EXHIBIT PCC-1T

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Application of QWEST CORPORATION Regarding the Sale and Transfer of Qwest Dex to Dex Holdings, LLC, a non-affiliate	Docket No. UT-021120

DIRECT TESTIMONY

OF

PETER C. CUMMINGS

QWEST CORPORATION

JANUARY 17, 2003

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1 ## I. IDENTIFICATION OF WITNESS

2 **Q. PLEASE STATE YOUR NAME, ADDRESS AND EMPLOYMENT.**

3 A. My name is Peter C. Cummings and my business address is 1600 Bell Plaza,
4 Room 3005, Seattle, Washington, 98191. I am employed by Qwest Corporation
5 as Director - Finance.

6 **Q. WHAT ARE YOUR JOB RESPONSIBILITES AT QWEST?**

7 A. My responsibilities include financial analysis of capital costs and capital structure
8 of Qwest Corporation. I develop cost of capital estimates for company cost
9 studies, capital budgeting, and economic analysis and testify on financial issues.

10 **Q. PLEASE REVIEW YOUR WORK EXPERIENCE.**

11 A. I began my career at Northwestern Bell in 1969 and have held positions in
12 Operator Services, Marketing, and Finance departments. For the last 16 years, my
13 job responsibilities have been focused on cost of capital and rate of return.

14 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND**
15 **OTHER QUALIFICATIONS.**

16 A. I received my B.A. degree from Bemidji State College in Minnesota. I have a
17 Master of Public Administration Degree from the University of Oklahoma and a
18 Master of Business Administration Degree from Creighton University in Omaha,
19 Nebraska. I am a Chartered Financial Analyst and a member of the Association
20 for Investment Management and Research, the Financial Management
21 Association, and the Seattle Society of Financial Analysts.

1 **Q. HAVE YOU EVER TESTIFIED IN REGULATORY PROCEEDINGS?**

2 A. Yes, many times. I have testified before the Federal Communications
3 Commission and before state commissions in Arizona, Colorado, Idaho, Iowa,
4 Minnesota, Montana, Nebraska, New Mexico, North Dakota, Oregon, South
5 Dakota, Utah, Washington, and Wyoming. I have testified primarily in rate cases
6 and wholesale cost dockets on rate of return, capital structure, and other financial
7 issues. I also provided testimony in support of the U S WEST/Qwest merger and
8 in other special-purpose dockets.

9 **II. PURPOSE OF TESTIMONY**

10 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS DOCKET?**

11 A. My testimony is filed in tandem with that of Qwest witness Brian G. Johnson.
12 The purpose of our testimony is to explain why the sale of Dex is critical to the
13 continued financial viability of QC, and Qwest Communications International Inc.
14 ("QCI"), QC's ultimate parent corporation. Mr. Johnson and I focus on the
15 months prior to the announcement of the Dex sale transaction, conditions leading
16 up to the decision to sell Dex, and the significance of the closing of the
17 transaction. In so doing, our testimony demonstrates that the sale of Dex is in the
18 public interest.

19 My testimony focuses on Qwest's historical situation and current financial
20 obligations and challenges. Mr. Johnson's testimony touches on those same
21 subjects, but focuses to a greater extent on Qwest's strategic goals and the options
22 Qwest evaluated and pursued to address its financial difficulties.

1 **Q. WHAT ISSUES WILL YOU ADDRESS IN YOUR TESTIMONY?**

2 A. My testimony addresses the following issues:

3 Section III: I provide a general description of QCI and QC financing. I describe
4 how corporations, including QCI and QC, generate cash necessary to operate their
5 businesses, through equity or debt financing, operating revenues, and occasional
6 asset sales. I then discuss the importance of cash, or liquidity, to the business.

7 Section IV: I discuss how a number of events led to significant concerns about
8 QCI's liquidity, its ability to service its debt load, and QCI's decision to sell Dex.
9 QCI's declining revenues and a series of missed Wall Street expectations
10 beginning in late 2001 resulted in QCI and QC being unable to access the
11 commercial paper market. This required them to fully draw down and amend a
12 $4 billion syndicated credit facility by February 2002. This in turn led credit
13 rating agencies to downgrade both QCI's and QC's debt ratings, ultimately to
14 "junk bond" status. Beginning in 2001, QCI's stock price began a steep decline,
15 from $40 per share in January 2001, to the teens by year-end 2001. The stock
16 price ultimately sank as low as $1.07 in August 2002. This discussion provides
17 the necessary background for Mr. Johnson's testimony regarding QCI's decision
18 to sell Dex, his summary of the Dex sale transaction and his discussion of the
19 critical need to close both phases of the sale transaction.

