11 Management Service Co.;
12 • Inflated depreciation rates based on short service lives and exaggerated removal cost
13 allowances;
14 • Possible revaluation of plant based on replacement value;
15 • Allocation of parent company debt service costs to United NJ.

16 **Q: Ms. Baldwin, does this complete your summary of your understanding of Snavely King's**
17 **concerns about the proposed divestiture of LTD?**

18 A: Yes. It is also my understanding that the analysis is necessarily preliminary, because there is
19 not yet sufficient information to assess the impact of the proposed spin-off on United NJ's

[196]/ Debt $57.9 million/Equity $105.6 million from Exhibit No. MAG-2

1 accounts.

2 **Q: Do you concur with these concerns raised by Snavely King?**

3 A: Yes. As I discuss throughout this testimony, the Joint Petitioners' proposed divestiture would
4 expose New Jersey consumers to risk without any offsetting benefit. The Joint Petitioners have
5 not provided adequate information to the Board to enable the Board to ensure that the spun off
6 company will be sufficiently financially viable. Based on the information provided thus far,
7 the proposed transaction would unnecessarily threaten the affordability of rates and the quality
8 of service for more than 200,000 customers in New Jersey.

9

1 **IV. SPRINT PAYPHONE**
2
3 **The Joint Petitioners have failed to demonstrate that Sprint's payphone operations comply with**
4 **the requirements of the Telecommunications Act of 1996.**
5
6 **Q: Did the Joint Petitioners submit any testimony and/or cost studies regarding Sprint**
7 **Payphone?**
8 A: No.
9 **Q: Have the Joint Petitioners submitted any information demonstrating their compliance**
10 **with Section 276 of the Act?**[197]
11 A: No. Section 276 of the Act, as implemented by the FCC in various payphone orders, requires
12 that all subsidies be removed from Sprint/United NJ ("Sprint Payphone") effective April 1997,
13 as evidenced in tariff filings required by the FCC.[198] Sprint Payphone has failed to provide a
14 fully distributed cost analysis based upon current revenues and expenses for each year
15 commencing in 1997 to show that all revenues exceed all expenses, as required by Section 276
16 of the Act. Because the Joint Petitioners have failed to provide this analysis, the Board cannot
17 ascertain whether Sprint Payphone is in compliance with the various FCC payphone orders.
18 Also, the Board should apply the FCC's "new services test" to the payphone service offering

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197/ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("1996 Act"). The 1996 Act amended the Communications Act of 1934. Hereinafter, the Communications Act of 1934, as amended by the 1996 Act, will be referred to as "the Act"; Citations shall be to the Section of the Act, as issued and not the codified citations found in the United States Code.

198/ The Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, codified at 47 U.S.C. §§ 151 et seq.

1 provided to Sprint Payphones and to Customer Owned Customer Operated Telephones
2 ("COCOTs").

3 **Q: Please provide some background on the payphone issues.**

4 A: Beginning in June, 1996, the FCC developed rules and policies to implement Section 276 of
5 the Act. Section 276(a) of the Act directed the FCC to prescribe a set of nonstructural
6 safeguards for Bell Operating Companies' ("BOCs") payphone service to implement the Act's
7 requirements that any BOC: (1) shall not subsidize its payphone service directly or indirectly
8 from its telephone exchange or exchange access service operations; and (2) shall not prefer or
9 discriminate in favor of its payphone service.[199] Under Section 276(b) of the Act, the FCC
10 was charged by Congress to issue regulations that would (1) establish a per call compensation
11 plan to ensure that all payphone providers are fairly compensated for calls; (2) discontinue the
12 intrastate and interstate carrier access charge payphone service elements and eliminate all
13 subsidies from basic exchange and exchange access revenues; and (3) provide a set of
14 nonstructural safeguards -- which at a minimum must include the nonstructural safeguards
15 adopted in the Computer Inquiry-III -- for BOCs to implement the objectives of the Act.[200]
16 The FCC adopted nonstructural safeguards to detect and remove subsidies that existed in
17 BOCs' payphone operations. These rules apply to both BOCs and incumbent local exchange
18 carriers.

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[199]/ 47 U.S.C. § 276(a). The FCC's orders and regulations apply to BOCs but state commissions may apply them to incumbent local exchange carriers as well.

[200]/ 47 U.S.C. § 276(b).

