market price. In my view, actual sales to non-affiliates in a competitive marketplace is ample evidence that the same price to affiliates is a prevailing and fair market price. North Supply will lose this non-affiliate business to another supplier if it is not competitive in the marketplace. I believe that the 75 percent "bright line" test is clearly excessive.

16. Because I have worked in this industry for several years, I am familiar with the structure of the supply and distribution affiliates of other large telecommunications companies. To my knowledge, North Supply is the largest and one of two or three LEC affiliated supply and distribution companies that make substantial sales to non-affiliates in the open market. The Commission's concerns that some LECs and their affiliates may abuse the current pricing rules should not cause the Sprint LECs to lose the benefits they derive from the operations of North Supply, the company best suited through its success in the open market to prove that it has prevailing prices.

17. The creation of a system that would provide estimated fair market value ("EFMV") is an expensive effort with little if any value when actual sales to non-affiliates in a competitive marketplace are occurring. Indeed, in the telecommunications equipment and supplies sector, I believe my competitors would provide what I call "entry level pricing" quotes in response to such inquires. As anyone who competes for new customers knows, firms often provide special deals to attract business and to

disrupt current supply arrangements. They, in effect, price below cost to gain entry into the supply channel. This entry level pricing disrupts relationships but does not last. Soon, this price is raised. Under these circumstances, the purchaser may be worse off because the original supplier is no longer able to provide the product at the previous price, either because the first supplier has been forced from business or because, due to lost volumes, it must pay more for the product. Thus, entry level pricing is not a dependable EFMV. However, firms desiring to expand have a great incentive to quote entry level prices to gain entry.

18. North Supply pricing is routinely and thoroughly investigated in reviews sponsored by state and federal regulators. Since 1975, after continuing reviews, the pricing of North Supply to affiliates has always been found to be reasonable and no adjustments have ever been made to the United Telephone accounts on account of purchases from North Supply.

19. I further believe that earnings incentives such as true price caps provide far better and far less expansive controls on potential affiliate pricing abuses than complex, expensive, intrusive, and unneeded estimates of fair market value or the ex-

cessive requirements of 75 percent of sales to outside markets can provide.

Steve L. McMahon

Steve L. McMahon
Executive Vice President - Operations
North Supply Company

STATE OF KANSAS)
)
COUNTY OF JOHNSON)

Subscribed and sworn to before me, a Notary Public, this 8th day of December, 1993.

Iris P. Ash

Notary Public

NOTARY PUBLIC STATE OF KANSAS
IRIS P. ASH
My Appt. Exp. March 1, 1996

My Commission Expires:
March 1, 1996

North Supply
A Sprint Company

EXHIBIT 1 to ATTACHMENT 1

Interoffice Correspondence

DATE: December 15, 1992

TO: Steve McMahon
Jerry Carson

FROM: Bob Thompson

SUBJECT: Price Policy

Effective January 1, 1993, North Supply's Telco division will operate under the following price policy:

> Products and services sold to affiliates are at prices no greater than similar products or services sold to non-affiliate customers under like terms, conditions or volume.

This policy will be monitored on a company-wide basis by the Strategic Pricing Group, currently within the Telco division. The Strategic Pricing Group's function is to manage this policy relative to regulatory compliance and prevailing market conditions. Divisional sales groups are ultimately responsible for specific quoted or contracted pricing decisions. The Strategic Pricing Group performs a consultative role, providing a regulatory and market condition framework within which individual pricing decisions should reside.

The divisional sales teams should anticipate the need to administratively support Strategic Pricing Group practices and procedures in the form of documentation adherence and maintenance. The Strategic Pricing Group is prepared to meet with individual sales groups to review these documentation practices.

clm

Bob Thompson

Attachment

cc: Bill Obermayer
Terry Bryan
Vahid Rezvani
Flem Cheatham
Brad Sumner
Adel Rizk

NORTH SUPPLY COMPANY

General Price Policy

Prices for North Supply products and services are based on prevailing competitive market conditions for similar product/service group sales.

Affiliate Price Policy

Products or services sold to affiliates are at prices no greater than similar products or services sold to non-affiliate customers under like terms, conditions or volume.

These two general statements reflect the pricing policies in operation for North Supply. This narrative is written for the purpose of adding clarity and understanding to these broad general statements. The reader of this document is intended to be a member of North Supply's management team. The reader's experience and knowledge of North Supply is necessary to decipher terminology and to apply the dynamic market conditions against our internal operating procedures.