20 Finally, I discuss the Second Amended and Restated Credit Agreement (the
21 "ARCA") and the results of QCI's December 2002 private debt exchange as they
22 relate to the Dex transaction. The ARCA is a re-negotiation of the $4 billion
23 Amended Credit Facility, which was set to mature in May 2003. The ARCA,
24 which would likely not have been possible without the Dex transaction, greatly

1 improved Qwest's short-term liquidity position and eased critical financial
2 covenants under which Qwest was very likely to default. The just-completed
3 private debt exchange also relates to and improved Qwest's liquidity situation.
4 Along with the sale of Dex, the ARCA and the private debt exchange demonstrate
5 Qwest's diligent efforts to de-lever its balance sheet, improve its liquidity position
6 and stabilize its financial situation in order to avoid bankruptcy.

7 **III. GENERAL DESCRIPTION OF QCI AND QC FINANCING**

8 **Q. PLEASE DISCUSS HOW QC IS RELATED TO QCI.**
9 A. QC is a regulated local exchange carrier, and provides basic local exchange,
10 IntraLATA toll and other telecommunications services to customers in
11 Washington and 13 other states. QC is a subsidiary of Qwest Services
12 Corporation ("QSC"), which in turn is a subsidiary of the parent holding
13 company, QCI. QSC also owns Qwest Dex Holdings, Inc., which in turn owns
14 Dex. An organizational chart depicting this structure is attached as Exhibit PCC-
15 2.

16 **Q. EXPLAIN THE IMPORTANCE OF CASH TO QCI AND QC.**
17 A. Cash is a corporation's lifeblood. QCI and QC use cash to pay expenses (interest
18 payments, vendor expenses, payroll, taxes, etc.), make capital investments, and
19 repay debt obligations as they mature.

20 **Q. WHAT ARE THE SOURCES OF CASH AVAILABLE TO QCI AND QC?**
21 A. QCI and QC can generate cash from three basic corporate activities: operating
22 activities, financing activities and investing activities. Cash from operating

1 activities, as its name suggests, is cash generated by the day-to-day operations of
2 the business. Cash from financing activities comes from sales of equity and debt.
3 These are the primary sources of cash for QC and QCI. Cash from investing
4 activities comes from investment returns and sales of assets.

5 **Q. PLEASE DESCRIBE "CASH FROM OPERATIONS."**

6 A. Cash from operations is obtained from the operations of the company, generally
7 through the sale of telecommunications products and services. This source of
8 cash is generally recurring in some pattern such as monthly, quarterly, or annually
9 and is primarily used to pay ongoing operating expenses such as wages, vendor
10 invoices, taxes, etc.

11 **Q. PLEASE DESCRIBE CASH FROM THE SALE OF EQUITY.**

12 A. Cash from the sale of equity is derived from the sale of stock in the corporation.
13 The sale of stock normally happens at the start-up of a corporation. The
14 corporation may issue additional stock as the firm grows to pay for additional
15 plant and investment. While cash can be used to pay for any product or service,
16 cash from equity often provides the cash for necessary start-up expenses and
17 investments incurred before revenues are sufficient to pay for the ongoing
18 operations of the firm. QCI is the Qwest entity whose stock is publicly traded on
19 the New York Stock Exchange. The equity recorded on QC's books came from
20 equity investment by QCI and its predecessor companies.

1 **Q. PLEASE DESCRIBE CASH FROM THE SALE OF DEBT.**

2 A. Debt can generally be divided into three categories: short, intermediate, and long
3 term. The distinction between intermediate and long term debt maturity is rather
4 arbitrary and deals with both the time to maturity and the interest rate paid by the
5 entity issuing the debt. The interest rate generally increases as the length of the
6 debt maturity increases. The cash raised by selling debt can be used to pay
7 operating expenses, make investments, and to pay-off or reduce other debt,
8 generally of a shorter maturity. Intermediate and long-term debt is often
9 associated, like equity, with the financing of capital investments. Short-term debt
10 is debt due within one year and includes maturing intermediate and long term debt
11 issues, bank loans, and commercial paper.

12 **Q. EXPLAIN THE TERM "COMMERCIAL PAPER."**

13 A. Commercial paper is an unsecured, short-term security issued by companies that
14 provides ready access to cash. Commercial paper, due to its very short maturities,
15 carries low interest rates. It is the corporate equivalent of short term U.S.
16 Treasury Bills. Commercial paper is frequently paid off and reissued as the needs
17 of the business dictate. Corporations that issue commercial paper are required to
18 maintain bank loan lines of credit, or credit facilities, as a backup to their
19 commercial paper programs. The bank loan credit facilities generally carry higher
20 interest rates than commercial paper issues.