REDACTED VERSION

1 **Q: Please describe the types of payphone lines that BOCs historically offered.**

2 A: Historically, BOCs had offered two types of lines for payphone use: (1) a network controlled
3 Line (NCL) and (2) a Customer Owned Customer Operated Telephone (COCOT) line. BOCs'
4 payphones used NCL lines almost exclusively with payphone sets referred to as "dumb"
5 payphones. A "dumb" payphone is a payphone set with all functions related to operation of
6 the payphone performed at the central office. BOCs did not make NCL lines available to
7 Independent Payphone Service Providers ("IPSP"). BOCs' NCL line service is a bundled
8 service which includes several bundled elements and features such as answer supervision and
9 call screening. BOCs only made COCOT lines available to IPSPs which used "smart"
10 payphones. "Smart" payphones have a computer board in the phone that performs most, if not
11 all, of the central office functions that the NCL line provides to BOCs payphones. BOCs did
12 not file tariffs for NCL lines. But, BOCs offered COCOT lines under filed tariffs known as
13 COCOT tariffs. COCOT tariffs set forth the elements and features that an IPSP may select on
14 an unbundled basis. The FCC adopted various regulations implementing Section 276 of the
15 Act.

16

17 The First Payphone Order and the Payphone Reconsideration Order,[201] required BOCs to

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[201]/ See *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No.. 96-128, Report and Order, 11 FCC Rcd 20541 (1996) ("*First Payphone Order" or* "*First Report*") and *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-128, Order On Reconsideration, 11 FCC Rcd 21233 (1996) (*Payphone Reconsideration Order*).

1 implement nonstructural safeguards to ensure that nondiscriminatory service is available to all
2 payphone operators and to ensure that any payphone operator has the option to use either
3 "dumb" or "smart" phones or any combination of the two. The FCC required that BOCs,
4 including ILECs, either reclassify their payphone assets to a non-regulated payphone account
5 or transfer such assets to an affiliate or a separate operating division. Thus, payphone assets
6 are treated for regulatory purposes as a nonregulated service. Payphone assets includes all
7 facilities related to payphone service with the exception of network services which would
8 continue to be provided by the LEC as regulated services. The FCC's orders require that
9 services provided to payphones by BOCs are regulated services and must be provided under
10 tariffs. In particular, the FCC stated at paragraph 169 of its Reconsideration Order that:"We
11 conclude that the payphone assets to be reclassified or transferred include all facilities related
12 to payphone service, with the exception of loops connecting the payphones to the network, the
13 central office "coin-services," and operator service facilities supporting incumbent LEC
14 payphones."
15
16 Network services include transmission services which include local loop, central office coin
17 services and operator service facilities. These transmission services are part of the network
18 equipment necessary to support basic telephone services. [202]

---

[202]/ See ¶ 159 of the *First Payphone Order* that provides that these three services are part of the network equipment necessary to support basic payphone service.

1 The FCC reiterated in its *Payphone Reconsideration Order* at 162 -- that the FCC requires in
2 accordance with its *First Payphone Order* -- that LECs must provide any network service
3 upon request, when the FCC stated: "In addition, as required by the Report and Order, any
4 basic network services or unbundled features used by a LEC's operations to provide payphone
5 services must be similarly available to independent payphone providers on a
6 nondiscriminatory, tariffed basis."

7 **Q: Please describe the tariff requirements.**

8 A: The FCC requires the filing of Federal and state tariffs for basic payphone services provided
9 by the BOCs to its payphones and to COCOT payphones.[203] These payphone tariffs must be
10 cost based, contain no subsidies, and be nondiscriminatory. Under the *Payphone*
11 *Reconsideration Order,* BOCs were required to file a Comparably Efficient Interconnect (CEI)
12 plan for payphone service and have the plan approved by the FCC. The CEI plan had to
13 describe how the BOC would comply with the FCC's equal access and nonstructural safeguards
14 for the provisions of nondiscriminatory payphone service for NCL and COCOT service. As
15 part of the CEI Plan, the BOC had to certify that (1) it has an effective cost accounting manual
16 ("CAM") filed with the FCC; (2) it has an effective interstate CCL tariff reflecting a reduction
17 for deregulated payphone costs and reflecting additional multiline subscriber line charge
18 ("SLC") revenue; (3) it has effective intrastate tariffs reflecting the removal of charges that
19 recover costs of payphones and *any intrastate subsidies*; (4) it has deregulated and reclassified

[203]/ *See Payphone Reconsideration Order* at ¶¶ 162-167.

1 or transferred the value of payphone customer equipment ("CPE") and related costs as required
2 in the First Payphone Order; (5) it has in effect intrastate tariffs for basic payphone service (for
3 both "dumb" and "smart" payphones); and (6) it has in effect intrastate and interstate tariffs for
4 unbundled functionalities associated with those lines.[204]

5

6 Each BOC submitted a CEI plan and the FCC approved the various CEI plans. As a result,
7 COCOTs can now offer payphone service using either "smart" or "dumb" payphone sets or
8 some combination of the two in a manner similar to Local Exchange Carriers ("LEC"). At the
9 Federal level, the FCC required BOCs to file Federal tariffs for payphone-specific, network
10 based features and functions that they provided separately and on an unbundled basis from the
11 basic payphone line. The BOCs filed the appropriate tariffs. The FCC instructed the BOCs
12 to file additional Federal tariffs if any of the following circumstances occurred: (1) if a BOC
13 chose to unbundle additional payphone-specific features and functions, (2) if states require
14 further unbundling, or (3) if an IPSP requests additional unbundled features and functions
15 through the Open Network Architecture ("ONA") 120-day service request process.