The reader should know a separate document has been written for the benefit of those external to North Supply whose familiarity with procedures and daily market conditions may not be as thorough. The content of both documents is intended to be the same. A broader level of explanation is thought to be more useful (less interpretive) for the external readers.

The General Price Policy uses the term "prevailing competitive market conditions." What are prevailing competitive market conditions?

Prevailing Competitive Market Conditions

These conditions are the most generally existing terms of sale (including prices) that exist for a specific product or service at a given point in time. The North Supply prices that are considered system prices, i.e., affiliate (A) and non-affiliate (NA) are intended to represent prevailing competitive market conditions for a traditional wholesale distribution sale.

Certainly, there are numerous individual customer conditions and circumstances which do not fall into the traditional wholesale distribution sale category. These are considered to be the minority and are measured in terms of their difference from market conditions on a case by case basis. The fact remains, however, that our system pricing cannot address the numerous exceptions. It must address the vast majority of transactions we execute relative to prevailing market conditions.

To that end, we designed a data program whose objective is to measure the market competitiveness of our system pricing. It is called "Price Baskets" and it is currently being managed by Rick Crawford in the Telco Operations division under the supervision of Bill Byers.

Prior to price baskets, the capture and analysis of market conditions for a given product was very informal. It often relied on a product marketing person's retention level of occasional feedback. And, as you can appreciate, with 30,000+ products this is very difficult. Price baskets allow feedback to be placed against historical data and possibly stimulate adjustments in our system' prices.

It is important to understand that price baskets measure North Supply sales activity. Price baskets do not directly measure our competitors' sales. Price baskets directly confirm or deny that North Supply's system prices are prevailing competitive market prices by analyzing the market distribution of North Supply sales. Lost business can be placed against price baskets to conclude if lost revenue resulted in lost profits to North Supply. Before baskets, this tool was not readily available.

Price Baskets

The FCC has become very sensitive to sales from a deregulated entity to an affiliated regulated entity at prices above market levels. Regulations (86-111) exist prohibiting such activity.

Price baskets were created out of a need for North Supply to know whether we were in compliance with FCC regulation 86-111. Generally, this regulation requires that 20% of our sales of like products or services be to non-affiliated markets at or above affiliated price levels.

To verify that this was occurring, the price basket program was created. There are 305 baskets. One is a drop ship basket. Three hundred and four of the baskets contain inventoried items only. To the best of our ability, each stock basket contains like products--all the screwdrivers are in one basket of screwdrivers. The stock basket components are represented by material codes and related vendor number.

The single drop ship basket measures all drop shipments. The scope of the drop ship transactions and the variables associated with individual drop ship products do not provide for comparability with inventory transactions. The administration of pricing policy by the part numbers or groups of part numbers which comprise the baskets used for inventory transactions likewise does not lend itself to drop ship transactions. Recognizing these limitations, North Supply administers its pricing policy for drop ship transactions as a single service basket.

The price basket reports record the accumulated sales year to date of each basket for Sprint OTC, Sprint LDD and the combined non-affiliate market. If 20% or more of the basket sales were to the combined non-affiliate market at or above affiliated price levels, then the basket and its individual components are considered to be at market level and in compliance with the FCC.

If the basket sales to the combined non-affiliate market is less than 20% or at prices below affiliate sales, then there is analysis of the basket required, documentation and possibly corrective action to create a confirmed market price in compliance with regulatory statute.

Since the basket measures all sales and all sales are not at system prices (A, NA), the basket program has an option to exclude any sales entered into the special price files. Sales which are entered into special price files are, therefore, subtracted from the full (all sale) basket. The result is ideally a price basket which records all the transactions made at the system (loaded) price (A, NA) levels. This is exactly what we want to measure. If system prices (A, NA) are too high the baskets could reflect this in several ways:

1. Less than 20% will be sold into NA markets.

2. A decline in total basket sales may occur.

3. A large number of entries into the special price file.

If system prices are too low, the basket may detect this by:

1. A significant increase in basket sales for no other reason, or

2. A wide spread in non-affiliate margins versus affiliate margins.

3. Few, if any, entries into the special price file.

From a marketing perspective, the baskets can serve as a warning or an organized way of detecting possible change in the market price.

Special Price Files

The importance of a special price file entry by all sales groups cannot be overstated. If special prices are authorized and not entered into a special price file, they will not be subtracted from the basket. This will drive the non-affiliated prices down exerting unwarranted downward pressure on affiliated price levels and North Supply profits. It is absolutely essential that all sales groups properly manage special price file authorization and entry.

When are special prices (non-system prices) justified for a non-affiliated opportunity?

