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

THERESA A. JENSEN

QWEST CORPORATION

JANUARY 17, 2003

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1 **I. IDENTIFICATION OF WITNESS**

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

4 A. My name is Theresa A. Jensen and my business address is 1600 7th Ave., Room
5 3206, Seattle, Washington, 98191. I am employed by Qwest Services
6 Corporation ("QSC") as the Senior Director of Washington Regulatory Affairs for
7 Qwest Corporation ("QC") and other QSC subsidiaries.

8 **Q. PLEASE REVIEW YOUR PRESENT RESPONSIBILITIES.**

9 A. I am primarily responsible for all aspects of regulatory compliance for QSC,
10 particularly QC's regulated Washington operations. My responsibilities include
11 oversight of regulatory filings and advocacy, including presentation of testimony,
12 as in this docket. I am also primarily responsible for QSC's and its affiliates'
13 communications with the Washington Utilities and Transportation Commission
14 ("Commission").

15 **Q. BRIEFLY OUTLINE YOUR EMPLOYMENT BACKGROUND.**

16 A. I have been employed by Qwest and its predecessors since 1972 and in my current
17 assignment since 1991. I began my career in telecommunications in 1972 as a
18 directory assistance operator. I also worked as a customer service representative
19 for about six years. I then spent several years in Marketing, holding various job
20 responsibilities, including market administrator, account executive, sales
21 manager, instructor, market manager, data systems manager, and product
22 manager. From 1987 until 1991, I worked in Strategic Planning and was
23 responsible for developing U S WEST's Open Network Architecture Plan.

1 **II. PURPOSE AND SUMMARY OF TESTIMONY**

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

3 A. The purpose of my testimony is to address the public policy and regulatory issues
4 surrounding Qwest Communications International Inc.'s ("QCI") sale of the
5 directory publishing assets and business of Qwest Dex, Inc. ("Dex"). My
6 testimony will demonstrate to the Commission that the sale is in the public
7 interest and should be approved as expeditiously as possible without conditions
8 that would defeat the purpose of the transaction.

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

10 A. My testimony addresses the following issues:

11 • the structure of the transaction;
12 • the necessity of the sale in light of QCI's highly leveraged financial condition
13 and the impact of QCI's financial condition on QC;
14 • QC's current responsibilities with regard to directory publishing and how
15 those obligations will continue to be met after the sale;
16 • a brief history of the regulatory treatment of the directory publishing business
17 in Washington;
18 • the relief requested by Qwest in this docket; including:
19   • the financial value associated with the Dex business in Washington,
20   • the proposal for the financial disposition of the Dex sale, including a
21   discussion of the effect of the sale on QC's rates, and
22   • how the sale is in the public interest.

1 **Q. PLEASE IDENTIFY THE OTHER QC WITNESSES AND THE TOPICS**
2 **THEY WILL ADDRESS.**

3 A. As stated before, I will generally confine my testimony to the regulatory and
4 public policy issues attendant to the sale. Peter C. Cummings and Brian G.
5 Johnson will testify as to the financial necessity of the sale, and George A.
6 Burnett will testify as to operational components of the transaction and Dex's
7 business. Phil Grate's testimony examines who should receive the gain on the
8 sale of Dex using the two-step risk and burden test the Commission employs to
9 make such determinations. His testimony reviews evidence that indicates who,
10 ratepayers or investors, has borne the risk of loss and burden of the directory
11 advertising business.

12 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

13 A. On August 19, 2002, QCI agreed to sell Dex's directory publishing business to an
14 entity formed by the private equity firms of The Carlyle Group and Welsh,
15 Carson, Anderson & Stowe ("Buyer"). The total purchase price for the
16 transaction is $7.05 billion. The sale is divided into two stages. The first stage,
17 called Dexter, involved Dex operations in Colorado, Iowa, Minnesota, Nebraska,
18 New Mexico, North Dakota and South Dakota. Of the total purchase price, $2.75
19 billion was allocated to the Dexter stage, which closed on November 8, 2002.

20 The second stage, called Rodney, is scheduled to close in 2003. It involves the
21 remaining Dex operations in Arizona, Idaho, Montana, Oregon, Utah, Washington
22 and Wyoming. The balance of the purchase price, $4.30 billion (subject to
23 adjustments relating to the Dexter adjusted earnings, before interest, taxes,
24 depreciation and amortization ("EBITDA") number, and the working capital of

1 Rodney at the time of closing) is due on closing of the second stage. The closing
2 of Rodney is also contingent upon other conditions including any required
3 regulatory approvals and on Buyer's ability to obtain additional debt and equity
4 financing.

5 The sale is in the public interest in five distinct ways. First, the sale is necessary
6 to preserve the financial integrity of QC. Second, the sale ensures that QC's
7 directory publishing obligations will continue to be fulfilled. Third, the sale will
8 not result in any increase in QC's rates. Fourth, the sale will not distort or impair
9 the development of the competitive market. Fifth, the sale ensures that Qwest
10 captures the value of Dex now, receives fair value for the transaction, and avoids
11 risk and uncertainty in the future.

12 Finally, there is no need for the Commission to impose any conditions on the
13 approval of the Dex sale. The recent history of directory operations in
14 Washington was thoroughly reviewed in the Fourteenth Supplemental Order
15 ("Accounting Order") in Docket No. UT-980948.[1] In the Accounting Order, the
16 Commission held that it had only been asked in 1983 and later cases to approve
17 certain publishing agreements and transfers of certain tangible assets and cash.[2]
18 The Accounting Order includes an extensive discussion characterizing the
19 transfers that occurred pursuant to Pacific Northwest Bell's (PNB's) request in
20 Docket No. FR-83-159 and subsequent proceedings and the Commission approval

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[1] In re the Petition of U S WEST Communications Inc. for an Accounting Order, Docket No. UT-980948, Fourteenth Supplemental Order; Order Denying Petition, July 27, 2000 (the "Accounting Order").

[2] Accounting Order, ¶¶ 169, 176-177.

1 obtained in each. It repeatedly states that PNB had transferred certain assets, but
2 only temporarily outsourced the publishing function.[3]

3 Based on this understanding, Qwest interprets the Accounting Order to hold that
4 the goodwill associated with the directory advertising business and the right to be
5 the directory publisher on behalf of Qwest are still retained by QC.[4] Therefore,
6 QC does not believe the Dex sale is subject to Chapters 80.12 RCW or 480-143
7 WAC. QC understands the Accounting Order held that, under Chapter 80.16
8 RCW, the Commission has the authority to impose imputation on an ongoing
9 basis when QC's affiliate owns and operates a directory publishing business that
10 serves QC.[5] However, the Dex sale terminates the QC affiliate arrangement
11 between QC and Dex through the sale of the directory publishing business to the
12 Buyer, which is not part of the Qwest family of companies. Thus, the issue of
13 imputation as an alternative to a distribution at the time of a transfer to a Qwest
14 affiliate must be re-addressed.

15 The practice of substituting the earnings imputation, for ratemaking purposes, for
16 the actual payments (if any) by Dex for rights or services that QC provides and
17 that allow Dex to publish directories containing Yellow Pages advertising on
18 behalf of QC can no longer be sustained on the basis of the Qwest affiliate

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[3] Id., ¶¶ 141, 147, 155, 158, 159, 176.

[4] The Company's regulated balance sheet has never included a capitalized amount reflecting the right to publish the Company's directories nor, as Mr. Grate's testimony explains, has it ever included any amount for the goodwill of the directory advertising business that the Company originally created and always operated outside regulation (collectively hereinafter, "goodwill"). Further, as Mr. Grate explains, the Commission long ago established and has consistently followed a policy of allowing no return on goodwill type assets or recovery of such assets through depreciation.

[5] Accounting Order, ¶¶ 172-173.

1 relationship discussed in the Accounting Order.[6] The Commission should issue
2 an order that resolves the directory issue through the continuation of the existing
3 directory earnings imputation until any ratepayer interest in the sale proceeds is
4 satisfied which is projected to be 2011. QC's proposal strikes an appropriate
5 balance among the interests of ratepayers, shareholders and the broader public
6 that is fair and that preserves affordable, efficient, reliable and available service as
7 Washington transitions to a fully competitive market. If the Commission
8 determines that it is required to approve the Dex sale, I recommend that it adopt
9 Qwest's proposal to continue existing imputation for a finite period of time and to
10 do so without further conditions.

11 **III. THE TRANSACTION**

12 **Q. PLEASE PROVIDE AN OVERVIEW OF THE STRUCTURE OF THE**
13 **TRANSACTION**

14 A. The sale will be completed in two stages for a total sale price of $7.05 billion.
15 The first stage of the sale (Dexter) involved all Qwest Dex operations in
16 Colorado, Iowa, Minnesota, Nebraska, New Mexico, North Dakota, and South
17 Dakota for an agreed purchase price of approximately $2.75 billion. The first
18 stage of the sale closed on November 8, 2002.