16 **Q: Are there state tariff requirements as well?**

17 A: Yes. In addition to Federal tariffs, the FCC directed that state tariffs be filed for NCL and
18 COCOT payphone service offerings. State tariffs and Federal tariffs had to be cost based,
19 contain no subsidies and be nondiscriminatory. The FCC defined cost based to mean that

[204]/ *See Payphone Reconsideration Order* at ¶¶ 131-132.

1 tariffs must be priced in accordance the "new services test" set forth in 47 C.F.R. § 61.49. The
2 new service test is a cost-based test that establishes the direct cost of providing the new service
3 as a price floor and then a reasonable level of overhead is added to derive the overall price of
4 the new service.[205] If the tariff price of a service exceeds the price floor established under the
5 new service test, the tariff is cost based. After tariffs are filed, the tariffs must be reviewed for
6 compliance with the FCC's other requirements which include that tariffs contain no subsidies,
7 are nondiscriminatory, and comply with Sections 201 and 202 of the Act.[206] The FCC
8 delegated to the State commissions, the obligation to review state tariffs for compliance with
9 Section 276 of the Act and the FCC's implementing regulations.[207]

10 **Q: Please describe the FCC-established accounting safeguards for tariffs.**

11 A: The FCC mandated certain accounting safeguards for all tariffs. In particular, the FCC
12 required BOCs to comply with five safeguards: (1) establishment of effective accounting
13 procedures, in accordance with Commission's Part 32 Uniform Systems of Accounts
14 requirements and affiliate transactions rules, as well as the Commission's Part 64 cost

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[205]/ *See I/M/O Local Exchange Carriers' Payphone Functions and Feature; Bell Atlantic Telephone Companies Revisions to Tariff F.C.C. No. 1; GTE System Telephone Companies Revisions to Tariff F.C.C. No. 1; GTE Telephone Operating Companies Revisions to Tariff F.C.C. No.* 1, FCC 97-392, *Memorandum Opinion and Order* at ¶ 2 (released October 29, 1997) (*Memorandum Opinion and Order*).

[206]/ 47 U.S.C. §§ 201 and 202.

[207]/ *See Payphone Reconsideration Order* at ¶163; see also *Id*. at n. 492 (noting that the "new services test required in the *First Payphone Order* is described at 47 C.F.R. Section 61.49(g)(2)"); *See I/M/O/ Bell Atlantic Telephone Companies' Comparably Efficient Interconnection Plan for the Provision of Basic Payphone Service; Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, DA 97-791, 12 FCC Rcd 4275, at ¶¶ 62-63 (1997).

1 allocation standards; (2) the filing of cost allocation manuals (CAMs) reflecting the accounting
2 rules and cost allocation standards adopted by each BOC; (3) mandatory audits of carrier cost
3 allocations by independent auditors, who must state affirmatively whether the audited carrier's
4 allocations comply with their cost allocation manuals; (4) the establishment of detailed
5 reporting requirements and the development of an automated system to store and analyze the
6 data; and (5) the performance of on-site audits by Commission staff. The FCC's approval of
7 every CEI Plan was conditioned upon each BOCs' compliance with these five safeguards and
8 each BOC's commitment to file changes to its CAM to cover the accounting revisions
9 necessary to reflect the transfer of payphone assets to a non-regulated service.

10 **A Cost Allocation Manual is a tool for identifying subsidies.**

11 **Q: Please describe generally the FCC's rules that govern carriers'' cost allocation.**

12 A: The FCC in 1987 established two complementary sets of rules, one governing how carriers
13 allocate their costs between regulated and non regulated activities, and the other governing
14 transactions between regulated and non regulated lines of business. These rules ensure that
15 regulated services do not improperly subsidize non regulated services. Subsidization can occur
16 in two ways: (1) by pricing services provided by the regulated portion of the business to the
17 non regulated portion of the business below cost, and (2) by pricing services provided by the
18 non regulated portion of the business to the regulated portion of the business at inflated prices.
19 As a result of the FCC's deregulation of payphone assets, the FCC directed the BOCs to revise
20 their CAM filings to reflect the new regulatory treatment of payphones. BOCs' network