The easiest answer is when North Supply can generate more profit by selling to the non-affiliate and all the affiliates at the special price than we can by selling to the affiliates at the existing system price under the affiliated terms and conditions of sale.

Each division must make their own determinations on a case by case basis. But, as a special price decision is selected, it is a mandatory requirement to clearly document the applicable different terms, different volume which is supporting this lower than system price. It is also mandatory that a special price be entered into the special price file. This entry is a part of the documentation requirement.

Keep in mind that a position could be taken to lower the system price rather than load a special price. This would be applicable in cases where volume is the only different criteria. The non-affiliated opportunity may coincide with a price basket situation which is out-of-balance. In such a case, the non-affiliated opportunity may be a catalyst to prompt a lowering of system price.

In addition to volume, there are three other identifiable different terms or conditions which may qualify for special prices.

1. When freight which is normally absorbed in the price of the product is paid by the customer.

   Since surface freight from the distribution centers is not charged to the affiliated system, a lower affiliated price can be offered to any non-affiliated customers willing to pay freight. The percent difference between the current A price and the special non-affiliated offered price must equate to the freight expense of an anticipated typical shipment. The Traffic department will be required to qualify that expense. Therefore, a projected typical shipment expense as a percent of the affiliated price must be determined for the product(s) offered on a freight paid basis. Proper documentation is required.

2. When a hard contract (take or pay) is negotiated with a non-affiliated customer.

   Affiliates do not guarantee that they will purchase any fixed quantity from NSC. A non-affiliate that commits to x quantity over a y contract period can be offered a better price than the affiliate when:

   A. X quantity is greater than the affiliate's prior annual usage.

   B. The product in question is not an affiliated standardized product.

   Again, a contractual commitment implies there is documentation available to support this non-affiliated customer guarantee.

3. When a vendor has identified a specific non-affiliated opportunity as qualifying for a lower cost of goods than North Supply currently receives from that vendor for the affiliated market.

   In these cases, it is assumed the vendor is willing to pass that lower cost to North Supply. North Supply, in turn, may lower its offered sell price to the non-affiliate by no greater a percentage than it received from the vendor.

   Again, proper documentation is required.

Conclusion

The objective of system pricing, price baskets and special price files is to provide the means to measure market price and to implement pricing in order to achieve our financial objectives. These tools are not intended to restrict sales. They are intended to maximize the profitability of the company in all markets. They must be managed in concert with one another to be effective. If any one of them is analyzed by itself, the dynamics of market price becomes undervalued.

The procedures and practices which support these concepts follow. The management of these procedures and practices belongs to all sales and marketing personnel. Since these are relatively new, they are subject to some modification and evolving improvement. This is encouraged. Submit any concerns or questions to Rick Crawford or Bill Byers.

Attachment 2

An Assessment of the FCC Notice of Proposed Rulemaking on the Affiliate Relationships of Sprint North Supply Company

Gregory Loyd Mann, Ph.D.
Managing Vice President
Greenwich Associates

Introduction

On October 29, 1993 The Federal Communications Commission issued a **Notice of Proposed Rulemaking** for comment by interested parties to Proceeding FCC93-251. Sprint Corporation engaged **Greenwich Associates** to assist its staff in the preparation of a response. One area of general concern expressed by Sprint management was the FCC proposed restriction on the use of Prevailing Company Pricing (PCP) methods to relationships where the non regulated affiliate sells at least 75% of its output to non-Sprint enterprises (hereafter referred to as non affiliate sales). The FCC argues that restriction on the use of Prevailing Company Price is warranted given

- the inconsistent treatment of prevailing company pricing methods by affiliates with each other; and

- the unnecessary burden it presents to both the Commission and the carriers to differentiate and administer

Ostensibly, the FCC proposed restriction offers the agency the means to improve reporting and monitoring of the carriers' relationships with their affiliates. However, it is our professional opinion that further restriction on the use of PCP is unwarranted and unnecessary to the achievement of better reporting and monitoring of affiliate transactions.

Issue

At issue in this proceeding is the use of Prevailing Company Price(PCP) methodologies in determining the price charged to the regulated affiliates of Sprint Corporation by Sprint North Supply Company. The FCC suggests that Prevailing Company Price should be excluded from the list of accepted valuation methods for products/services provided by Sprint North Supply Company to its affiliates because it fails the "arms length" test deemed the most reliable determinant of rational economic behavior. The FCC implies - by its stated preference for "arms length" relationships - that such relationships offer regulators an inherently higher level of confidence in management decisions than that presented by comparable transactions amongst affiliates. Yet with rare exception, the major abuses of public trust in the procurement area have been with non affiliate rather than affiliate entities.