19 The second stage of the sale (Rodney) involves all Dex operations in Arizona,
20 Idaho, Montana, Oregon, Utah, Washington, and Wyoming for an agreed
21 purchase price of approximately $4.30 billion and is scheduled to close in 2003.
22 The purchase price for Rodney is subject to adjustment based upon the final

[6] Accounting Order, ¶¶ 172, 173.

1 Dexter sales price. The second stage is contingent upon the receipt of any
2 necessary state regulatory approvals (assuming the conditions of such approval do
3 not exceed the terms set forth in the purchase agreement) and on the Buyer's
4 ability to obtain debt financing for the transaction and to secure additional equity
5 financing. The two-stage approach has allowed the Buyer to acquire a portion of
6 the business and to begin operations quickly. It also allowed QCI to receive a
7 portion of the sale proceeds in 2002, in furtherance of the company's debt
8 restructuring and de-levering strategy.

9 **Q. WHAT IS THE RELATIONSHIP BETWEEN QCI, QC AND DEX?**

10 A. QCI is QC's ultimate parent, or holding company. QCI owns QSC, which in turn
11 owns QC. QSC also owns Qwest Dex Holdings, Inc., which in turn owns Dex.
12 Mr. Cummings includes an organizational chart as Exhibit PCC-2 to his
13 testimony. QC is the incumbent local exchange carrier in many parts of the state
14 of Washington and many aspects of its business are regulated by the Commission.
15 Dex is an integrated operation and is not regulated by the Commission. Although
16 QCI indirectly owns both QC and Dex, the two companies are otherwise
17 financially separate and operationally independent.

18 **IV. FINANCIAL NECESSITY OF SELLING DEX**

19 **Q. HAS THE COMMISSION RECOGNIZED THAT THE FINANCIAL**
20 **INTEGRITY OF QC IS AN IMPORTANT PUBLIC INTEREST**
21 **CONSIDERATION?**

1 A. Yes. It has long been recognized that the financial health and viability of a public
2 utility is a primary consideration in the public interest.[7] Under rate of return
3 regulation, this consideration is addressed by assuring that QC is allowed the
4 opportunity to earn a sufficient and fair rate of return.[8]

5 **Q. WHY IS IT IMPORTANT THAT QC HAVE CONTINUING ACCESS TO**
6 **CAPITAL MARKETS?**

7 A. QC needs access to capital markets to ensure that it can continue to meet service
8 demand, provide new services, and maintain a reliable local network. This, in
9 turn, directly benefits the public interest and Washington ratepayers by ensuring
10 their access to a robust local network through a sound local telephone company.

11 **Q. WHAT IS THE RELATIONSHIP BETWEEN QC'S FINANCIAL**
12 **VIABILITY AND QCI'S FINANCIAL CONDITION?**

13 A. All of QCI's subsidiaries, including QC, gain access to equity markets through
14 QCI. In addition, even though QC issues its own debt, its access to and cost of
15 debt is affected by the debt rating of QCI. Mr. Cummings explains the
16 relationship between QCI and QC bond ratings and costs of debt in his testimony.
17 Thus, it is imperative that QCI maintain its financial integrity to the direct benefit
18 of QC and its customers.

19 **Q. WHAT DOES THE SALE OF DEX HAVE TO DO WITH QCI'S**
20 **FINANCIAL VIABILITY?**

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[7] *See* Washington Utilities and Transportation Commission v. Avista Corporation, Docket Nos. UE-996106 and UG-991607, Third Supplemental Order, September 29, 2000, ¶324.

[8] *See* RCW 80.01.040, RCW 80.36.080 and Jewell v. Washington Utilities and Transportation Commission, 90 Wn.2d 775, 777, 585 P.2d 1167 (1978).

1 A. As explained by Mr. Johnson and Mr. Cummings, QCI was required to sell Dex
2 as a critical component of its strategy to preserve and strengthen the financial
3 integrity of QCI. Without the entire sale, bankruptcy is likely.

4 **V. QC'S DIRECTORY-RELATED OBLIGATIONS**

5 **Q. DOES QC HAVE CERTAIN OBLIGATIONS RELATED TO**
6 **DIRECTORIES?**

7 A. Yes, QC does have obligations related to directories under federal and state law.

8 **Q. WHAT ARE QC'S OBLIGATIONS RELATED TO DIRECTORIES**
9 **UNDER FEDERAL LAW?**

10 A. Under Section 222 of the Federal Telecommunications Act of 1996, QC, like
11 every provider of local telecommunications services, is required to provide certain
12 Subscriber List Information ("SLI") to its competitors and to any person who
13 seeks it.[9]

14 In addition, Section 271 of the federal Act imposes certain requirements on QC
15 for access and interconnection that specifically include "[W]hite pages directory
16 listings for customers of the other carrier's telephone exchange service."[10] This
17 requires QC to include its competitors' customer listings in any directories that
18 QC or its affiliates publish.

19 **Q. WHAT OBLIGATIONS DOES QC HAVE RELATED TO DIRECTORIES**
20 **UNDER WASHINGTON LAW?**

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[9] 47 U.S.C. § 222(e).

[10] 47 U.S.C. § 271(c)(2)(B)(viii).

1 A. WAC 480-120-041 requires each telecommunications company to publish in its
2 directory a consumer information guide which details the rights and
3 responsibilities of a utility customer. The guide must describe processes for
4 establishing credit, determining the need and amount for deposits, the procedure
5 whereby a bill becomes delinquent, the steps which must be taken by the utility to
6 disconnect service and the right of the customer to pursue any dispute with the
7 utility first by procedures within the utility and then to the Commission by formal
8 or informal complaint.

9 WAC 480-120-042 requires: (1) a telephone directory to be published regularly
10 (at least once every fifteen months) for each exchange, listing the name, address
11 and telephone number of the subscribers who can be called in that exchange;[11] (2)
12 that subscribers be furnished with the directory or directories that contain listings
13 for all subscribers who can be called toll free from that exchange for no charge;
14 and (3) include the information listing (name and telephone number) of each local
15 exchange company that is providing service in the area covered by the directory.

16 WAC 480-120-251 will replace WAC 480-120-041 and -042 as of July 1, 2003.
17 WAC 480-120-251 details the directory service obligations of local exchange
18 companies and mirrors WAC 480-120-041 and -042, with two additional
19 requirements. WAC 480-120-251 will require the consumer information guide to
20 describe the Washington Telephone Assistance Program and federal enhanced
21 tribal lifeline program, if applicable.

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[11] This obligation does not apply to non-listed or non-published telephone numbers. An address can also be omitted per the subscriber's request.

1 In addition, in Docket Nos. UT-941464, et al., the Commission ordered Qwest:
2 (1) to include all simple listings of telephone subscribers submitted to Qwest by
3 companies serving the same area served by the directory or database, for no
4 charge, as part of Qwest's WAC 480-120-042 obligation; and (2) the database of
5 directory listings be the same that is provided to the company's directory
6 publishing subsidiaries and other directory publishers.

7 Finally, the terms and conditions in Qwest's SGAT and Commission approved
8 resale and interconnection agreements detail how Qwest provides
9 nondiscriminatory access to white pages listings.[12]

10 **Q. HOW DOES QC CURRENTLY FULFILL ITS DIRECTORY**
11 **OBLIGATIONS IN WASHINGTON ARISING UNDER FEDERAL AND**
12 **STATE LAW?**

13 A. QC currently fulfills its directory publishing obligations in three ways:

14 • through a Publishing Agreement with Dex whereby Dex publishes and
15 distributes White Page directories for QC;
16 • through its interconnection agreements with competitive carriers that either
17 extend to directories or facilitate competitors' contact with Dex; and,
18 • by integrating listings from competitive carriers and including them in the
19 information that QC transmits to Dex for publishing.

20 QC will continue to fulfill these obligations in the same way with the Buyer after
21 the sale of the business and assets of Dex. In addition, as described by Mr.
22 Burnett, QC will remain in control of its SLI as it does today, so that customers'

[12] *See* Qwest SGAT Section 10.4, White Pages Directory Listings.

1 privacy expectations associated with non-published or non-listed service are
2 protected.

3 **Q. PLEASE DESCRIBE THE CURRENT DIRECTORY PUBLISHING**
4 **AGREEMENT.**

5 A. As I mentioned, QC today fulfills its obligations to publish and distribute White
6 Pages directories in Washington through a Publishing Agreement with Dex.[13] In
7 this contractual relationship, QC also licenses its SLI to Dex. In turn, Dex
8 compiles, publishes and distributes white page directories. In addition, Dex
9 replaces directories as necessary and re-publishes directories at certain set
10 intervals, usually annually.