1 services would remain regulated services provided under filed tariffs while payphone
2 operations to the public would be a non regulated service. The FCC approved the revised
3 CAM filings in June of 1997.[208] The FCC in the CAM Approval Order, emphasized the
4 appropriate standards for pricing transactions between regulated and non regulated business
5 lines for payphone services when it stated at 7:
6
7 Section 32.27 of the Commission's rules prescribe rules that govern transactions between a
8 carrier and its nonregulated affiliates (footnote omitted). Section 32.27(b) protects ratepayers
9 by requiring that when an unregulated affiliate transfers assets to or performs services for the
10 carrier, those assets or services are not charged to the carrier's regulated operations at an
11 inflated price. Similarly, when the carrier transfers assets to or performs services for an
12 unregulated affiliate, section 32.27(c) ensures that the regulated operations are compensated
13 for the full value of such assets or service (footnote omitted). These rules protect against
14 subsidization of unregulated affiliates by regulated operations, which could be both
15 anticompetitive and detrimental to ratepayers.
16
17 These rules result in the segregation and apportionment of revenue and expenses between the
18 a BOC's payphone operation and a BOC's regulated operation which assists in the

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[208]/ *See I/M/O Local Exchange Carriers Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs*, DA 97-1244, (released June 13, 1997) (*CAM Approval Order*).

1 identification and elimination of subsidies. Under this framework, the purchase of network
2 services from the BOC's regulated operation are expenses to the payphone operation and
3 revenue to the BOC's regulated operation. If all payphone revenues exceed all payphone costs
4 incurred by a BOC in its payphone operation, then the payphone operations is subsidy-free.
5 Similarly, if regulated services are provided above incremental cost, and below stand-alone
6 costs, no subsidy can exist from regulated services.

7 **The FCC directed state commissions to apply federal standards.**

8 **Q: Please describe state PUCs' role, as set forth by the FCC.**

9 A: The FCC directed State commissions to review all payphone tariffs and determine whether
10 tariffs are cost based, contain no subsidies, are nondiscriminatory, and are otherwise consistent
11 with the Act, including the FCC's nonstructural safeguards. The FCC rejected the position that
12 the FCC should review the reasonableness of payphone service tariffs in light of tariffs filed
13 at the state level.[209] The FCC stated clearly that State commissions must apply the FCC
14 requirements to new and previously filed tariffs as part of the review of intrastate payphone
15 tariffs.[210] An independent analysis must be made. One cannot assume that previously
16 approved tariffs comply with the FCC's payphone requirements.

17 **Q: Did the FCC make other directives affecting payphone tariffs?**

18 A: Yes. On the Federal level, the FCC directed the BOCs to eliminate the carrier line common

---

209/ *See Memorandum Opinion and Order* at ¶ 12.

210/ *See Payphone Reconsideration Order* at ¶ 163.

1 charge ("CCL") subsidy. BOCs were directed to reduce their interstate CCL charges by an
2 amount equal to the interstate allocation of payphone costs currently recovered through those
3 charges. In addition, the FCC required that BOCs remove from their regulated intrastate and
4 interstate rate structures all other payphone subsidies.[211] As a result, BOCs and ILECs were
5 required to file revised tariffs no later than January 15, 1997 with the Common Carrier Bureau
6 to reduce their interstate CCL charges by an amount equal to the interstate allocation of
7 payphone costs currently recovered through those charges and file state tariffs no later than
8 April 15, 1997 that reflected the removal from its intrastate basic payphone service rates any
9 charges that recover the costs of payphones. More importantly, the FCC required states to
10 determine the intrastate rate elements that must be removed to eliminate any intrastate
11 subsidies.
12
13 All payphone tariffs whether filed at the FCC or with states are subject to and must be
14 reviewed for compliance with the FCC's requirements. As discussed above, the FCC delegated
15 to the states the authority to review all intrastate payphone tariffs and the FCC required that
16 a state apply these requirements and the Computer III guidelines to the review of tariffs for

[211]/ At the Federal level, VNJ (formerly Bell Atlantic), as a price cap LEC had to use the following method to remove payphone costs from its CCL rates: (1) VNJ had to develop a common line revenue requirement using ARMIS costs for calendar year 1995; (2) VNJ had to develop a payphone cost allocator equal to the payphone costs in Section 69.501(d) divided by total common line costs, based upon 1995 ARMIS data; and (3) VNJ had to reduce its PCI in the common line basket by this payphone cost allocator minus one.

1 intrastate services provided to payphones.[212]

2

3 Section 276(c) of the Act grants the FCC authority to preempt state requirements that conflict
4 with or that are inconsistent with the FCC's Federal standards. Thus, the FCC has the
5 authority to regulate intrastate matters regarding payphones and preclude inconsistent or
6 conflicting regulations by State commissions. The FCC's jurisdiction and authority to regulate
7 payphones, including imposing mandatory Federal standards on the states, was sustained on
8 review by the District of Columbia Court of Appeals. The Supreme Court of the United States
9 declined to grant certiorari from the decision of the District of Columbia Court of Appeals on
10 March 30, 1998.[213] Therefore, State commissions by law must follow the FCC standards in
11 the review of intrastate payphone tariffs.