Principal Observations

Upon examination of the affiliate transaction rule changes proffered by the FCC in this **Notice** I have concluded that the proposed set of revisions are universally predicated upon flawed logic, ignorance of fact and unwarranted fear. The latter is extremely difficult to address. The former two are easier . The balance of this paper will be devoted to exploring instances of that flawed logic and ignorance in the hope of improving the products of this proceeding.

In contrast to the conclusions presented by the FCC in its **Notice**, I would submit that -

Sprint North Supply Company competes in both "internal" and "external" markets that are effectively equivalent in their buying mentalities

The Sprint North Supply Company currently supplies the principal material requirements for all of the Sprint Corporation's local exchange company subsidiaries. It does so without a master contractual agreement which binds any subsidiary to purchase any material products offered by Sprint North Supply. Instead, North Supply employs a two-element strategy of 1)price and 2)service to maintain the business and goodwill of its internal customers.

The effectiveness of this strategy has been recently demonstrated with the reassignment - after extensive management evaluation - of Central Telephone Company's material management requirements to North Supply from Alltel Corporation. Sprint's local telecommunications division management cited both lower cost and enhanced service as major considerations in its decision. The decision to reassign fulfillment responsibilities to Sprint North Supply for Central Telephone evidences the existence of certain decision attributes characteristic of a fully competitive market -

- •independent authority for decisions is vested with the customer
- •alternative sources of supply are available
- •negotiable terms/conditions for service are available
- •right of rescission/employment at will by both parties

Collectively, the four market attributes produce an internal negotiating framework that roughly parallels an open market. The relationship prospers or fails upon the mutual satisfaction the parties derive from the business arrangement.

Examination of the business relationship between Sprint local exchange units and Sprint North Supply Company closely parallels the business relationship Sprint North Supply Company maintains with its non affiliate customers. Here again, with only very limited use of contractual agreements (only in extraordinary circumstances) Sprint North Supply Company has chosen to employ price and service as the critical strategy components in acquiring and retaining non affiliate customers. Here again, Sprint maintains an equivalent set of operating guidelines to govern its business relationships -

- •independent authority for decisions is vested with the customer
- •alternative sources of supply are available
- •negotiable terms/conditions for service are available
- •right of rescission/employment at will by both parties

It is our professional opinion that any characterization of the affiliate markets and non affiliate markets of Sprint North Supply as distinctly - and necessarily - different in their construct - and conduct - is a mischaracterization of both the market mechanisms and the individual participants. Furthermore, we have concluded that because participants in each of the respective market segments exhibit a high degree of similarity in their approach to business relationships they will evidence similar behaviors when presented with price and service considerations. Therefore, I see no reason for Sprint to continue to distinguish between these two market segments in regulatory representations nor to endorse any artificial differentiation in the way North Supply is permitted to address its respective markets.

Prevailing Company Price equates to "prevailing competitive price" for both affiliate and non affiliate transaction matters involving Sprint North Supply Company

Sprint North Supply's pricing methodologies effectively provide a price range on its products that closely parallel the range of prices available on the open market. The company methodology groups equivalent products (i.e., potential substitutes), adjusts for volume and administrative costs and sets target prices for all customers -affiliate and non affiliates - in a nondiscriminatory manner. Since 1974 the level of non affiliate sales has continued to grow steadily - in proportion to its affiliate sales - offering conclusive evidence that the price charged by Sprint North Supply is at least within the range of market tolerance. Given the fact that Sprint North Supply has not set its prices with the intent of maximizing its non affiliate market share it is reasonable to conclude that its prices are sufficiently competitive with those available from other sources to be deemed acceptable by the FCC as "prevailing".

The use of a "prevailing competitive price" is the only feasible means of administering transactions conducted by Sprint North Supply Company on behalf of the Sprint Corporation affiliates

Sprint North Supply Company serves as the principal purchasing agent for all of the Sprint Corporation's local exchange company subsidiaries as well as over 12,000 non affiliate entities. In its capacity as a wholesaler to those entities it reviews, evaluates and ultimately acquires tens of thousands of products, replacement components and materials. Sprint North Supply must continuously reevaluate the delivery schedules of its suppliers, stocking levels and demand forecasts to balance the potential economic benefit available to its clients offered by consolidated procurement and its material handling costs for shipping, warehousing and asset accounting.