11 **Q. HOW WILL THIS PUBLISHING AGREEMENT CHANGE AFTER THE**
12 **SALE?**

13 A. There will essentially be no changes in these directory publishing arrangements
14 after the sale. Buyer has entered into a new Publishing Agreement with QC
15 modeled on the current QC-Dex Publishing Agreement. Buyer has agreed that for
16 the 50-year duration of that Publishing Agreement, it will compile the directories
17 from SLI provided by QC, and publish and distribute White Pages directories in
18 the exchanges served by QC.

19 In addition, the new Publishing Agreement defines the legal obligations of the
20 Buyer to assist QC in fulfilling its obligations. These provisions ensure that QC
21 will continue to be able to satisfy its directory publishing obligations after the sale
22 is completed. First, the new Publishing Agreement contains consultation
23 provisions whereby the Buyer has agreed to consult with QC on any proposed

[13] See data response to ATG-02-040, Attachment H.

1 material changes to a White Pages directory. Second, there are provisions
2 allowing QC to terminate the agreement if it cannot fulfill its obligations through
3 the agreement. Under Section 6.2(b) of the Publishing Agreement, if the Buyer
4 breaches the agreement "in a manner that results in a material and continuing
5 failure to discharge the Publishing Obligation with respect to any Primary
6 Directory," QC may terminate the agreement with respect to that directory and
7 fulfill its regulatory directory publishing obligations itself. Third, per the terms of
8 the Publishing Agreement, the Buyer's successors in interest, if any, will be
9 legally bound to meet the obligations imposed upon the Buyer under the
10 agreement. As a consequence, through the Publishing Agreement, QC has
11 ensured continuous performance and fulfillment of its existing directory
12 publishing obligations without the imposition of new cost considerations.

13 **Q. HOW DOES QC CURRENTLY MANAGE OTHER PROVIDERS'**
14 **INFORMATION IN THE DIRECTORY PUBLISHING CONTEXT?**

15 A. QC integrates the subscriber lists of other providers into its SLI and transmits that
16 information to Dex. Other providers' SLI is not differentiated from its own in any
17 way.

18 **Q. WILL QC CONTINUE TO INTEGRATE OTHER PROVIDERS' SLI**
19 **AFTER THE SALE?**

20 A. Yes. The only difference is that it will be transmitted to a Dex that is under new
21 ownership. In addition, as it does now, the Buyer will also be free to continue to
22 independently negotiate with other providers to obtain their SLI.

23 **VI. THE HISTORY OF DEX IN WASHINGTON**

1 **Q. IN ORDER TO PROVIDE CONTEXT FOR YOUR DISCUSSION OF THE**
2 **DEX TRANSACTIONS, PLEASE PROVIDE A BRIEF HISTORY OF THE**
3 **REGULATORY TREATMENT OF DEX IN WASHINGTON.**

4 A. The relevant history is as follows. QC's and U S WEST Communications, Inc.'s
5 ("U S WEST") predecessors, PNB, Pacific Telephone & Telegraph, the Sunset
6 Telephone and Telegraph Company, and the Home Telephone and Telegraph
7 Company of Spokane ("companies"), published directories for the companies'
8 exchanges in Washington. Between 1883 and 1916, the companies' rates were
9 not subject to cost-of-service regulation. During this period, the companies
10 created and operated the directory publishing business without any contribution
11 from ratepayers, any rate assurance, or any rate oversight by the Commission. By
12 no later than 1921 and through 1984, the companies' regulated accounts included
13 both the expenses and the revenues associated with their directory business
14 operations. The tangible asset investment used to publish the directories was
15 included in the companies' regulated rate base. However, the companies'
16 regulated rate base did not include any amount for the goodwill of the directory
17 advertising business, the right to publish directories for the telephone company or
18 any other form of unrealized going concern value of the directory publishing
19 operation. Further, no return on the value of these intangible assets was allowed
20 under regulation of the companies in Washington.[14]

21 Incident to the divestiture of the Bell System, PNB transferred its directory
22 publishing operations, including employees, tangible assets and working capital,

[14] As Mr. Grate's testimony explains, the Company created the goodwill of the directory advertising business early in its history when its rates were unregulated, competition was prevalent, and its earnings were low. This goodwill existed before ratepayers bore any risk of loss on the predecessor Companies' assets or the financial burden of any of the predecessor Companies' activities. The predecessor Companies' stockholders bore the risk of loss and financial burden of developing the goodwill of the directory advertising business.

1 to its unregulated affiliate, Landmark Publishing Company ("Landmark").[15] In
2 December 1983, PNB applied for approval of the transfers of the tangible assets, a
3 leasehold interest, cash working capital, and publishing agreements between
4 Landmark and PNB. The Commission, while not approving the compensation
5 associated with the transfers or publishing agreements for ratemaking purposes,
6 approved the transfers and publishing agreements pursuant to Chapters 80.12 and
7 80.16 RCW. The Commission reserved the right to determine reasonable
8 revenues and expenses, together with their proper regulatory treatment, in any
9 formal proceeding before the Commission dealing with the results of PNB's
10 operations for ratemaking purposes.[16]

11 In Docket No. UT-950200, U S WEST challenged the Commission's authority to
12 impute directory earnings to U S WEST's regulated operations. The Commission
13 rejected this challenge and ordered imputation of directory earnings in an amount
14 equal to what would have been shown on U S WEST's regulated accounts if the
15 1983 transfer had not occurred. The Commission ordered this as compensation
16 for PNB's transfer of the "valuable regulatory asset" of the directory publishing
17 business for inadequate consideration. The Commission imputed directory

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[15] Since the end of 1983, the directory business has been operated by a subsidiary of Landmark, initially named U S WEST Direct and now called Qwest Dex, Inc. The directory business Qwest Dex, Inc. operates today is different in several significant ways from the business which had previously been operated by PNB. For example, the directory business has expanded into geographical areas where QC does not provide regulated telecommunications local exchange service (Greater Snohomish County directory). Qwest Dex also publishes more than one directory in a given area (Puget Sound "On the Go" directory). Also, Qwest Dex includes CLEC listings and sells advertising to CLEC-served businesses. The directory business has also expanded into new markets, such as the Internet, which do not involve regulated local exchange telecommunications service.

[16] In re Pacific Northwest Bell Telephone Company, Cause No. FR-83-159, Order Granting Application, in Part, (December 30, 1983), at 2; Accounting Order, ¶27.

1 revenue of $79.9 million annually (equivalent to approximately $51 million net
2 income) into U S WEST's regulated accounts in the rate case.[17]

3 On appeal, the Washington Supreme Court upheld the Commission's decision in
4 Docket No. UT-950200, but also held that imputation of directory earnings could
5 end when there was a sale of the business and fair compensation had been
6 received by U S WEST.[18]

7 Following the Supreme Court decision, U S WEST filed a request to end
8 imputation in Docket No. UT-980948. U S WEST introduced evidence of the
9 value of the directory business as it had existed in 1983 and evidence that the
10 cumulative publishing fees received by PNB and imputed directory earnings
11 included in rates of PNB and U S WEST since divestiture exceeded that value
12 plus reasonable interest since 1983. The Commission denied U S WEST's
13 request, holding that the directory publishing "function" had never been
14 permanently transferred to Landmark from PNB in 1983 or at any subsequent
15 time by it or any successor company. The Commission held that it had only been
16 asked in 1983 and later cases to approve certain publishing agreements and
17 transfers of certain tangible assets and cash.[19]

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[17] Washington Utilities and Transportation Commission v. U S WEST Communications, Inc., Docket No. UT-950200, Fifteenth Supplemental Order (April 11, 1996). In addition, in Docket No. UT-970766, the Company's rates were adjusted based on updated earnings information. This case did not change the mechanism of imputation, but increased the annual revenue imputation from $80 million to $85 million (equivalent to $54 million in annual directory earnings imputation).

[18] U S WEST Communications, Inc. v. Utilities and Transportation Commission, 134 Wn.2d 48, 102, 949 P.2d 1337 (1997).

[19] Accounting Order, ¶¶ 169, 176-177

1 Q. **DID PNB'S DIRECTORY PUBLISHING OPERATIONS REDUCE RATES**
2 **FOR TELEPHONE SERVICE PRIOR TO 1984?**

3 A. As Mr. Grate testifies, for at least 60 years prior to the 1984, directory advertising
4 revenues in the computation of rates for telephone services caused those rates to
5 be lower than they would have been absent the revenues.

6 Q. **PLEASE PROVIDE A BRIEF HISTORY OF DIRECTORY IMPUTATION**
7 **IN WASHINGTON.**

8 A. As previously stated, the Commission, while not approving the compensation
9 associated with the transfers or publishing agreements for ratemaking purposes,
10 approved the transfers and publishing agreements pursuant to Chapters 80.12 and
11 80.16 RCW in 1983. The Commission reserved the right to determine reasonable
12 revenues and expenses, together with their proper regulatory treatment, in any
13 formal proceeding before the Commission dealing with the results of PNB's
14 operations for ratemaking purposes. Rates set in Docket No. U-82-19 were in
15 effect prior to the 1984 transfer through May 31, 1987.