12 **Q: How are these issues relevant to the Sprint Payphone Proceeding?**

13 A: The Board needs to find that the "new services test" is appropriate to use to review the
14 intrastate tariffs of Sprint Payphone and then after appropriate payphone rates are set, the
15 Board needs to determine whether all subsidies have been removed.

212/ *See Implementation of the Payphone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket 96-128, Order, 12 FCC Rcd. 20997 at ¶ 2 (1997) (*Payphone Clarification Order*); Paragraph 2 provides in pertinent part: "Tariffs for payphone services, including unbundled features and functions filed pursuant to the *Payphone Reclassification Proceeding*, must be cost-based, nondiscriminatory, and consistent with both consistent Section 276 and the *Computer III* tariffing guidelines." The RBOC Coalition in this proceeding argued that the "new services test" did not apply to state tariffing of payphone services. The FCC flatly rejected that argument in ¶¶ 31-32 of the *Payphone Clarification Order*.

213/ *See Illinois Public Telecommunications Association v. The Federal Communications Commission et al*., 117 F.3d 555(D.C. Cir. 1997), *amended* 123 F.3d 693 (D.C. Cir. 1997), *certiorari denied*, March 30, 1998, 1999 US LEXIS 2146, 66 U.S.L.W. 3639.

1 The subsidy portion of the proceedings will involve the following:

2 1) Sprint Payphone has the burden of proof to demonstrate it complies with FCC
3 Federal Standard under Section 276 of the Act.

4 2) FCC Federal Standards and the Board's adoption of the "new services test"
5 require that Sprint payphone tariffs must be cost-based, contain no subsidy, and
6 be non-discriminatory.

7 3) A fully distributed cost analysis is the appropriate methodology for determining
8 whether no subsidies exist.

9 4) Under a fully distributed cost analysis, all payphone revenues must exceed all
10 payphone costs.

11 5) Sprint Payphone may not rely on previously filed and approved State tariffs as
12 a substitute for performing an FDC (fully distributed cost) analysis to determine
13 compliance with the FCC's Federal Standards and that the analysis must
14 demonstrate that the intrastate tariffs are cost-based, contain no subsidies, are
15 non-discriminatory, and are otherwise consistent with the Act, including the
16 FCC's non-structural safeguard standards.

17 6) Sprint Payphone must provide income and expense data for 1997 and for
18 subsequent periods to show that its payphone operations contain no subsidies
19 as of April 5, 1997 and remain subsidy free today.

1 **The new services test also applies to Sprint's Payphone service.**

2 **Q: Has the FCC examined the "new services test" since the inception of the Sprint Payphone**
3 **Proceeding?**

4 A: Yes it has. In response to Wisconsin Commission's belief that it lacked jurisdiction under state
5 law to ensure that the rates, terms, and conditions applicable to providing basic payphone
6 services comply with the requirements of Section 276 of the Act and the FCC's *Payphone*
7 *Orders*,[214] the FCC's Common Carrier Bureau sent a letter to the Wisconsin Commission that
8 required the four largest LECs in Wisconsin to file with the FCC tariffs that set forth the rates,
9 terms, and conditions associated with payphone service, along with the required
10 documentation. In addition it issued an Order[215] that clarified those terms that was applicable
11 to all ILECs. Subsequent to the Bureau Order, the FCC issued its own Memorandum Opinion
12 and Order in response to an application for review from the LEC Coalition that essentially
13 affirmed most of the Bureau Order's findings.[216]

214/ *See Illinois Public Telecommunications Association v. The Federal Communications Commission et al.*, 117 F.3d 555(D.C. Cir. 1997), *amended* 123 F.3d 693 (D.C. Cir. 1997), *certiorari denied*, March 30, 1998, 1999 US LEXIS 2146, 66 U.S.L.W. 3639.

215/ *In the Matter of Wisconsin Public Service Commission: Order Directing Filings,* DA No. 00-347, Order, 15 FCC Rcd 9978 (March 2, 2000) (*Bureau Order*).

216/ *In the Matter of Wisconsin Public Service Commission: Order Directing Filings,* FCC No. 02-25. Memorandum Opinion and Order, 17 FCC Rcd 2051 (January 31, 2002) (*Wisconsin Order*), affirmed *New England Public Communications Council v. FCC*, 334 F.3d 69 (D.C. Cir. 2003).