21 **Q. PLEASE DESCRIBE CASH FROM THE SALE OF ASSETS.**

22 A. A company can also raise cash by selling assets. A company may sell assets
23 when it no longer needs them, when it reorganizes its business, or when, as with

1 the sale of Dex, it has a greater need for the immediate cash from the sale than the
2 cash flow that can be obtained over time from the asset itself.

3 **Q. WHAT IS CASH FLOW?**

4 A. Cash flow is the difference between all inflows of cash (such as revenues) and all
5 outflows of cash (such as cash expenses). A company can improve cash flow by
6 increasing cash proceeds flowing into the business, decreasing cash flowing out of
7 the business, or both.

8 **Q. WHAT IS FREE CASH FLOW?**

9 A. Free cash flow is cash generated by operating activities, less cash used for capital
10 expenditures. The cash flow remaining is free cash flow. Free cash flow is the
11 net cash from operations that is available for payments to capital providers (e.g.,
12 payment of maturing debt and dividends to shareholders).

13 **Q. WHEN ANALYSTS DISCUSS LIQUIDITY, WHAT ARE THEY**
14 **TALKING ABOUT IN RELATION TO CASH, CASH FLOW, AND FREE**
15 **CASH FLOW?**

16 A. Liquidity refers to the availability of sufficient cash to operate the business,
17 including cash to satisfy short-term obligations (expenses) and long term
18 obligations (debt maturity). A textbook definition of liquidity is cash and cash
19 equivalents that can be readily accessed to meet payment obligations when they
20 come due. Cash equivalents would include assets that can be readily converted to
21 cash such as exchange-traded common stock, investments in other companies,

1 accounts receivable, short term investments, and readily marketable assets such as
2 real estate.

3 IV. THE FINANCIAL SITUATION OF QCI AND QC

4 **Q. PLEASE DESCRIBE THE PRE-SALE FINANCIAL SITUATION OF QCI**
5 **AND QC.**

6 A. It is necessary to review the events in the months leading up to the Dex sale
7 transaction in August 2002 in order to understand the financial situation that led
8 QCI to consider selling Dex. In January 2002, QCI had declining EBITDA,
9 declining revenues, and over $25 billion in debt on its balance sheets.[1] QCI's
10 fourth quarter financial report stated:

11 "Reported revenue for the quarter was down approximately six percent to
12 $4.70 billion, down 314 million from $5.02 billion in the same period last
13 year."
14
15 "For the quarter, pro forma normalized earnings before interest, taxes,
16 depreciation and amortization (EBITDA) was $1.61 billion compared with
17 pro forma normalized EBITDA for the same period last year of $1.99
18 billion."
19

20 QCI's stock price had steadily declined from the mid-$40's in January 2001 to the
21 mid-teens by January 2002. *See* Exhibit PCC-3 (QCI stock price chart). There
22 was concern in the financial markets and a high-level of scrutiny from investment
23 analysts regarding QCI's financial condition. By the beginning of 2002, it was
24 apparent that the economic downturn coupled with reduced demand and

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[1] *See* QCI Form 8-K, Jan. 29, 2002 (4th Quarter Financial Results Announcement). I reference a number of QCI SEC filings throughout my testimony. These are available at http://www.sec.gov, and through the Qwest Investor Relations section of the Qwest website at http://www.qwest.com.

1 overcapacity in the telecommunications industry placed QCI at serious risk of
2 being unable to generate sufficient cash flow to service its debt obligations.

3 **Q. WHAT STEPS DID QCI TAKE IN RESPONSE TO ANALYSTS'**
4 **CONCERNS?**

5 A. As part of its earnings announcement on January 30, 2002, QCI stated that it was
6 evaluating various plans to generate additional cash to reduce the debt on its
7 balance sheet, sometimes referred to as "de-levering" the balance sheet.[2] QCI
8 stated that it was considering a number of alternatives to address these issues,
9 including: "issuing equity-based securities, [and] sales of assets or of securities
10 associated with those assets, including, among others, wireless, access lines,
11 directories, its applications service provider business and other non-core assets."[3]

12 **Q. DID QCI' S AND QC' S FINANCIAL SITUATION IMPACT THEIR**
13 **ABILITY TO OBTAIN FINANCING?**

14 A. Yes. QCI's and QC's steadily worsening financial situation did impact their
15 ability to obtain financing. This first became an issue with regard to their ability
16 to refinance, or "roll over" their commercial paper. As I previously explained,
17 commercial paper is an unsecured, short-term security that provides ready access
18 to cash. Commercial paper carries low interest rates, and has therefore
19 historically been a critical component of QCI's and QC's financing portfolio.
20 Beginning in early 2002, it became increasingly difficult for QCI and QC to roll
21 over their commercial paper. Eventually, QCI and QC were forced from the

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[2] *See* QCI Form 8-K, Jan. 29, 2002.