16 Subsequently, in Docket No. U-85-52, there were still significant directory
17 revenues included in the revenue requirement, primarily from publishing fees paid
18 by Dex (U S WEST Direct at that time) to the local exchange company. These
19 revenues caused the rates paid by Washington ratepayers to be lower than they
20 would otherwise have been. However, most of the cost of producing directories
21 was incurred by Dex, rather than by U S WEST in 1985 and, therefore, not included
22 in the test year revenue requirement

23 In the Second Supplemental Order, Docket No. U-86-156, the Commission
24 treated Directory as a regulatory asset and determined that the public interest

1 requires the full reasonable value of directory publishing be available to PNB for
2 ratemaking purposes. It found that the then-current publishing fee was not
3 determined in an arms-length transaction with each party seeking to maximize
4 return, but deferred adjusting the value until a later time.[20]

5 In February 1989, the Commission filed a complaint against PNB alleging
6 excessive earnings. As part of a settlement of the rate complaint and adoption of
7 an Alternative Form of Regulation ("AFOR"), PNB agreed by stipulation to
8 imputation of a portion of Yellow Pages income as fulfilling a part of the
9 Company's revenue requirement for regulated services.[21] As a result of the
10 stipulation, the Company imputed $39,900,000 in directory revenues at the
11 commencement of the plan.

12 The stipulation included a provision that income exceeding a predefined benchmark
13 would be shared between ratepayers and the company's owners according to a
14 specified formula ("sharing plan"), and that the Commission would distribute the
15 ratepayers' share among specified alternatives. An updated directory imputation was
16 included in the calculation of income used in the sharing formula for each year
17 during the plan. Sharing actually occurred for years 1990 through 1993 under this
18 plan. However the Company had no excess revenue under the sharing plan in 1994
19 and 1995; therefore no sharing occurred.

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[20] The Commission ruled that the appropriate compensation for PNB for allowing its affiliate to publish directories would be determined in the next Company general rate case. *See* Docket No. U-86-156, Second Supplemental Order at pp. 13-14, and Docket No. UT-950200, Fifteenth Supplemental Order at p. 32.

[21] Washington Utilities and Transportation Commission v. Pacific Northwest Bell Telephone Company, Docket Nos. U-89-2698-F and U-89-3245-P, Fourth Supplemental Order Appendix A at pp. 14-17 (January 16, 1990).

1 On February 17, 1995, the Company filed a general rate case in Docket No. UT-
2 950200. In that case the imputation of directory revenues was increased to
3 $79,900,000. Rates resulting from this docket were in effect between May 1,
4 1997 and January 31, 1998. Finally, in Docket No. UT-970766, effective
5 February 1, 1998, the WUTC ordered an imputation of $85,223,468, using a 1996
6 test year. This was the last Commission order that included a directory
7 imputation calculation.

8 **VII. COMMISSION ACTION REQUESTED BY QWEST IN THIS DOCKET**

9 **Q. IS QC SEEKING TO INCREASE ITS RATES AT THIS TIME AS A**
10 **RESULT OF THE DEX SALE?**

11 A. No. QC is not asking to increase its rates at this time based upon the Dex sale.
12 Therefore, the sale need not affect current levels of directory revenue imputation.
13 Under QC's proposal, Washington ratepayers will continue to receive the current
14 value of the existing imputation embedded in rates until the ratepayer interest in
15 the sale proceeds is satisfied in year 2011.

16 **Q. PLEASE EXPLAIN HOW RATEPAYERS WILL CONTINUE TO**
17 **RECEIVE THE CURRENT VALUE OF THE EXISTING IMPUTATION**
18 **EMBEDDED IN RATES UNTIL 2011.**

19 A. Ratepayers will receive the current value of the existing imputation of
20 $103,370,843 as an adjustment to revenues for the regulated results of operation
21 each year until 2011. The adjustment will be in accordance with the imputation
22 methodology employed since 1989 and detailed in the settlement agreement.[22]
23 The adjustment to revenues is included in the results of operations reported by QC

[22] *Id.*

1 to the Commission on a quarterly basis. Once the ratepayer interest is satisfied in
2 2011, the imputation adjustment will end.
3

4 **Q. HOW WILL THE RATEPAYER RECEIVE THE BENEFIT OF THIS**
5 **ADJUSTMENT?**

6 A. The ratepayer will receive the benefit of this adjustment in the exact same manner
7 as they do today. The adjustment is utilized as part of the calculation of the
8 Company annual intrastate results in the determination of its actual rate of return.
9 Hence, the Dex sale does not result in a rate change. The value of imputation is
10 only relevant when the Company's results of operations are formally reviewed as
11 part of a rate case or earnings investigation. Under the merger settlement
12 agreement, such a review will not occur prior to January 1, 2004. Under QC's
13 proposal, should a review commence between 2004 and 2011, the amount of
14 annual imputation to QC intrastate revenues will be $103,370,843. This is an
15 increase of $18,147,375 or 21% since the Commission last updated the imputation
16 value in Docket No. UT-970766.[23]

17

18 **Q. WHAT IF PRIOR TO 2011, THE COMPANY'S RATES ARE NO**
19 **LONGER SUBJECT TO REGULATION BECAUSE ITS RETAIL**
20 **SERVICES HAVE ALL BEEN COMPETITIVELY CLASSIFIED?**

21 A. At the point in time all of the Company's retail services have been competitively
22 classified, which enables the company to price its services according to the
23 competitive market, imputation is essentially terminated since the Company's
24 retail rates are no longer set through rate of return regulation. Hence, the

[23] The value of imputation in Docket No. UT-970766 was $85,223,468 in revenue.

1 ratepayer interest associated with the Dex sale will be fully satisfied when rates
2 no longer require the support of the imputation of directory revenues.
3
4 **Q. DOES THE DEX SALE REQUIRE COMMISSION APPROVAL?**
5 A. No. QC does not believe the Dex sale is subject to Chapters 80.12 RCW or 480-
6 143 WAC. RCW 80.12.020 requires pre-approval of any sale, lease, assignment
7 or other disposal by a public service company or any of its franchises, properties
8 or facilities <u>which are necessary or useful in the performance of its duties to the</u>
9 <u>public</u>. WAC 480-143-480(4) clarifies that, for purposes of RCW 80.12.020,
10 property is not "necessary or useful" if it is excluded from the public service
11 company's rate base.

12 QC does not suggest that this lack of authority changes the Commission's rulings
13 in the prior dockets associated with directory revenues and/or earnings and the
14 imputation of those revenues for ratemaking purposes. QC's interpretation of the
15 Accounting Order (which held that QC retained the right to publish directories
16 and the goodwill associated with the directory advertising business) is that no
17 approval is required under Washington law for the sale or transfer of this asset to
18 the Buyer. The goodwill associated with the directory advertising business in
19 Washington and the right to publish a directory on behalf of Qwest have always
20 been excluded from the rate base of PT&T, PNB, U S WEST and QC. In fact,
21 there is no asset of any kind on QC's Washington regulated asset accounts which
22 pertains to the directory business. As such, the sale of goodwill to the Buyer and
23 the right to publish directories on behalf of Qwest do not require Commission
24 approval, even if the transferor is QC.

1 As for the remaining directory business assets, since QC understands that the
2 Commission already approved (in 1983) the transfer of those other assets, no
3 approval is necessary for the transfer to occur as a part of the Dex sale.

4 **Q. ARE THE COMMISSION'S AFFILIATED INTEREST STATUTES AND**
5 **RULES IMPLICATED BY THIS SALE?**

6 A. RCW 80.16.020 requires QC to file a copy or summary of any contract or
7 arrangement for the furnishing, purchase, sale, lease or exchange of any property,
8 right or thing between itself and an affiliated interest. The Commission may
9 believe that the following two provisions of the Dex sale agreement are subject to
10 Chapters 80.16 RCW and 480-146 WAC.

11 a. Pass-through transfer to GPP LLC. The structure of the Dex sale will
12 require the transfer of the Rodney assets from Qwest Dex, Inc. to its
13 newly-created affiliate, GPP LLC, immediately prior to closing. At
14 closing, the ownership of GPP LLC will be transferred from Qwest
15 Dex, Inc. to the Buyer. In substance, this is a sale or transfer to a non-
16 Qwest entity, the Buyer, which uses a Qwest affiliate as a conduit for a
17 very brief period of time. In substance, this is not an affiliated interest
18 transaction between QC and GPP LLC. To the extent that the
19 Commission finds the Dex sale is resulting in a transfer of a QC asset,
20 QC would anticipate that the Commission may also therefore find the
21 Dex sale to involve an affiliated interest transaction since that asset is,
22 albeit only for an instant, arguably moving from QC to another of
23 QC's affiliates (GPP LLC).