The use of a uniform prevailing company price for both affiliates and non affiliates provides Sprint North Supply the ability to normalize for periodic management purchasing decisions which may temporarily increase/decrease the unit price of its various supported products. It also provides customers - both affiliate and non affiliate - a degree of price certainty evident within a fully competitive market.

The proposed 75% standard for the use of prevailing company price (PCP) is unreasonable and unachievable in a fully competitive market

The FCC has proposed in this Docket to deny Sprint - and the industry - the option to use Prevailing Company Price methods for charging subsidiaries for purchases from Sprint North Supply unless it can demonstrate that over 75% of Sprint North Supply's sales are to non affiliates. It is unclear from the Notice the evidentiary basis for the recommended 75% level. However, one can only conclude that the FCC has independently determined the proposed standard to be reasonable to achieve.

In fact, the standard appears unreasonable to either attain and/or maintain in the current marketplace. For both Sprint North Supply - and the industry as a whole - the 75% level represents a virtually impenetrable barrier. No affiliated procurement organization that we are familiar with currently satisfies the proposed requirement. Currently, Sprint North Supply Company derives approximately 61% of its revenue from non affiliate sales. This represents the highest attained level of non affiliate sales of any affiliated procurement organization subject to this proceeding. That achievement is the product of an extremely aggressive sales effort on the part of Sprint North Supply conducted over two decades to find additional domestic and international markets for products/services it is currently authorized to offer.

In order for Sprint North Supply to substantially improve its relative performance against the proposed FCC standard, Sprint North Supply must effectively de-emphasize its supplier role to the Sprint affiliates or substantially increase its competitive effectiveness in non affiliate markets. A decision to employ either - or both - of these strategies would offer no substantive benefit to the local exchange carrier units in the future which we believe is a major consideration ignored in the promotion of such a requirement. Any de-emphasis on affiliate procurement could produce inventory shortages, increased order intervals and higher material prices to the local exchange companies.

Increased non affiliate sales could only be achieved at the expense of another supplier and at possibly unattractive terms/conditions. Over the past decade. Sprint North Supply Company has pursued an aggressive - but prudent - strategy which balances internal commitments to affiliate clients with the attractiveness of non affiliate markets. Despite its aggressiveness, that strategy has allowed Sprint North Supply Company to only slightly improve its relative proportion of non affiliate sales in recent years. Sprint North Supply's relatively small increase in non affiliate sales over the past decade reflects the increasing competition from other wholesalers and manufacturers. Based upon current market conditions it is reasonable to conclude that neither Sprint North Supply Company nor any other party to this proceeding can achieve compliance with the proposed FCC requirements without significant realignment of resources and some consequential degradation of its affiliate commitment. That would be an unacceptable tradeoff and represent a willful abrogation of public responsibility on the part of the corporation if it were authorized.

With the likelihood of achieving the 75% standard highly improbable - if not impossible, it can only be concluded that achievement of the standard is not a goal sought by the FCC in its proposal. Instead, the FCC proposes to knowingly establish a standard no one is able or willing to pursue. This is not only unreasonable it constitutes punitive regulation.

The proposed 75% standard for the use of prevailing company price (PCP) is unnecessary in a competitive market

The proposal by the Commission to restrict the use of Prevailing Company Price methodologies in situations where companies can demonstrate that over 75% of those transactions are with non affiliates suggests that affiliate transactions based upon Prevailing Company Price methodologies have an inherent bias that disadvantages regulated affiliates. The imposition of such a standard suggests that such bias can only be mitigated by the elimination of PCP or by the addition of significant levels of non affiliate market demand.

First, the Commission has not introduced in this proceeding sufficient evidence to suggest that such bias does, in fact, exist or if it does exist that the imposition of such a standard will result in any improved cost to the regulated units.

Second, the need to encourage growth in non affiliate demand is unnecessary. Sprint North Supply Company is an independently managed unit of Sprint Corporation responsible for its own financial performance. The company has a significant stake in the non affiliate business market which it must defend against competitive encroachment and satisfy new requirements. With the proposed deployment of new telecommunications networks in the next decade by non-traditional players it is reasonable to conclude that North Supply will be aggressively pursuing the business opportunities they present. Any standard that the Commission may choose to impose in that environment is completely artificial and lacks any correlation to the market performance of either Sprint North Supply Company or any other competitor for that business.

The proposed 75% standard for the use of prevailing company price (PCP) is theoretically unsupportable in a competitive market

The Commission offers no supportable research to conclude that attainment of a 75% non affiliate revenue component is in the public interest. A review of professional literature related to - and academic research conducted on - affiliate transactions fails to offer any theoretical foundation for the establishment of the proposed standard.