[3] *Id.*

1 commercial paper market because investors were not willing to reinvest in new
2 QCI or QC commercial paper. By mid-February 2002, they were effectively shut
3 out of the commercial paper market, requiring them to fully draw down the
4 existing $4 billion syndicated bank credit facility ("Credit Facility") that backed
5 up their commercial paper program, in order to repay their existing commercial
6 paper indebtedness.[4]

7 **Q. HOW DID THE BOND RATING AGENCIES REACT TO QCI AND QC**
8 **NOT HAVING ACCESS TO THE COMMERCIAL PAPER MARKET?**

9 A. When QCI and QC became unable to access the commercial paper market, the
10 bond rating agencies reacted with downgrades of both QCI's and QC's long-term
11 and short-term debt ratings. Moody's Investor Service lowered QCI's long-term
12 and QC's long-term and short-term ratings, commenting that:

13 Qwest's difficulty in rolling its commercial paper has required the
14 company to utilize its $4.0 billion bank facility. Without access to
15 commercial paper, the company's alternate liquidity has been
16 reduced by the drawdown on its bank facility. This lack of
17 alternate liquidity considerably limits the company's financial
18 flexibility and poses a risk to damage Qwest's overall competitive
19 profile if not resolved expeditiously.[5]

20 Standard & Poor's similarly lowered its long-term ratings on both QCI and QC.
21 Fitch Ratings also downgraded both QCI and QC, commenting:

22 The downgrades reflect Fitch's view that the liquidity of the
23 company has been materially reduced following the draw down of
24 its previously untapped $4 billion bank facility on February 13 and
25 14. ... To resolve the rating outlook that exists at the current

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[4] "On February 14, 2002, Qwest issued a press release announcing that it had taken steps to address short-term liquidity pressures in the commercial paper market by drawing down on its $4 billion credit facility." QCI Form 8-K, Feb. 15, 2002.

[5] Moody's Investor Service Rating Action, February 14, 2002, "Moody's Lowers Ratings of Qwest Communications International and Subsidiaries, Keeps All Ratings On Review For Possible Further Downgrade."

1 "BBB" level, Fitch will continue to monitor Qwest's operating
2 performance in the currently weak environment for telecom
3 services, as well as evaluate measures Qwest may undertake to
4 strengthen its balance sheet. Such measures may include the sale
5 of non-core assets and/or the issuance of equity-like securities.[6]

6 **Q. EXPLAIN WHAT THESE CREDIT AGENCY RATINGS MEAN, AND**
7 **THE SIGNIFICANCE OF THESE DOWNGRADES.**

8 A. Bond ratings are indicators of credit quality. The interest rate cost to the company
9 issuing the bonds increases as its bond rating decreases. The February 14, 2002
10 rating downgrades recognized the additional risk inherent in QCI and QC bonds
11 due to their exit from the commercial paper market and draw down of the Credit
12 Facility, but kept the ratings within the investment grade category. Bonds rated
13 within the "BBB" (S&P and Fitch) or "Baa" (Moody's) rating categories and
14 above are considered investment grade bonds. Bonds rated in the "BB" and "Ba"
15 rating categories and below are considered high yield or "junk" bonds. A further
16 series of downgrades, which I discuss later in my testimony, ultimately left both
17 QCI and QC with junk bond ratings. I have attached as Exhibit PCC-4 a chart
18 depicting the chronology of the credit rating agency actions.

19 **Q. WHAT OTHER EVENTS IN THIS TIME FRAME CONTRIBUTED TO**
20 **QCI' S FINANCIAL CONCERNS?**

21 A. On March 11, 2002, QCI received an informal inquiry from the Denver Regional
22 Office of the SEC relating to matters involving Qwest's accounting policies,

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[6] Fitch Ratings, February 14, 2002, "Fitch Ratings Downgrade Qwest; Maintains Negative Outlook."