1 b. *Publishing and related agreements.* Under RCW 80.16.010, the
2 statutory definition of "affiliated interest" includes every corporation
3 or person with which the public service company has a management or
4 service contract. The meaning and breadth of "management or service
5 contract" are unclear on the face of the statute. The Dex sale
6 agreements include a Publishing Agreement and a Public Pay Station
7 Agreement, both of which, depending on the scope of "management or
8 service contract" in RCW 80.16.010, may arguably give rise to the
9 notice requirements under RCW 80.16.020.

10 **Q. WHAT SHOULD THE COMMISSION ORDER IF IT BELIEVES IT**
11 **MUST ADDRESS THE ABOVE TWO PROVISIONS AS PART OF THE**
12 **DEX SALE AGREEMENT?**

13 A. The Commission should approve the pass-through transfer to GPP LLC as a
14 temporary transfer until such time the sale closes and should not impose any
15 conditions on the approval of this temporary transfer that would defeat the
16 purpose of the transaction or impose any new liabilities.

17 The Commission should also find that the Publishing Agreement and the Public
18 Pay Station Agreement are not subject to the notice requirements under RCW
19 80.16.020 and that this arrangement does not require future adjustments for rate
20 making purposes under RCW 80.16.010.[24]

21
22

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[24] In the October 9, 2002 Notice of Opportunity to File Written Comments in Docket No. A-021178, the Commission agreed that "management or service contracts" needed to be further defined. RCW 80.16.010 was first enacted in 1933 and last modified in 1961. This subject was also discussed at the August 8, 2002 workshop where the industry and the Commission Staff considered if legislation should be introduced to clarify or eliminate this statute provision.

1 **Q. SHOULD THE COMMISSION ADDRESS THE FINANCIAL**
2 **DISPOSITION OF THE DEX SALE?**

3 A. Yes. In the Accounting Order, the Commission recognized that future events
4 might require a reexamination of certain aspects of the financial relationship
5 between QC and Dex.[25] In addition, certain provisions of the Rodney purchase
6 agreement require QCI to quantify any regulatory impacts associated with the
7 transaction.[26] Indeed, given QCI's purposes for consummating the Dex sale, the
8 Rodney sale may not close if the associated regulatory impacts exceed the
9 threshold set forth in the purchase agreement. Thus, the Commission should
10 address the financial consequences of the Dex sale.

11 **Q. HOW DOES QC PROPOSE THE COMMISSION ADDRESS THE**
12 **FINANCIAL DISPOSITION OF THE DEX SALE?**

13 A. The Commission should issue an order that continues imputation until the
14 ratepayer interest in the sale proceeds is satisfied. The order should strike a
15 balance among the interests of ratepayers, shareholders and the broader public
16 that is fair, that preserves affordable, efficient, reliable service and that will not
17 defeat the critical purpose of stabilizing QCI's financial condition. I will review
18 the financial value associated with the Dex business in Washington prior to
19 discussing the details of QC's proposal. Then, I will explain how continuation of
20 directory imputation for a finite period of time can be utilized to satisfy the
21 ratepayer interest.

22

[25] Accounting Order, ¶¶ 175, 179, 180.

[26] See Purchase Agreement Between Qwest Dex, Qwest Services Corporation, Qwest Communications International Inc. and Dex Holdings LLC (Rodney) at § 5.4 (b)(ii). Pages WA 000597-000598 of ancillary documents previously produced in this docket.

1 2 **VII. THE FINANCIAL VALUE ASSOCIATED WITH THE DEX BUSINESS IN WASHINGTON**

3 4 **Q. WHAT IS THE ESTIMATED NET BOOK VALUE OF THE DEX BUSINESS INTEREST TO BE SOLD?**

5 A. An accurate estimate of the net book value for the Dex business interest to be sold
6 and the final sales price remains impracticable at this time. However, Qwest has
7 prepared a preliminary estimate of the gain on the sale of Dex and a computation
8 of the portion of that estimated gain related to Washington. Qwest's preliminary
9 estimate is provided in Confidential Exhibit TAJ-2C.

10 The gain estimate assumes a sales price of $7.05 billion. The actual sales price
11 will not be known until after a computation of the Post-Closing Working Capital
12 Purchase Price Adjustment set out in Paragraph 2.9 of the Rodney Purchase
13 Agreement and the Buyer's and Seller's agreement on that adjustment.

14 The preliminary gain calculation relies on estimates of net book value and
15 transaction costs. Neither the actual net book value at closing nor the actual
16 transaction costs will be known until after closing.

17

18 19 **Q. HOW DID QWEST COMPUTE THE ESTIMATED GAIN FROM THE SALE OF DEX?**

20 A. Understanding that a gain calculation would be necessary to in order to address an
21 appropriate balancing of ratepayer and shareholder interests in the directory
22 business, Qwest prepared a preliminary estimate of the gain from the sale,
23 provided as Confidential Exhibit TAJ-2C. This gain calculation, as a preliminary

1 matter, recognizes that the sales proceeds include not only the current value of the
2 directory publishing business that was transferred to an unregulated affiliate in
3 1984. The sale also includes other lines of business that were developed in
4 unregulated subsidiaries separate from Qwest's local exchange business and its
5 ratepayers. In particular, I refer to the portion of the sale connected with 1) LCI;
6 2) the NewVentures/Internet lines of business; 3) secondary directories; and 4);
7 non-Qwest listings in primary directories. I explain each of these in detail below.
8 Identifying and removing that portion of the gain associated with these items
9 leaves the gain associated with that portion of the sale that is arguably subject to
10 sharing between ratepayers and customers, recognizing the balancing of interests
11 required in this exercise. The gain calculation then determines the portion of this
12 remaining gain allocable to the Washington jurisdiction. Using this figure, as set
13 forth in Confidential Exhibit TAJ-2C, I then propose a specific disposition of this
14 gain that fairly and effectively balances ratepayer and shareholder interests.

15 **Q. WHY DO THE RATEPAYERS HAVE A CLAIM OVER ONLY A**
16 **PORTION OF THE SALE PROCEEDS?**

17 A. Any ratepayer interest in the value of the directory publishing business is based
18 on the Commission's recognition that, prior to 1984, publishing revenues and
19 expenses were a part of Qwest's (the Company's) results of operation for
20 regulatory purposes, which the Commission described as a "regulatory asset" of
21 the Company. Since 1989 in Washington, directory revenue imputation has
22 served as a mechanism by which the Company's operating results are restated to
23 reflect earnings as if the Yellow Pages directory business had not been transferred
24 to an affiliate in 1984. As this Commission has held, "[I]mputation is the
25 ascription or attribution of income, not recorded otherwise on any of USWC's

1 accounts, implemented by an accounting adjustment. It revises USWC's earnings
2 for regulatory purposes (that is, for setting rates), to reflect a *portion* [emphasis
3 added] of affiliate U S WEST DEX's earnings."[27]

4 Identifying and removing that portion of the gain related to the business that was
5 not part of Qwest's results of operations prior to the 1984 transfer leaves the
6 remaining gain that is arguably subject to sharing between ratepayers and
7 customers, recognizing the balancing of interests required in this exercise. The
8 gain calculation then determines the portion of this remaining gain allocable to the
9 Washington jurisdiction. Using this figure, as set forth in Confidential Exhibit
10 TAJ-2C, I then propose a specific disposition of this gain that strikes an
11 appropriate balance among the ratepayers, shareholders and the broader public
12 that is fair and that preserves affordable, efficient, reliable and available service.

13 **Q. WHAT IS LCI?**

14 A. LCI was a subsidiary of QCI before it merged with U S WEST, Inc. (USWC's
15 parent corporation) in June of 2000. LCI's financial results have never been
16 imputed into regulated results of operations or a cost of service calculation in any
17 state. Therefore it has no relationship to the directory publishing business and
18 generates no publishing revenues. Furthermore, it is highly probable there is no
19 gain on the Dex sale attributable to LCI; however, if there were it is not
20 attributable to Washington regulated operations.

[27] Accounting Order, ¶ 172.

1 **Q. WHY ARE THE NEW VENTURES/INTERNET LINES OF BUSINESS**
2 **EXCLUDED?**
3 A. The NewVentures/Internet lines of business are what remains of the former
4 Marketing Resources Company (MRC). MRC was a separate unregulated
5 subsidiary created shortly after divestiture. It was never a part of Washington's
6 regulated results, nor was it part of the directory publishing affiliate, U S WEST
7 Direct. In 1991, U S WEST Direct and MRC each became separate operating
8 divisions of U S WEST Marketing Resources Group, which eventually became
9 Qwest Dex. The NewVentures/Internet business has generated losses throughout
10 most of its history. Even after MRC and U S WEST Direct were merged into one
11 company, separate financial reporting was maintained for regulatory purposes.
12 None of its assets, revenues or expenses has been included in the computation of
13 directory imputation in any state. Hence, the portion of the gain on the Dex sale
14 attributable the NewVentures/Internet line of business is not attributable to
15 Washington regulated operations.