1 **Q: What position did the FCC adopt on the "new services test" and its application to**
2 **payphone rates in its Wisconsin Order.**

3 A: The FCC affirmed the Bureau's order that the "new services test" requires the use of a
4 consistent methodologies in computing direct costs for related services and that a "total service
5 long run incremental cost" ("TSLRIC") methodology is one of several forward- looking
6 methodologies that can be used.[217] The FCC also opined that overhead loading factors under
7 the "new services test" that are based upon UNE overhead factors are acceptable.[218] The FCC
8 held:

9 In sum, we establish a flexible approach to calculating BOC's overhead
10 allocation for intrastate payphone line rates. States may continue to use UNE
11 loading factors to evaluate BOC's overhead allocation for payphone services,
12 but we do not required that UNE overhead allocations must serve as a ceiling
13 on payphone service overhead loading. To evaluate such a ceiling, states
14 should use the methodology from either the Commission's *Physical*
15 *Collocation Tariff Order* or *ONA Tariff Order*. Consistent with Commission
16 precedent, the BOC's bear the burden of justifying their overhead allocations
17 for payphone services and demonstrating compliance with our standards.[219]
18

19 Lastly, the FCC opined that BOC's payphone line rates should be adjusted to account for
20 subscriber line charge ("SLC") by reducing the monthly per line charge determined under the
21 new services by the amount of the applicable SLC in effect at the time the rates are reviewed.[220]

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[217]/ *Wisconsin Order* at ¶¶ 24, 49-50.

[218]/ *Id.* at ¶ 52.

[219]/ *Id.* at ¶ 58.

[220]/ *Id.* at ¶ ¶ 61, 68.

1 In summary, the directives by the FCC in its Payphone Orders and its Wisconsin Order are that
2 the BOC must show that its line rates reflect its forward-looking economic costs (FLEC),
3 which is also consistent with the pricing approach taken by the FCC in its *Local Competition*
4 *Order*. FLEC is composed of two parts: the direct cost of the service and the share of the
5 forward-looking joint and common costs that the service shares with the provisioning of other
6 services. The FCC found that ILECs are not subject to the "new services test" under Section
7 276, but state commissions could impose such requirements under state law.

8 **Q: Does the FCC specify the exact costing methodology required to implement the "new**
9 **services test"?**

10 A: No. Other than requiring that it be a forward-looking economic cost similar to that set forth
11 in the *Local Competition Order*[221] the FCC is not otherwise definitive about the exact costing
12 methodology the BOC should employ.

13 **Q: What directions does the FCC provide for addressing the problem of overhead costs?**

14 A: The Wisconsin Order[222] paraphrases the statement from the Bureau Order[223] :

15 the LECs must justify the methodology used to determine [payphone service]
16 overhead costs. Absent justification, LECs may not recover a greater share of
17 overheads in rates for the service under review than they recover in rates for
18 comparable services. Given that the new services test is a cost-based test,

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221/ *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996,* CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (August 8, 1996) (Local Competition Order).

222/ *Wisconsin Order,* para. 51.

223/ *Bureau Order,* para. 11.

REDACTED VERSION

1 overhead allocations must be based on costs, and therefore may not be set
2 artificially high in order to subsidize or contribute to other LEC services. For
3 purposes of justifying overhead allocations, UNEs appear to be "comparable
4 services" to payphone line services, because both provide critical network
5 functions to an incumbent LEC's competitors and both are subject to a
6 "cost-based" pricing requirement. Thus, we expect incumbent LECs to explain
7 any overhead allocations for their payphone line services that represent a
8 significant departure from overhead allocations approved for UNE services.

9 Again, the FCC sets a more flexible tone by allowing States to use UNE loading factors for the
10 BOC's overhead allocation for payphone services, but states, "[w]e we do not require that UNE
11 overhead allocations must serve as a ceiling on payphone service overhead loading. To
12 evaluate such a ceiling, states should use the methodology from either the Commission's
13 Physical Collocation Tariff Order or ONA Tariff Order. Consistent with Commission
14 precedent, the BOCs bear the burden of justifying their overhead allocations for payphone
15 services and demonstrating compliance with our standards."[224]

16 **Q: Has Sprint Payphone demonstrated its compliance with the FCC requirements?**

17 A: No it has not. There is nothing on the record, thus far, in this proceeding that would allow any
18 independent analysis of whether or not Sprint Payphone filing has satisfied the "new services
19 test". As required by the FCC directives, any rate revision of payphone line rates must be
20 accompanied by the necessary cost support data and analysis as a first step in determining
21 whether or not the Sprint Payphone has satisfied the "new services test." Sprint Payphone has
22 failed to take that first step.

[224]/ *Wisconsin Order,* at ¶ 58.