1 practices and procedures in 2000 and 2001.[7] The announcement of the informal
2 investigation likely created doubts in the minds of investors about how to evaluate
3 QCI, because the inquiry raised questions as to QCI's prior financial results and
4 future earnings. On April 3, 2002, the SEC issued a formal order of investigation.
5 Because of the SEC investigation, QCI could not issue new stock or bonds to the
6 public in a registered offering, as its financial records could no longer be verified
7 in the registration document required to issue such securities.

8 **Q. WHAT WERE QCI AND QC DOING IN RESPONSE TO BEING SHUT**
9 **OUT OF THE COMMERCIAL PAPER MARKET?**

10 A. On March 12, 2002, QC completed a $1.5 billion offering of 8.875% 10 year
11 bonds. QC used a portion of the proceeds to pay off its share of the indebtedness
12 on the $4.0 billion Credit Facility, leaving QC with no further obligations under
13 the Credit Facility. On March 15, 2002, QCI announced an amendment to the

[7] "On March 11, 2002, Qwest Communications International Inc. ("Qwest") issued a press release disclosing an informal inquiry from the Securities and Exchange Commission." QCI Form 8-K, March 11, 2002. A copy of the press release is attached to the 8-K and reads in part: "Qwest Communications International Inc. today said it received an informal inquiry from the Denver regional office of the Securities and Exchange Commission (SEC) requesting voluntary production of documents. Qwest intends to respond fully to this request, which was received in a letter Friday, March 8, 2002. The matters identified by the SEC as the focus of the informal inquiry have previously been the subject of disclosure by Qwest and have been widely reported in the investment community and in the media. The matters relate to three areas of Qwest's accounting policies, practices and procedures in 2000 and 2001, including revenue recognition and accounting treatment of (i) sales of optical capacity assets (often referred to as Indefeasible Rights of Use or "IRUs"), particularly sales to customers from whom the company agreed to purchase optical capacity; (ii) the sale of equipment by Qwest to customers from which Qwest bought Internet services or to which Qwest contributed equity financing, including equipment sales to KMC and Calpoint; and (iii) Qwest Dex, particularly changes in the production schedules and lives of some directories. The SEC informed Qwest that this informal inquiry is not an indication that it or its staff believes any violation of law has occurred, nor should Qwest consider the inquiry an adverse reflection on any entity or security."

1 Credit Facility.[8] The amendment relaxed the financial covenants associated with
2 the Credit Facility, permitting QCI to maintain a ratio of consolidated debt to
3 consolidated EBITDA for the trailing four quarters of not more than 4.25x at
4 March 31, June 30 and September 30, 2002, and a ratio of 4.0x at December 31,
5 2002 and March 31, 2003. The previous debt coverage ratio limit had been 3.75x.
6 The amendment also reduced the amount of funds available under the Credit
7 Facility to $3.4 billion, and required QCI to use a portion of net proceeds from
8 future sales of assets and capital market transactions, including the issuance of
9 debt and equity securities, to prepay the Credit Facility until the outstanding
10 balance was $2 billion or less. The Credit Facility was originally scheduled to
11 mature on May 3, 2002, but QCI exercised its option to extend the maturity to
12 May 3, 2003.[9] Hereinafter, I refer to the Credit Facility, as amended on March
13 15, 2002, as the "Amended Credit Facility."

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[8] "On March 15, 2002, Qwest Communications International Inc. ("Qwest") amended its $4 billion unsecured bank agreement." QCI Form 8-K, March 18, 2002. A copy of a press release is attached to the 8-K and states: "Qwest Communications International Inc. (NYSE: Q) today announced it has amended its $4 billion unsecured bank credit agreement. The company believes that available cash and borrowings available under the bank facility will be sufficient to pay debt maturing in the next twelve months and to fund its capital and operating expenditures during that period. Qwest continues to expect to become cash flow positive in the second quarter of 2002. . . . As part of the amendment, Qwest is permitted to maintain a ratio of debt to Consolidated EBITDA (as defined in the agreement) for the trailing four quarters of not more than 4.25 at March 31, June 30 and September 30, 2002 and 4.0 at December 31, 2002 and March 31, 2003. The previous debt coverage ratio limit was 3.75. The bank facility matures May 3, 2002, but the company presently expects to exercise its option to extend the maturity to May 3, 2003, as permitted by the agreement."