16 **Q. WHAT ARE SECONDARY DIRECTORIES?**
17 A. Secondary directories are those directories that Dex publishes of its own accord,
18 rather than through a contractual obligation with Qwest. These directories are
19 published at Dex's discretion in order to compete more effectively in the
20 advertising market and to maximize advertising sales by providing directories that
21 allow advertisers to focus their advertising message to a specific geographic scope
22 which best represents the advertisers' customer base. Secondary directories serve
23 as a focused advertising medium for both consumers and advertisers. Secondary
24 directories were not published when the directory operations were part of the
25 regulated operations in Washington. In fact, Dex did not start publishing

1 secondary directories in Washington until more than a decade after the Yellow
2 Pages business was established as a separate subsidiary in 1984[28], therefore the
3 portion of the gain attributable to secondary directories is not attributable to
4 Washington regulated operations.

5 **Q. PLEASE DESCRIBE THE SECONDARY DIRECTORIES DEX**
6 **PUBLISHES IN WASHINGTON.**

7 A. Dex publishes two Secondary Directories in Washington. The first directory
8 covers greater Snohomish County, which includes listings in exchanges totally
9 outside Qwest's service area that are primarily served by Verizon.[29] The other
10 Secondary Directory published by Dex is the "on-the-go" directory that covers the
11 greater Puget Sound area from Snohomish County to Pierce County and includes
12 only business listings. The Snohomish County directory generally does not
13 include listings for, nor is it delivered to Qwest customers.[30] The On-the-Go
14 directory is a specialty directory that targets a unique market of users that are
15 primarily wireless phone users. The area covered by these directories and the
16 target advertising market further indicates that the gain from sale of these
17 directories is not attributable to regulated operations.

18 **Q. WHAT ARE PRIMARY DIRECTORIES?**

[28] The Greater Snohomish County directory was first published by Dex in 1994 and the Greater Puget Sound On-the-Go directory was first published in 1998.

[29] The exchanges are Alderwood Manor, Arlington, Bothell, Brier, Camano Island, Darrington, Edmonds, Everett, Gold Bar, Granite Falls, Index, Kenmore, Lake Stevens, Lakewood, Lynnwood, Maltby, Marysville, Mill Creek, Monroe, Mountlake Terrace, Mukilteo, Skykomish, Snohomish, Stanwood, Startup, Stevens Pass, Sultan, Woodinville, and Woodway.

[30] *See* excerpt of Qwest's response to Data Request ATG 01-016S1, attached as Confidential Exhibit TAJ-3C.

1 A. Primary Directories are those directories published on behalf of QC to meet its
2 Washington regulatory obligations. They include Qwest, independent local
3 exchange company ("ILEC") and CLEC listings within Qwest exchanges.

4 **Q. HOW DID QWEST APPORTION LISTINGS IN THE PRIMARY**
5 **DIRECTORIES BETWEEN QWEST AND NON-QWEST LISTINGS?**

6 A. Qwest apportioned listings in the Primary Directories between Qwest and non-
7 Qwest listings. Non-Qwest listings make up 25.6% of all the listings in Qwest
8 Primary Directories across the region and 27.5% of the listings in Qwest Primary
9 Directories in Washington.[31] The majority (90.2%) of the non-Qwest listings are
10 ILEC listings expanding the scope of Dex publishing activities beyond QC and its
11 customers.[32] Like Secondary Directories they are published at Dex's discretion in
12 order to compete more effectively in the advertising market and to maximize
13 advertising sales by providing directories that allow advertisers to focus their
14 advertising message to a specific geographic scope which best represents their
15 customer base. They serve as a focused advertising medium for both consumers
16 and advertisers.

17 CLEC listings currently make up approximately 9.8% of non-Qwest listings and
18 did not commence until approximately 1996. When the Commission adopted the
19 stipulation agreement which included imputation, CLEC listings were not a
20 consideration since they did not exist. The inclusion of CLEC listings is a
21 requirement of the Commission Order in Docket Nos. UT-941464, et al., and

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[31] *See* Confidential Exhibit TAJ-4C, Qwest's response to data request ATG-01-016S1, 2001 Listings by Directory. Approximately 708,548 (27.5%) of the listings in Washington Primary Directories are non-Qwest listings.

[32] *Id.* As of November, 2002, there were 69,851 CLEC listings in Washington.

1 Section 271 of the Federal Telecommunications Act of 1996. Hence, the portion
2 of the gain attributable to CLEC non-Qwest listings (approximately 6.9%) should
3 not be attributable to Washington regulated operations.

4 **Q. SO YOUR APPORTIONMENT ESSENTIALLY CALCULATES THE**
5 **PROPORTION OF WHITE PAGES LISTINGS THAT ARE NOT QWEST**
6 **CUSTOMERS AND REMOVES THAT SAME PROPORTION OF THE**
7 **OVERALL ESTIMATED GAIN ON THE DIRECTORY BUSINESS, IS**
8 **THAT CORRECT?**

9 A. Actually, the proportion of white page listings that are not Qwest customers is
10 used on a directory by directory basis, to determine the proportion of Qwest and
11 non-Qwest revenues by directory. The percentage of Qwest and non-Qwest
12 revenues is then used to allocate the estimated gain on the directory business.

13 **Q. HOW DOES THIS DIFFER FROM USING THE PERCENTAGE OF**
14 **LISTINGS TO ALLOCATE THE GAIN?**

15 A. In Washington, approximately 72.5% of the white page listings are Qwest
16 subscriber listings and 27.5% are non-Qwest listings (other ILEC and CLEC
17 listings). The result of allocating revenues on an individual directory basis results
18 in 26.4% rather than 27.5% of the gain from Washington primary directories
19 being removed.

20 **Q. WHY DOES QWEST APPORTION THE VALUE OF THE YELLOW**
21 **PAGES PUBLISHING BUSINESS BASED ON THE PROPORTION OF**
22 **QWEST TO NON-QWEST WHITE PAGES LISTINGS?**

23 A. There are two reasons. First, Qwest believes that ratepayer benefit from yellow
24 pages publishing ought to be calculated in a manner that is consistent with the

1 environment that existed when the publishing business was assigned to the local
2 exchange company and imputation was first instituted. At that time, the rationale
3 was that the value of the publishing business had been created in part due to the
4 local exchange company's de facto monopoly position in the provision of local
5 exchange service. The value of the yellow pages business at that time could
6 arguably be attributed, at least in part, to the fact that all of the local exchange
7 company's customers would see the ads and most, if not all, of the advertisers
8 were local exchange company customers. When the Company operated directory
9 operations, it delivered its directories to its own customers rather than to everyone
10 located within the geographic area covered by each directory. Thus, the
11 Commission attributed value to the association of the yellow pages
12 advertisements with the incumbent LEC's name, when the incumbent LEC served
13 virtually all of the subscribers.

14 The current environment is significantly different. Many of the "eyes" that now
15 see the yellow pages advertisements are not Qwest subscribers, but are
16 subscribers of independent LECs, CLECs, or wireless providers. To retain the
17 consistent application of the attribution of value to local exchange subscribers of
18 the incumbent company, it is now necessary to apportion that value between
19 Qwest and non-Qwest listings because many listings in the white pages are no
20 longer Qwest listings. Second, the additional revenues that are earned by Dex as
21 the result of Dex publishing ILEC listings and delivering directories to non-Qwest
22 customers are not due to Qwest regulated operations or Qwest ratepayers and the
23 gain from this portion of the business are not attributable to Washington regulated
24 operations.

1 **Q. WHAT PERCENTAGE OF THE GAIN REMAINS AFTER REMOVING**
2 **THE GAIN ASSOCIATED WITH LCI, NEW VENTURES/INTERNET,**
3 **SECONDARY DIRECTORIES AND NON-QWEST PRIMARY**
4 **DIRECTORIES?**
5 A. The remaining gain from Qwest Primary Directories is 70.7% of the total.

6 **Q. HOW DOES QWEST ALLOCATE THE GAIN TO WASHINGTON?**
7 A. Washington revenues from Qwest primary directories is 17.44% of the total
8 revenues from Qwest primary directories in the entire 14-state region, thus
9 17.44% of the remaining gain is allocated to Washington to be considered by this
10 Commission for disposition between ratepayers and investors.

11 **VIII. QWEST PROPOSAL FOR DISPOSITION OF THE GAIN**

12 **Q. WHAT SHARE OF THE AFTER-TAX GAIN DOES QWEST CONSIDER**
13 **APPROPRIATE TO ADEQUATELY ADDRESS THE RATEPAYER**
14 **INTEREST IN THE SALE PROCEEDS?**
15 A. As Mr. Grate has demonstrated in his testimony, Washington ratepayers are
16 entitled to no more than 50% of the gain realized from the disposition of the
17 tangible assets under the guidelines established by the *Democratic Central*
18 *Committee*. Qwest, however, is willing to share 50% of the after-tax gain
19 associated with primary Qwest listings as the appropriate share to be allocated to
20 ratepayers for continued imputation at the current level. The effect of applying
21 continued imputation to the ratepayer portion of the gain as proposed by Qwest is
22 portrayed at Confidential Exhibit TAJ-4C.