1 **The FCC's non-structural safeguards are insufficient to prevent cross-subsidization.**

2 **Q: Are the non-structural safeguards instituted by the FCC sufficient in preventing**
3 **cross-subsidization in payphone operations?**

4 A: No. The non-structural safeguards can be viewed as necessary, but not sufficient in preventing
5 cross-subsidies or ensuring the elimination of all subsidies. Sprint is an upstream provider in
6 a regulated market supplying intermediate inputs (lines and supplementary services) to its
7 competitors in an essentially unregulated, competitive downstream market - payphone calling.
8 The danger of overcharging or engaging in some form of prize freeze is minimized by the new
9 services test discussed above. And to a certain extent the new services test also reduces the
10 ability to engage in cross-subsidization of the unregulated payphone-calling operations since
11 the new services test requires the removal of all subsidies. However, although the FCC has
12 developed a set of accounting rules and policies to non-structural separate the provisioning of
13 lines and associated services from the non-regulated payphone calling service, the two entities
14 are still part of the same overall firm and the only real separation is due to accounting rules and
15 regulations, which are only sufficient if there is an independent analysis of the costs attributed
16 to each of the two distinct entities.

17

18 In addition, the payphone industry exhibits two characteristics that increase its vulnerability

1 to cross-subsidies - high level of common costs[225] and monopoly power (in the supply of
2 payphone lines and associated network services - e.g., the central office coin-service, or
3 operator service facilities). Even the Senate, in its Committee Report, similarly recognizes
4 that BOCs have the "incentive and the potential for all the forms of discrimination,
5 cross-subsidy, and leveraging of bottleneck facilities that both the divestiture and the
6 Commission's regulatory regime for competitive [BOC] offerings are supposed to prevent."[226]

7 **Q: What are the FCC's rules and policies on how to handle the possibility of subsidies**
8 **within payphone operations?**

9 A: As shown above, Section 276 of the Act directed the FCC to proscribe safeguards so that: "…
10 any Bell operating company that provides payphone service - (1) shall not subsidize its
11 payphone service directly or indirectly from its telephone exchange service operations or its
12 exchange access operations."[227]

13

14 Throughout its various orders, including the Wisconsin Order, the FCC has responded to this
15 directive by statements that instruct the BOCs and other payphone-calling providers to remove

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225/ "The vast majority of the costs of providing payphone services are *fixed* costs that are *common* (also referred to as "joint and common") to the provision of all payphone services. These fixed common costs include the capital cost of buying and instaliing a payphone in a particular location and certain monthly recurring costs, such as the cost of leasing the local line and monthly maintenance and overhead costs, also known as sales, general, and administrative (SG&A) costs." *Third Payphone Order,* para. 31.

226/ S. Rep. No. 104-23, at 57-58 (March 30, 1995) (emphasis added).

227/ 47 U.S.C. Section 276(a)(1).

1 subsidies from their payphone operations.

> 2 We also order that subsidies from basic telecommunications services paid to
> 3 some carriers for providing payphone services be terminated as soon as it is
> 4 practicable. We condition the competitive entry of these carriers into the
> 5 nonregulated activity of providing payphone services on their termination of
> 6 these subsidies.[228]

> 7 Because LECs will terminate, pursuant to Section 276(b)(1)(b), subsidies for
> 8 their payphones within one year of the effective date of the rules adopted in this
> 9 proceeding.[229]

10

11 The full details on the removal of subsidies associated with access are given in paragraphs

12 181-183 of the First Report.

13 **Q: Has Sprint Payphone provided the requisite cost support to show that its payphone**

14 **operations contains no subsidies?**

15 A: No. The present filing provides no current data or analysis to determine whether payphone

16 operations are subsidy-free at this time.

17 **Q: Even though Sprint Payphone has not submitted an analysis to show that its payphone**

18 **operations are subsidy-free, is there a consensus cost methodology that would allow one**

19 **to determine if a subsidy exits or not?**

20 A: There is no consensus amongst either accountants or economists as to the correct costing

21 approach needed for determining whether a subsidy is present. The problem derives from the

22 allocation of joint and common costs. There are several theoretical economic approaches that

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[228]/ *First Report,* para. 4.

[229]/ *First Report,* para. 50. For details on implementation, see *First Report,* paras. 181-183.

REDACTED VERSION

1 would be difficult to implement. Section 276 of the Act is explicit that all subsidies must be
2 removed without any qualification limiting the methodology to be used. Therefore, under
3 Section 276, all tests for subsidies must be satisfied in order to comply with the law, as
4 implemented by the FCC. This includes compliance with a fully distributed cost (FDC) subsidy
5 analysis where all income must exceed all expenses. [230]

6 **Q: What has been the cost methodology favored by the FCC in determining cross-subsidies?**

7 A: The FCC has generally favored FDC in testing for subsidies. This was the evidence set forth
8 in the NJ Payphone Proceeding and acknowledged by the ALJ: "(3) A fully distributed cost
9 analysis is the appropriate methodology for determining whether no subsidies exist."

10

11 Sprint Payphone has filed no subsidy analysis with respect the current proceeding to
12 demonstrate compliance with Section 276 of the Act. The Board should require Sprint
13 Payphone to show that the proposed rate satisfies the new services test and that its payphone
14 operation continues to have all subsidies removed.