[9] *Id.* "As part of the amendment, Qwest is permitted to maintain a ratio of debt to Consolidated EBITDA (as defined in the agreement) for the trailing four quarters of not more than 4.25 at March 31, June 30 and September 30, 2002 and 4.0 at December 31, 2002 and March 31, 2003. The previous debt coverage ratio limit was 3.75. The bank facility matures May 3, 2002, but the company presently expects to exercise its option to extend the maturity to May 3, 2003, as permitted by the agreement."

1 **Q. DID THIS ADDITIONAL FINANCING RESOLVE QCI' S FINANCIAL**
2 **CONCERNS?**

3 A. Only for the very short term, meaning through the second quarter of 2002. QCI
4 still carried a debt load in excess of $26 billion and was continuing to see
5 declining revenues, resulting in decreasing EBITDA. On April 18, 2002, QCI
6 announced a downward revision to its 2002 financial guidance, citing continuing
7 weakness in both the telecommunications sector and the regional economy, and
8 announced that, "It has decided to proceed with seeking proposals from potential
9 buyers for its Dex (directories) and Wireless businesses and is also working on
10 selling its Qwest Cyber Solutions business and other assets, including access lines
11 and wireless towers."[10] On April 30, 2002, QCI announced first quarter financial
12 results: [11]

13 "Reported revenue for the quarter was down approximately 13.5 percent
14 to $4.37 billion from $5.05 billion in the same period last year, primarily
15 due to the absence of optical capacity asset sales and certain Internet
16 equipment sales."

17 "For the quarter adjusted EBITDA (adjusted earnings before interest,
18 taxes, depreciation and amortization) was $1.45 billion compared with
19 adjusted EBITDA for the same period last year of $2.0 billion."

20 "For 2002, it expects recurring revenues for local service to decline by 3%
21 to 4% compared with 2001. . . It expects net debt at the end of 2002 of just
22 over $25 billion."

23 The credit rating agencies again reacted, downgrading QCI's and QC's bond
24 ratings in April 2002. A series of further downgrades finally dropped QCI's and
25 QC's bond ratings into junk status. *See* Exhibit PCC-4 (chronology of credit

[10] *See* QCI Form 8-K, April 19, 2002

[11] *See* QCI Form 8-K, May 1, 2002.

1 rating agency action). QCI's stock price also continued to decline. *See* Exhibit
2 PCC-3 (QCI stock price chart).

3 **Q. EXPLAIN THE SIGNIFICANCE OF JUNK BOND CREDIT RATING**
4 **STATUS.**

5 A. On May 22, 2002, Standard & Poor's downgraded both QCI and QC from
6 investment grade "BBB-" to the non-investment grade ("junk") bond rating of
7 "BB+". Moody's and Fitch soon followed with downgrades to junk grade ratings
8 as shown in Exhibit PCC-4. The significance of junk ratings for corporate bond
9 issuers is that they have to pay significantly higher interest rates than investment
10 grade issuers, reflecting their companies' higher risk. Additionally, the market for
11 junk bonds is smaller than the investment grade market. Many institutional
12 investors are prohibited from acquiring or retaining junk bonds in their portfolios,
13 or are limited in the quantity they may acquire or retain. Having their credit
14 ratings downgraded to junk status further reduced QCI's and QC's ability to raise
15 cash through debt financing.

16 **Q. MR. JOHNSON REFERS TO THE ARCA. WHAT ARE THE KEY**
17 **TERMS OF THE ARCA?**

18 A. The Second Amended and Restated Credit Agreement ("ARCA") refinanced
19 approximately $3.354 billion of indebtedness then existing under the Amended
20 Credit Facility.[12] QSC assumed all of the currently outstanding debt under the
21 Amended Credit Facility. Qwest Capital Funding ("QCF") and QC, which were

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[12] "On September 4, 2002 Qwest Communications International Inc. ("Qwest") announced that it had reached unanimous agreement with the 29 lenders in its syndicated credit facility to amend Qwest's $3.4 billion credit facility. " QCI Form 8-K, September 5, 2002.

1 the borrowers under the Amended Credit Facility, are not obligated under the
2 ARCA as borrowers. The ARCA provided additional security for the bank
3 lenders and established a new maturity date of May 3, 2005, requiring
4 intermediate payments before that date with specific payments tied to the sale of
5 Dex and other asset sales. The ARCA also relaxed the debt to EBITDA ratio
6 covenants under the Amended Credit Facility, providing that QCI must maintain a
7 6.0x debt to EBITDA ratio, and QC must maintain a 2.5x debt to EBITDA ratio.