1 This proposal is balanced and fair because it favors the ratepayers by allocating to
2 them a portion of the gain that is greater than the share of risk of loss on assets
3 that the ratepayer has borne as demonstrated by Mr. Grate's testimony.
4 Ratepayers have never borne any of the financial burden of the Company's
5 directory publishing and advertising activities, only the risk of loss on the tangible
6 assets that supported the Company's directory publishing and advertising
7 activities for a maximum of 60 out of the 120 years.[33] Thus ratepayers should
8 receive no more than 50% of the gain realized from the disposition of the tangible
9 assets.

10 The vast majority of the gain on the sale of Dex is derived from the goodwill the
11 business has built up over a period of more than 100 years of directory advertising
12 sales. Ratepayers bore none of the cost of creating this goodwill and have borne
13 none of the risk of loss of this goodwill. Hence, they are not entitled to the gain
14 attributable to the goodwill of the business. However, in the interest of balancing
15 ratepayer and shareholder interests, Qwest is proposing sharing 50% of all the
16 gain - not distinguishing between the gain attributable to tangible assets, as
17 opposed to goodwill - as set forth in Confidential Exhibit TAJ-4C.

18 **Q. WHAT VALUE DO RATEPAYERS CURRENTLY RECEIVE FROM THE**
19 **IMPUTATION THE COMMISSION ORDERED IN QC'S LAST RATE**
20 **CASE?**

21 A. In the Company's most recent rate case, Docket No. UT-970766, the Commission
22 imputed $85,223,468 of Dex revenues to the Company's 1996 test year.[34] By

[33] However, Mr. Grate points out that this 60-year period was less risky than the preceding and following periods during which the Company bore the risk of loss.

[34] Washington Utilities and Transportation Commission v. U S WEST Communications, Inc., Docket No. UT-970766, Tenth Supplemental Order; Commission Decision and Order Rejecting Tariff Filings;

1 virtue of this imputation, the Company's pre-tax cost-of-service was $85,223,468
2 less than it would have been without the imputation.

3 **Q. HOW DOES QWEST'S PROPOSAL STRIKE A FAIR BALANCE**
4 **AMONG THE INTERESTS OF RATEPAYERS, SHAREHOLDERS AND**
5 **THE BROADER PUBLIC?**

6 A. Qwest's proposal strikes a fair balance among the interest of ratepayers,
7 shareholders and the broader public because:

8 - It does not result in a rate change;
9 - It captures and preserves the benefit for ratepayers without any further action
10 on the Commission's part; and
11 - It allows QCI to retain the proceeds from the sale to meet its financial
12 obligations, which will enable it to further de-lever its balance sheet,
13 necessary to avoid bankruptcy and to preserve efficient and reliable service.

14 **Q. ARE THERE ANY OTHER FACTORS THAT THE COMMISSION**
15 **SHOULD CONSIDER IN DETERMINING WHETHER TO APPROVE**
16 **THIS TRANSACTION AND WHAT RATEPAYER BENEFIT IS**
17 **APPROPRIATE?**

18 A. Yes, there are at least two additional compelling factors. First, the Commission
19 should consider the changed telecommunications environment and the difference
20 in market conditions between where the industry finds itself in 2003 and where
21 the industry was when imputation was deemed proper. Second, the Commission
22 should also consider how the transaction allows Qwest and its ratepayers to avoid
23 certain future risks and uncertainty. I will discuss each of these considerations
24 separately.

Requiring Refiling (January 16, 1998), §III D. Table – Results of Operations, Line 30. $55,284,464 x conversion factor of 1.568135.

1 **Q. WHY SHOULD THE COMMISSION CONSIDER THE CHANGED**
2 **TELECOMMUNICATIONS ENVIRONMENT AND MARKET**
3 **CONDITIONS WHEN IT MAKES ITS DECISION?**

4 A. The Commission has recognized that ending imputation might be justified based
5 on changed circumstances, separate and apart from the sale transaction that is
6 presented in this case.[35] It is unclear what the Commission or the parties might
7 have had in mind that would constitute "changed circumstances" when that
8 language was first employed, but by anyone's measure, circumstances have
9 certainly changed since divestiture in 1983, and perhaps even more dramatically
10 since the last U S WEST rate case in 1997. The Commission's regulatory duties
11 leave it well aware of changed circumstances that have recently occurred and that
12 exist at this time.

13 **Q. HOW HAVE THE TELECOMMUNICATIONS ENVIRONMENT AND**
14 **MARKET CONDITIONS CHANGED?**

15 A. During the 1997-2000 period, the stock market soared, new companies were
16 created and went public seemingly overnight, and local telecommunications
17 competition began to take hold in earnest. The Commission issued a number of
18 cost docket orders during that time period establishing rates to enable local
19 competition on a resale and facilities basis, and made significant progress during
20 that time on the issues in Qwest's SGAT/271 proceeding, establishing terms and
21 conditions for local competition in Qwest's historic operating territory.

22 Since mid-2000, there has been a significant economic downturn suffered by the
23 state in general and by the telecommunications industry specifically. Some
24 carriers have declared bankruptcy and many more have simply ceased doing

[35] Accounting Order, ¶19.

1 business. However, at the same time, competition remains robust – Qwest is no
2 longer "the phone company," with the implications of a monopoly carried by that
3 phrase. Qwest faces local competition from wireless carriers, CLECs, and cable
4 companies. To the extent that the imputation of directory revenues has
5 historically been associated with flowing the benefit of the publishing operation to
6 the ratepayers, the Commission may note that many companies now have
7 ratepayers side by side with Qwest. Customers have choices for local service.

8 Under the competitive and economic circumstances in the industry alone, the
9 Commission could independently decide that imputation is no longer appropriate.

10 **Q. HASN'T THE CHANGED TELECOMMUNICATIONS ENVIRONMENT**
11 **AND MARKET CONDITIONS HURT THE GROWTH OF**
12 **COMPETITION IN WASHINGTON?**

13 A. No. It has affected the number of alternative carriers offering service in
14 Washington but it has not effected the growth in lines served by alternative
15 carriers. Confidential Exhibit TAJ-5C demonstrates the growth in unbundled
16 services, resale and UNEs that has occurred over the last couple of years. It
17 indicates a 224% growth in unbundled loops, a 284% growth in ported numbers
18 and a 152% growth in UNE-P. Customers who have service from competitive
19 providers no longer receive the benefit of imputation since the prices for these
20 wholesale services do not include an imputation calculation. As more customers
21 have a choice of telecommunications providers and as more customers obtain
22 service priced by the market (as opposed to prices resulting from rate regulation),
23 the benefit of and rationale for imputation is diminished.

1 **Q. IF THE BENEFIT OF AND RATIONALE FOR IMPUTATION IS**
2 **DIMINISHED UNDER MARKET BASED PRICING, SHOULDN'T THE**
3 **COMMISSION DISPOSE OF THE RATEPAYER INTEREST**
4 **IMMEDIATELY WHILE THERE IS STILL SOME VALUE?**

5 A. No. The Commission decision to adopt imputation of directory revenues was
6 intended to protect the ratepayer from any harm associated with the transfer of the
7 business to an affiliated company. The ratepayer is not harmed by the termination
8 of imputation when competitive alternatives exist that allow the customers to
9 choose among multiple providers for the telecommunications services they desire.

10 However, although local markets in Washington are open to competition,
11 competitors may not yet have entered all markets and all consumers may not yet
12 be enjoying the benefits of a fully competitive market. The eight year period is a
13 reasonable transition which allows the Commission to balance the interest of the
14 ratepayers, shareholders, and the broader public by adopting a resolution of
15 imputation that is fair, that preserves affordable service for those ratepayers that
16 do not yet have choice, that ensures continued efficient and reliable service for
17 Qwest ratepayers and that phases out imputation as customers gain a choice of
18 alternative providers.

19

20 **Q. WHAT DO YOU MEAN WHEN YOU SUGGEST THAT RESOLUTION**
21 **OF THIS TRANSACTION ALLOWS QWEST AND ITS RATEPAYERS**
22 **TO AVOID FUTURE RISK AND UNCERTAINTY?**

23 A. Another factor the Commission should consider is that ratepayers have received
24 the benefit of imputation since 1984, and have received the benefit of the growth
25 in that business through increased imputation. During that time, as now, Qwest
26 has been free to sell the business. The fact that it did not allowed ratepayers to

1 enjoy growth in the business that they would not have enjoyed otherwise.
2 However, the Commission must bear in mind that continued increased growth in
3 the future is by no means assured as discussed in the direct testimony of William
4 Kennard on behalf of Dex Holdings, LLC.[36] A sale of the business now, at a
5 significant value, is a good result for both shareholders and ratepayers.