15 **Q: Please summarize your testimony regarding Sprint's payphone operations.**

16 A: My testimony primarily addresses two issues: (1) the FCC rules and policies regarding the
17 payphone lines and the "new services test", and (2) the FCC's rules and policies regarding
18 subsidies in payphone operations. By not submitting the supportive data or analysis, Sprint

[230]/ One such methodology is Activity Based Costing, which is viewed as a more sophisticated means of implementing FDC, not as a departure from FDC.

1 Payphone has shown that it proposed payphone line rates satisfy Section 276 of the Act in any
2 respect.

3 **Q: Do you have any recommendation to address your concerns?**

4 A: Yes. Sprint Payphone should be directed by the Board to provide testimony that includes the
5 cost support, analyses, and related data to show compliance with the "new services test" and
6 that no subsidy exists at this time. Absent support being filed, the Petition regarding payphone
7 line rates should be rejected. I reserve the right to supplement by Direct Testimony, if and
8 when, Sprint Payphone supplements its filing to comply with Section 276 of the Act.

1 **V. RECOMMENDED CONDITIONS**
2
3 **The Board should impose conditions to mitigate and/or prevent harms to consumers and to**
4 **enhance and/or increase the likelihood of benefits for consumers.**
5
6 **Q: Ms. Baldwin, do you believe the Board should approve the Joint Petition carte blanche?**

7 A: No. First of all, there is insufficient information at this point to assess whether the spun off
8 company would be financially viable, whether consumers are being properly compensated for
9 branding, yellow pages, and the spinning off. Furthermore, until Sprint completes filings for
10 SEC it is premature to expect the Board and the parties to assess the merits of the proposed
11 transaction. If the Board approves the transaction, it should only do so contingent upon
12 explicit conditions that would (1) mitigate and/or prevent harms that the transaction r would
13 likely cause and (2) enhance and/or increase the likelihood of benefits. Furthermore, these
14 conditions should be designed so that:

15 • The Board, competitors, and consumers can readily monitor the Joint Petitioners'
16 compliance.
17
18 • The Board can enforce them (*i.e.*, the financial incentives for compliance are sufficient,
19 and the Joint Petitioners' compliance can be assessed).
20
21 • The conditions do not sunset, but rather only terminate based upon an affirmative
22 finding by the Board that they are no longer necessary. The Joint Petitioners should
23 bear the burden of proving that the conditions are no longer necessary.

24 **Q: Do you have any preliminary recommendations to offset the risks that the proposed**
25 **transaction creates?**

26 A: Yes. As presently structured, the risks to consumers greatly exceed the nebulous benefits.

1 Among other conditions, the Joint Petitioners should commit to the following in order to
2 mitigate the significant risk that the proposed divestiture poses for residential and business
3 consumers in United NJ's territory:

4 • A five-year rate freeze for basic local exchange service
5 • A Yellow Pages credit of $65 million for consumers
6 • A divestiture credit based on the spinning off of LTD, as discussed in detail in my
7 testimony.
8 • Establishment of up-to-date service quality standards and financial incentives for
9 compliance, as well as measurable milestones for remedying declining service quality.
10 • Deployment of stand-alone DSL, available for all consumers[231]
11 • Deployment of fiber in United NJ's territory
12 • Expanded efforts to increase Lifeline participation.
13 • Sprint Nextel should guarantee the debt obligations that LTD assumes and should also
14 guarantee all pension obligations for LTD..
15 • The debt instruments should be modified to remove any requirement that excess
16 earnings must be applied to the debt obligations.

[231]/ In his concurring statement in the FCC's *Verizon MCI Merger Order*, FCC Commissioner Adelstein stated: "By conditioning this merger on the offering of a stand-alone DSL broadband offering, we create an opportunity for the development of competitive Voice Over Internet Protocol (VoIP) and help spur innovative communications technologies. According to consumer advocates, many consumers will want bundled services, but when companies unilaterally mandate that broadband and phone services be purchased together, they diminish the incentive of consumers to purchase VoIP phone service from competing providers or to rely on wireless service as their primary option." He also aptly observed that "[a] stand-alone DSL offering is an important contribution to the marketplace, but I do not pretend that it is a panacea. It will not provide greater choice for those who cannot afford DSL or who do not have DSL available in their area."

1 • Submission of comprehensive testimony demonstrating Sprint Payphone's compliance
2 with FCC directives.

3 Based on my review of outstanding data responses and the recently submitted voluminous
4 responses, I may supplement and/or modify my proposed conditions. I am attaching all
5 discovery responses received to date as a confidential attachment to my testimony. See RPA
6 Attachment (Box 1-5)

1 **VI. CONCLUSION**

2 **Q: Does this conclude your testimony at this time?**

3 A: Yes, at this time. There are numerous outstanding responses to data requests, and, therefore,
4 I reserve my right to supplement my testimony based on my review of these forthcoming
5 documents.