8 **Q. GIVEN THAT THE ARCA IS IN PLACE, DOES QCI STILL NEED TO**
9 **PROCEED WITH THE DEX SALE?**
10 A. Yes. While the ARCA provided additional headroom on QCI's financial
11 covenants, and extended the maturity dates under the Amended Credit Facility, it
12 did not provide any new cash to make payments, and that remains a critical issue.
13 Absent the Dex sale, QCI would lack the necessary cash to make the required
14 payments under the ARCA, and other upcoming maturities, including the Dex
15 Term Loan. The chart below depicts, as of November 1, 2002 (prior to the close
16 of "Dexter" – the first stage of the Dex sale), the debt maturities of QCI
17 subsidiaries, including QC, through the end 2007:

1 TABLE A:

2 **QCI Consolidated Debt Maturities ($ millions)**

3

	2002	2003	2004	2005	2006	2007	TOTAL
QC		1,155	850	441		160	2,606
QSC	1,354*	1,500*		1,250			4,104
QCF			1,250	500	1,250		3,000
QCI						11	11
QCC						350	350
TOTAL	1,354	2,655	2,100	2,191	1,250	521	10,071

4 * Includes Dexter close and assumes Rodney phase of Dex sale closes as
5 scheduled.

6 **Q. DID QCI USE THE PROCEEDS OF THE DEXTER CLOSING TO**
7 **REPAY A PORTION OF ITS INDEBTEDNESS?**

8 A. Yes. Pursuant to the terms of the ARCA, QCI paid $1,354 million from the
9 Dexter proceeds to reduce the QSC borrowings under the ARCA to $2.0 billion.
10 Unless QC is able to refinance its $1,155m of debt maturing in the first half of
11 2003, which is unlikely due to the continuing SEC investigation, the Dexter
12 proceeds will also be used to repay QC debt obligations.

13 **Q. AFTER COMPLETING THE FIRST STAGE OF THE DEX SALE AND**
14 **APPLYING THE PROCEEDS TO DEBT REDUCTION, IS IT STILL**
15 **NECESSARY TO SELL THE REMAINDER OF DEX?**

16 A. Yes. Completion of both phases of the Dex sale is critical to providing the cash
17 for Qwest to de-lever its balance sheet and meet its debt service obligations. The
18 entire Dex sale is absolutely necessary, as demonstrated by QCI's previous
19 disclosure that, even if QCI does realize the proceeds from both phases of the Dex
20 sale, it still may be unable to meet its debt service obligations through 2005:

1 "After giving effect to the first stage of the sale of Dex and the repayment
2 of certain Qwest Corporation Notes in October 2002, our consolidated
3 debt was $24.5 billion as of September 30, 2002. Thus, despite these
4 recent measures, there is substantial risk that our free cash flow from
5 operations as presently conducted and the cash proceeds from the sale of
6 the remainder of our Dex publishing business will be insufficient to meet
7 our debt service obligations after 2005. Even if we are successful in our
8 de-leveraging efforts, we may be unable to meet our debt service
9 obligations through 2005 (which include $6.9 billion of debt maturities)
10 without obtaining additional financing if we are unsuccessful in improving
11 our operations as we expect, if the declines in our revenues and profits are
12 worse than we expect, if economic conditions do not improve, or if the
13 sale of the Dex West business does not occur."[13]

14 **Q. PLEASE DESCRIBE QCI' S RECENTLY COMPLETED DEBT**
15 **EXCHANGE AND EXPLAIN HOW IT AFFECTS THE MATURITY**
16 **SCHEDULE OF OUTSTANDING DEBT?**

17 A. On November 20, 2002, QCI announced an offer to exchange approximately
18 $12.9 billion aggregate principal amount of outstanding debt securities of QCF
19 through a private placement for new debt securities.[14] On December 23, 2002,
20 QCI announced that, as of the December 20, 2002 offer expiration date, $5.2
21 billion in total principal amount of QCF notes had been validly tendered and
22 accepted for exchange for $3.3 billion of new QSC notes. The result of that
23 exchange is to reduce QCI's total debt by over $1.9 billion and to extend some

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[13] *See* QCI Form 8-K, Nov. 14, 2002.

[14] *See* QCI Form 8-K, Nov. 20, 2002. A press release attached to the 8-K notes: "Qwest Communications International Inc. (NYSE: Q; QCII) announced today that it has commenced a private offer to exchange $12,902,653,000 aggregate principal amount of outstanding debt securities of Qwest Capital Funding, Inc. (QCF), a wholly-owned subsidiary of QCII, in a private placement for new debt securities. The new securities include up to $4,000,000,000 of new senior subordinated secured notes of Qwest Services Corporation (QSC), a wholly-owned subsidiary of QCII."