6 **Q. WHY IS A SALE OF THE BUSINESS NOW A GOOD RESULT FOR**
7 **BOTH SHAREHOLDERS AND RATEPAYERS?**

8 A. Through a sale at this point in time, Qwest realizes the value of the business, and
9 avoids any future risk that competition will erode the revenue stream from yellow
10 pages or the value of the business. One of the historical rationales for imputation
11 was that the publishing operation received a benefit from its long association with
12 the monopoly incumbent local exchange company. As noted above, the advent of
13 local competition under the Telecom Act has reduced if not eliminated that
14 benefit.

15 **Q. HOW HAS THE ADVENT OF LOCAL COMPETITION REDUCED OR**
16 **ELIMINATED THOSE BENEFITS?**

17 A. Directory publishers have nondiscriminatory access to subscriber list information,
18 and can otherwise compete for directory advertising revenues. All print
19 publishing operations will face business risks, including price competition and
20 competition from advertising in other media such as the Internet, in the future.
21 Uncertainty about whether historic yellow pages revenues available for
22 imputation will increase, decrease, or remain flat is avoided by selling the asset at
23 this time, and realizing the significant and necessary benefit from that sale to
24 address the core needs of the business.

[36] January 17, 2003 Direct Testimony of William Kennard on behalf of Dex Holdings, LLC, pp. 9-11.

1 **IX. THE DEX SALE IS IN THE PUBLIC INTEREST**

2 **Q. IS THE SALE OF DEX IN THE PUBLIC INTEREST?**

3 A. Absolutely. The sale of Dex is in the public interest for five reasons. First, it is
4 essential that QC remain a financially viable company in order to maintain its
5 network and provide quality service to its retail and wholesale customers. QC's
6 financial viability is directly affected by the financial viability of QCI. As
7 explained by Mr. Cummings and Mr. Johnson, the sale of Dex is a major
8 component of QCI's effort to restructure its debt and de-lever its balance sheet
9 and is necessary to avoid bankruptcy and to address QCI's and QC's liquidity
10 needs. Mr. Cummings and Mr. Johnson testify that the proceeds from this sale
11 are essential for QCI to meet its debt maturity obligations. If the sale is not
12 completed and QCI is unable to meet its financial obligations, QC's ability to
13 provide quality and reliable service in Washington will be threatened.

14 Second, QC currently has a variety of regulatory obligations related to directories.
15 Today, these obligations are largely met through a Publishing Agreement with
16 Dex. As part of the Dex sale transaction, the Buyer has entered into a new
17 Publishing Agreement with QC under which QC's obligations will continue to be
18 fulfilled. Mr. Burnett explains this in greater detail in his testimony. QC will
19 continue to meet its regulatory obligations related to directories at no cost to
20 ratepayers.

21 Third, QC does not propose to increase its rates as a result of the sale, but rather
22 proposes to continue imputation of directory earnings at its present value until the

1 ratepayer interest in the sale proceeds is satisfied in 2011. This proposal does not
2 harm the ratepayer since rates do not change, which is consistent with the
3 agreements made in Docket No. UT-991358. In Docket No. UT-991358, Public
4 Counsel and the Commission Staff agreed not to initiate, or support any third-
5 party in a request for the Commission to initiate any complaint proceeding
6 regarding the overall revenues or earnings level of the Company prior to January
7 1, 2004.[37] The Commission also agreed it would not take any action that would
8 change the retail prices or access rates of the Company prior to January 1, 2004.
9 The Company agreed not to seek to increase any tariffed rate or charge prior to
10 January 1, 2004, except as otherwise specified in the agreement.[38]

11 Under QC's proposal, ratepayers will receive the current value of the existing
12 imputation of $103,370,843 (an increase of over $18 million or 21% of the value
13 last set in Docket No. UT-970766) for the regulated results of operation each year
14 until 2011. The benefit is received through the calculation of the Company's
15 results of operation and is most relevant when such results are formally reviewed
16 as part of a rate case or earnings investigation. Under QC's proposal, should a
17 review commence between 2004 and 2011, the amount of annual imputation to
18 QC intrastate revenues will be $103,370,843. If all of the Company's retail
19 services are competitively classified prior to 2011, imputation will essentially be

[37] Under the settlement agreement, Commission Staff and Public Counsel could seek to change rates to: (1) implement a state or federal program of universal service support, or similar program; (2) effect revenue-neutral rate rebalancing; (3) adjust revenues for changes in reciprocal compensation expense; or (4) adjust revenues for changes in mandated costs.

[38] The Company agreed to not seek to increase any tariffed rate or charge other than to: (1) implement a state or federal program of universal service support, or similar program; (2) effect revenue-neutral or revenue-negative rate rebalancing; (3) adjust revenues for increases in reciprocal compensation expense; (4) adjust revenues for changes in mandated costs and to recover mandates imposed by federal, state or local governments; or (5) make individual or minor rate adjustments in the normal course of its business (including, without limitation, individual case basis contracts, new service offerings and price listed services).

1 terminated since the Company's rates will no longer be set through rate of return
2 regulation. Hence, the ratepayer interest associated with the Dex sale will be fully
3 satisfied when rates no longer require the support of the imputation of directory
4 revenues, or 2011, whichever occurs first.

5 Qwest's proposal strikes a balance among the interests of ratepayers, shareholders
6 and the broader public because it does not result in a rate change and it captures
7 and preserves an appropriate benefit for ratepayers without any further action on
8 the Commission's part. It also benefits the ratepayer in that it allows QCI to
9 retain the proceeds from the sale to meet its financial obligations, which will
10 enable it to further de-lever its balance sheet. This is critically necessary to avoid
11 bankruptcy and to preserve efficient and reliable service.

12 Fourth, the transaction does not distort or impair the development of competitive
13 markets. Based on evidence presented in QC's recently concluded Section 271
14 proceeding, Docket Nos. UT-003022 and UT-003040, it is clear that the local
15 exchange market is fully open to competition in Qwest's service area and that
16 Qwest has satisfied the requirements of section 271 of the Act. In the 271
17 proceeding, the Commission found Qwest has demonstrated the presence of
18 facilities-based competition in the local exchange market in Washington.[39]

19 These findings, coupled with the Commission's finding of effective competition
20 for numerous services over the last several years in Docket Nos. U-86-34, et al.
21 (Centrex features and Intracall), UT-980630 (calling card services), UT-990021

[39] Comments of the Washington Utilities and Transportation Commission, Qwest Section 271 – Washington, WC Docket No. 02-189, p. 3.

1 (toll and operator services), UT-990022 (high capacity circuits in selected areas),
2 UT-990259 (directory assistance), UT-000883 (all business basic exchange
3 services provisioned over DS1 or greater circuits in selected areas), and UT-
4 021257 (ISDN, DSS and UAS services provisioned over DS1 or greater circuits
5 in selected areas) demonstrate continued development of competitive markets at
6 an accelerating pace. The sale of the Dex business will not distort or impair the
7 development of competitive markets. In addition, QC will continue to satisfy its
8 obligations to include in directories published on its behalf the listings of end
9 users of competitive local exchange providers as well as listings of the various
10 competitive providers.

11 Fifth, the sale ensures that Qwest captures the value of Dex now, receives fair
12 value for the transaction and avoids any future risk that competition will erode the
13 revenue stream from yellow pages or the value of the business. Revenues have
14 been imputed historically in part because of the belief that the publishing
15 operation received a benefit from its association with the monopoly incumbent
16 local exchange company. As noted above, the advent of local competition under
17 the Telecom Act has reduced or eliminated those benefits. Hence, uncertainty
18 about whether historic yellow pages revenues available for imputation will
19 increase, decrease, or remain flat is avoided by selling the asset at this time, and
20 realizing the significant and necessary benefit from that sale to address the core
21 needs of the business.

1 **X. CONCLUSION**

2 **Q. WHAT IS YOUR CONCLUSION?**

3 A. The sale of the business and assets of Dex is in the public interest. The sale is a
4 necessary component of QCI's overall debt restructuring and de-levering strategy,
5 and will help ensure QC's ongoing access to capital markets that is necessary for
6 the creation and maintenance of Washington's robust local telecommunications
7 network. The Publishing Agreement between QC and Buyer ensures that QC will
8 continue to meet its directory publishing obligations. Finally, QC is not
9 proposing any rate increase as a result of the sale at this time. The Ratepayer
10 interest will be satisfied by continuing imputation until an appropriate portion of
11 the gain has been credited which strikes a balance among the interests of
12 ratepayers, shareholders and the broader public that is fair and that preserves
13 affordable, efficient, reliable service.

14 Because the sale is in the public interest, if the Commission determines that it is
15 required to approve the sale, it should approve the sale as expeditiously as
16 possible, without imposing any conditions on approval that would defeat the
17 purpose of the transaction.