Conventional market management theory suggests that any marketing strategy which endeavors to produce a defined mix of revenues (such as that envisioned by the FCC for compliance) can only be achieved by utilizing discriminatory pricing methods to achieve. Given the restrictions on pricing set by the FCC in Docket 86-111 any use of discriminatory pricing to achieve the desired standards proposed in this docket would be a violation of the terms prescribed by that proceeding.

The proposed 75% standard will effectively reduce the buyer influence available by the affiliates over the operations of Sprint North Supply Company

The achievement of full compliance with the FCC test by Sprint North Supply Company will require: a)significant reallocation of existing resources within Sprint North Supply Company, b)increased sales and marketing expenditures, c)increased inventory commitments (both stocking levels and catalog items) and d)systems management enhancements. These changes would constitute a strategic shift in the directional development of Sprint North Supply Company as well as its value to Sprint Corporation which cannot be easily corrected.

Compliance will have the effective result of reducing the buyer influence which can be exercised upon North Supply Company by the regulated subsidiaries of Sprint Corporation. As the collective bargaining power of the affiliates diminishes they will have less ability to preserve the extraordinary service conditions now provided them by Sprint North Supply without supplemental financial consideration.

The proposed 75% standard could jeopardize the service commitment to the Sprint affiliates

The Sprint North Supply Company is responsible for ensuring operating units of Sprint Corporation are adequately supplied with material and services necessary to achieve their respective performance goals. Despite the fact that Sprint North Supply generates more revenue from its non affiliate customers its primary commitment to service has been, is and must continue to be the affiliated business units of Sprint Corporation.

Any failure on the part of Sprint North Supply to effectively satisfy the performance expectations of the Sprint affiliate entities could result in the withdrawal of the affiliates as customers of North Supply. The establishment of a mandated target for non affiliate sales introduces a potential challenge to North Supply's commitments to the Sprint affiliates.

Conclusion

The burden of gaining public acceptance for business relationships between Sprint affiliates and Sprint North Supply Company must be borne by Sprint management. The benefit provided to Sprint affiliates by that association cannot be replaced or replicated by any other institutional relationship - it can only be aggressively defended by management in every public forum offered to it. Any willingness to accept further restrictions upon that relationship will virtually foreclose any opportunity for the Sprint telephone company affiliates to retain competitive parity with new market entrants.

Author:

Mr. Mann is a Managing Vice President of Greenwich Associates - a management consulting firm specializing in telecommunications industry issues. Mr. Mann holds a B.A. from Graceland College, M.A. and Ph.D. from the University of Missouri. He has lectured extensively on issues of affiliate relationships and has authored several articles including **"Affiliate Interests: Strategic Imperative or Regulatory Impediment?"**, **"Directory Publishing: Affiliating for Advantage"** and **"Restoration in the Midst of Revolution: Affiliate Interests and the Information Highway"**. Additionally, Mr. Mann has testified in a number of state regulatory proceedings on issues of organization design and affiliate relationships.

An Assessment of the FCC Notice of Proposed Rulemaking on the Affiliate Relationships of Sprint/United Management Company

Gregory Loyd Mann, Ph.D.
Managing Vice President
Greenwich Associates

Introduction

Affiliate interests remain one of the most widely examined and debated subjects in the telecommunications industry. Public hearings and regulatory inquiries into affiliate matters have been conducted by over two dozen state regulatory agencies, the Federal Communications Commission, the National Association of Regulatory Utility Commissioners, the United States Congress and a number of trade associations during the past ten years. Despite the extraordinary attention given to the subject, public opinion regarding the merit of such relationships has not been altered significantly - nor is it expected to in the near future without substantial improvement in the way such business activities are represented to the public.

The FCC in Docket 93-251 suggests once again that large complex organizations such as Sprint are inherently less efficient than small companies in the delivery of telecommunications services. It implies that affiliate relationships contribute to the creation of unnecessary layers of management expense which are tolerated only because such extraordinary expenses are recoverable from rate payers of the regulated subsidiaries. The FCC recommends a series of changes to the current affiliate transaction rules specifically designed to demonstrate that inefficiency and excessive costs do exist - whether or not they do.

One such rule change is the application of an estimated fair market value test (EFMV) to all transactions involving the performance of services by one affiliate for another. Service transactions principally constitute activities performed by corporate parent organizations on behalf of their subsidiary business units. The affected services generally comprise essential legal, financial, managerial and technical activities that, if performed independently, would engender duplication of effort, additional cost and the increased probability of inconsistent reporting.