1 near-term maturities.[15] The exchange converts $735m of QCF debt previously set
2 to mature in 2004, 2005, and 2006 into $547m of new QSC debt set to mature in
3 2007.

4 **Q. DOES THE DEBT EXCHANGE REDUCE THE NEED TO COMPLETE**
5 **THE SALE OF DEX?**

6 A. No. The debt exchange provided some additional financial flexibility in the near
7 term, but completion of the sale of Dex remains the key component in QCI's
8 business plan to stabilize its financial position over the near and intermediate
9 term. The Wall Street Journal described the exchange as "at the low end of the
10 deal's expected range" and went on to note QCI's continuing problems:[16]

11 "Qwest, based in Denver, will cut its debt to $22.6 billion from $24.5
12 billion through the debt exchange. The company has been racing to
13 reduce a debt load that investors fear could force it into bankruptcy law
14 protection. At the same time, Qwest has been struggling with a flagging
15 core business, investigations into its accounting, and collapse of its stock
16 price."

17 Standard & Poor's rated the new bonds equivalent to the old bonds and
18 commented further saying that, "near-term liquidity still remains a source of
19 concern, particularly if closing of the $4.3 billion second phase of the company's

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[15] *See* QCI Form 8-K, Dec. 23, 2002. A press release attached to the 8-K states: "Qwest Communications International Inc. (QCII) (NYSE: Q) today announced the successful results of its offer to exchange $12.9 billion aggregate principal amount of outstanding debt securities of Qwest Capital Funding, Inc. (QCF), a wholly-owned subsidiary of QCII, in a private placement for new debt securities. As of the expiration of the offer on Friday, December 20, 2002, approximately $5.2 billion in total principal amount of the QCF notes had been validly tendered and accepted for exchange. This will reduce Qwest's total debt by over $1.9 billion-from approximately $24.5 billion to approximately $22.6 billion-and extend some near-term maturities."

[16] *See* The Wall Street Journal, December 24, 2002, page C-5. (Attached as Exhibit PCC-5)

1 directories sale is delayed beyond 2003."[17] After the debt exchange, the near term
2 schedule of debt maturities for QCI and its subsidiaries is as follows, as of
3 January 2003:

4 TABLE B:

5 **QCI Consolidated Debt Maturities ($ millions)**

	2003	2004	2005	2006	2007	TOTAL
QC	1,155	850	441		160	2,606
QSC	1,500*		1,250		547	3,297
QCF		963	421	881		2,265
QCI					11	11
QCC					350	350
TOTAL	2,655	1,813	2,112	881	1,068	8,529

6 * Includes Dexter close and assumes Rodney phase of Dex sale closes as
7 scheduled.

8 After the debt exchange, QCI has more than $8.5 billion of debt maturing in the
9 next five years and more than $6.5 billion maturing in the next three years. The
10 cash to be provided by the sale of Dex remains critical to reducing the company's
11 high level of debt.

12 **V. CONCLUSION**

13 **Q. COULD YOU PLEASE SUMMARIZE YOUR TESTIMONY?**

14 A. Yes. Qwest is facing very difficult financial times. Falling revenues, decreased
15 cash flows, high debt, outside investigations, a collapsed stock price, and a lack of
16 access to the commercial paper market left the company in a critical liquidity
17 situation and approaching bankruptcy by early 2002. As Mr. Johnson describes in

[17] *See* Standard & Poor's Press Release December 26, 2002. (Attached as Exhibit PCC-6).

1 his testimony, Qwest concluded that the sale of assets, specifically Dex, was
2 necessary to its strategy of de-levering its balance sheet and stabilizing its
3 liquidity situation. The Dex transaction was also critical to allowing Qwest to
4 successfully negotiate the ARCA. Absent the ARCA, Qwest would almost
5 certainly have been facing bankruptcy given the payment obligation of $3.4
6 billion in May 2003 and its inability to meet the debt covenants specified in the
7 Amended Credit Facility.

8 The sale of Dex (both phases) remains critical to Qwest's ability to avoid
9 bankruptcy in the short and intermediate term. The closing of the Rodney stage,
10 while vital to Qwest's strategy, may still not be sufficient in and of itself to allow
11 Qwest to meet its upcoming debt maturities. Whether the Rodney proceeds prove
12 to be sufficient they are clearly necessary in Qwest's efforts to avoid bankruptcy.

13 **Q. DOES THIS CONCLUDE YOUR TESTIMONY.**

14 A. Yes, it does.