While it remains unstated in the Notice it is reasonable to conclude that any service - or set of services - which fail to meet a prescribed "market test" would be prohibited or its use discouraged for the future. This rather summary approach fails to consider the many intrinsic benefits of centralized services not always evidenced in statistical exercises such as EFMV.

We do not mean to imply by our comments that estimates of fair market value are not important measures of relative cost and performance; and where the confidence level of data used in the estimate is high, the use of EFMV methodologies merit consideration. Similarly, where EFMV output can provide management a meaningful foundation for decision making we would endorse its use.

Neither of these situations exist in proposing use of an EFMV test to corporate services. The relative confidence level for market prices is extremely low as evidenced by a number of benchmarking surveys and value studies undertaken in recent years by members of the industry. Decisions to centralize and decentralize services have been in response as much to technological advances, increased business risk, customer expectations and productivity goals as simply to achieve parity with some target cost. Management must continue to baiances efficiency (cost) and effectiveness (customer satisfaction) to ensure its future success. Inordinate emphasis on the use of a single measurement such as EFMV fails to recognize the importance of that balance to the public.

The impact of the FCC proposed change to the United and Central Telephone Companies' operations of Sprint cannot be overemphasized. Sprint/United Management Company (SUMC) serves as the centralized managerial control point of the United and Central [redacted] these affiliates in fulfilling the legal and regulatory obligations common to all of the business entities.

The staff of SUMC functions as both a determinant of corporate strategy and a primary control mechanism for affiliate compliance to that corporate strategy. This staff provides directional support to management and staff of the subsidiary business units necessary for the business unit to fulfill its assigned role in the corporation's strategic plan.

The Sprint Board of Directors has established an extensive operational role for the SUMC corporate staff. Performance of this role generates a set of administrative costs ultimately charged to the Service Agreement and subsequently assigned to the subsidiary business units for reimbursement.

The magnitude of cost incurred by the staff of SUMC is directly correlated to the role defined by the Sprint Board of Directors for them in the management of the corporation's enterprises. Comparing SUMC costs to other companies in the industry would be both inappropriate and misleading since this role varies significantly across the industry as companies have selected different organizational structures and operational strategies to pursue their independent objectives. Likewise, other companies respective cost structures vary significantly as a reflection of their organizations and operations. Any comparison between them is increasingly irrelevant both because of the limited comparability and the changing organizational composition in response to altered market conditions and new corporate goals.

Goals provide the conceptual framework within which the Sprint Board of Directors and management have pursued various corporate strategies. Goals have also served to shape the organizational structure and affiliate relationships which exist between corporate staffs and the subsidiary business units. It is from these goals that the set of corporate services provided under the Services Agreement emerge as critical management activities.

Academicians and business practitioners generally agree that goals give definition and purpose to the decisions of management. Goals prescribe the breadth of alternative organizational structures and management relationships which would be considered suitable to the achievement of the corporation's objectives. They narrow management's decision horizon and simplify its decision processes. They also serve to pre-determine certain outcomes.

Precept

Four principles govern organization design and provide the necessary set of parameters around decisions of organizational structure and management relationship. These principles define a planning envelope for management to use in the achievement of its corporate goals and objectives. Briefly stated these four principles are:

- organizational structures are defined to facilitate the effective execution of corporate strategies
- organizational structures change to reflect changes in corporate objectives and business strategy requirements
- business unit autonomy is determined in accordance with strategy requirements
- business unit strategies are subsets of the corporate strategy and exist to fulfill corporate objectives

Academic literature continues to advocate - and the best business practice continues to demonstrate - the importance of these four principles in strategic business management. There is nothing to suggest, in either the operational requirements of the telecommunications business or the regulatory processes which govern it, that disregard for these principles is prudent or proper.

Organizational Perspective

Sprint has structured its subsidiary business units around a bi-modal format. Individual business units are grouped beneath senior corporate officers who provide managerial support for the respective business units. The organizational structure provides functional segmentation and specialization between centralized staff organizations and their decentralized operating subsidiary counterparts. In this arrangement strategic policies, procedures, practices, programs and products are defined at a consolidated level and assigned to the subsidiaries for implementation. The work products developed by the staffs are specifically designed to achieve specified corporate goals and objectives endorsed by the corporate board of directors.

Managerial specialization such as that employed by Sprint defines two primary management roles for the headquarters staffs

> **Control** - the process of restricting the potential set of actions of subsidiary management to a prescribed set of alternatives which are consistent with approved corporate goals and objectives.
>
> **Coordination** - the process of directing business unit resources to a specific set of operational and managerial priorities necessary to achieve predetermined corporate goals and objectives.

Both management functions are critical to any organization's mission and are essential regardless of the specific organizational design. In multi-unit organizational structures such as the United and Central Telephone Companies, resource control and coordination are extremely important to cost-effective management. Control is essential to ensure continued legal and regulatory compliance in a constantly changing business environment. Coordination is necessary to ensure operational continuity and technological compatibility in the subsidiary business units.

The full benefit of control and coordination principles, however, is not recognized by measurements such as the EFMV because benefit is largely accrued at the subsidiary level rather than at the corporate level and cannot be easily translated into specific expense categories. It comes in the form of shorter repair intervals, lower capital requirements, enhanced preventive maintenance programs, shorter product development intervals, higher quality transmission levels and a myriad of other operational improvements at the operating company level.

By maintaining a broad level of involvement by the SUMC staff in planning and operations activities of its subsidiaries, management employs a highly participatory organization model that establishes the SUMC departments in leadership roles for now and in the future. SUMC staff have intimate knowledge and understanding of the business enhanced by rotational assignments, etc. In an industry such as telecommunications where the future offers so much uncertainty extraordinary coordination and control is essential to ensure responsive and responsible management decisions by the corporation.

The need for strong directional control is even more clearly essential for the United and Central Telephone Companies' local exchange operations because of the relatively small size of its individual state operations and geographic dispersion. The United and Central Telephone Companies' total local exchange operations roughly equate in access lines and customers to a number of single state local exchange carriers (e.g., New York Telephone, New Jersey Bell, Pacific Telephone, Illinois Bell, Ohio Bell, Bell of Pennsylvania) who, in our opinion, benefit immensely in both organization choice and cost structures from a geographic concentration of customers. Sprint lacks that highly favorable concentration of customers and, therefore, has limited organizational choices and limited alternative cost structures.

Findings/Conclusions

Examination of the FCC proposal has led us to conclude a number of deficiencies exist in the FCC's rationale for changes to rules. These flaws diminish the reliability of any application to service transactions - especially those involving Service Agreement expenses incurred by the United and Central Telephone Companies' local exchange units. Specifically, we submit that -

The composition and cost of centralized services provided to subsidiary business units is a function of the Sprint organization model and lacks any equivalent basis for determining estimated fair market value

The Sprint board of directors has established a two-tier organizational structure in which it has grouped all subsidiary business units. Services provided to the subsidiary business units are determined by their universal need and economy. Costs for such services are assigned to each of the recipient organizations using a consistent cost allocation method for all subsidiaries. The proportion of cost for any corporate service assigned to a subsidiary will vary in accordance with the total incurred cost by the corporate department and the method chosen to allocate the cost to the business unit.

The affiliate cost to the subsidiary business units for services provided by the corporate staff is a reflection of the scope of services provided it under the Service Agreement. The United and Central Telephone Companies have determined that it is in their best interest to have a corporate staff at SUMC that provides a fairly extensive array of professional and technical services. This approach results in relatively large allocations by SUMC to the affiliates for the cost of those services.

Some members of the telecommunications community have settled upon different organizational structures, defined their corporate role smaller and, therefore, have incurred less affiliate expense and more direct local expense. Still others have sought to centralize as much as possible to their corporate center. The result has been the notable absence of any uniform organizational model upon which valid comparisons might be made..

It is the opinion of **Greenwich Associates** that without a generally accepted organizational model any attempt to gauge an estimated fair market value for corporate services would be unfair and unprofessional. .

The complement of corporate services provided by SUMC to its affiliate units is comprehensive and consistent with the strategic role defined for the corporate staff.

SUMC properly employs a professional corporate staff organization to augment the management resources of the United and Central Telephone Companies' business units. The corporate staff is responsible for the development of policies, practices, procedures, products and programs necessary to achieve corporate defined goals and objectives. Furthermore, the staff serves to control allocation, and coordinate the use, of corporate resources by the affiliate business units. By endeavoring to extend corporate responsibility to resource coordination and control, SUMC has legitimately broadened the scope of support available through centralized resource management. In doing so, it has outlined a participant role for the corporate staff in the operations of the affiliate business units.

It is the opinion of **Greenwich Associates** that the complement of services provided by the corporate staff is sufficient to ensure this participant role is beneficial to the affiliate and does not represent additional cost to the affiliate units in the performance of their assigned objectives.