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 nonaffiliate	Docket No. UT-021120

DIRECT TESTIMONY OF

WILLIAM E. KENNARD

ON BEHALF OF

DEX HOLDINGS LLC

JANUARY 17, 2003

I. INTRODUCTION AND BACKGROUND

Q. PLEASE STATE YOUR NAME FOR THE RECORD.

A. William E. Kennard.

Q. WHO IS YOUR EMPLOYER AND WHAT IS YOUR CURRENT POSITION?

A. I am Managing Director of the Telecommunications and Media Group of The Carlyle Group ("Carlyle"). My business address is 1001 Pennsylvania Avenue, N.W., Washington, D.C. I have held this position since May 2001.

Q. PLEASE DETAIL YOUR WORK EXPERIENCE.

A. In November 1997, President Bill Clinton appointed me as Chairman of the Federal Communications Commission ("FCC"). I served in that position through January 2001. As Chairman, I led the FCC's implementation of the Telecommunications Act of 1996, the first comprehensive overhaul of the nation's telecommunications laws since the New Deal era when the FCC was created. I guided the FCC's adoption of procompetitive rules that advanced the central goal of the 1996 Act, which is to bring consumers the benefits of competition in all areas of the telecommunications industry, including competition between and among incumbent local exchange carriers ("ILECs"), interexchange carriers, new entrants, and others.

Before serving as FCC Chairman, I served as the FCC's General Counsel from December 1993 until October 1997. As the FCC's chief legal officer, I was responsible for advising the FCC on all matters involving the interpretation and application of the Communications Act of 1934, as amended, as well as other enacted or proposed legislation or regulations affecting the responsibilities and jurisdiction of the FCC and defending its many orders in court. Before joining the FCC, I was a partner in the Washington, D.C. law firm of Verner, Liipfert, Bernhard, McPherson & Hand. From July 1983 through April 1984, I was the Assistant General Counsel of the National Association of Broadcasters. From September 1982 to July 1983, I was an associate attorney at the Verner, Liipfert firm. I received a one-year legal fellowship from the National Association of Broadcasters between September 1981 and September 1982.

Q. WOULD YOU PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND BRIEFLY?

A. I received my Juris Doctor degree from the Yale Law School in May 1981. I received an A.B. with distinction in communications from Stanford University in 1978.

Q. ARE YOU A MEMBER OF ANY PROFESSIONAL ORGANIZATIONS?

A. Yes. I am admitted to the bar in the state of California and in the District of Columbia. Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I will address three areas. First, I will show that the Buyer is exceptionally well qualified to own and operate Dex. Second, I will discuss the reasons why the Buyer will have incentives to ensure that it provides the full range of high-quality services necessary for Qwest Corporation to meet its directory publishing obligations. Third, I will address certain reasons why the proposed sale of Qwest Dex as provided in the Rodney Agreement and related transaction documents is in the public interest.

Q. DO YOU INTEND TO ADDRESS THE FINANCIAL IMPACTS OF THE TRANSACTIONS TO QWEST?

A. No. I believe that Qwest is in a better position to address the financial impacts of this transaction to itself. Moreover, I understand that Qwest will address this issue in this proceeding.

Q. PLEASE DESCRIBE THE PROPOSED SALE VERY BRIEFLY AS BACKGROUND TO YOUR TESTIMONY.

A. The sale is structured to take place in two parts. In the first phase of the transaction, under the Dexter Agreement, Dex Media East, LLC, a subsidiary of Dex Media, Inc., and an indirect subsidiary of Dex Holdings LLC (the "Buyer"), acquired the operations of Qwest Dex in the eastern portion of Qwest's local exchange operating territory, including the states of Colorado, Iowa, Minnesota, Nebraska, New Mexico, North Dakota, and South Dakota. That phase of the sale closed on November 8, 2002. Just prior to that closing, Qwest Dex, Inc. transferred its assets and liabilities in each of those states to its newly created subsidiary, SGN LLC. At the closing, the ownership of SGN LLC transferred from Qwest Dex to Dex Media East. The Rodney Agreement provides for a similar course of events to take place just prior to and at the closing of the Dex Media West phase of the transaction. At the Dex Media West closing, Qwest Dex, Inc. will transfer its remaining assets and liabilities, including those in Washington, Arizona, Idaho, Montana, Oregon, Utah, and Wyoming, to GPP LLC, a separate newly-created subsidiary of Qwest Dex, Inc., and transfer ownership of GPP LLC to Dex Media West, LLC, also a subsidiary of Dex Media, Inc, and an indirect subsidiary of Dex Holdings LLC.

II. BUYER'S QUALIFICATIONS/REGULATORY COMPLIANCE

Q. PLEASE IDENTIFY THE BUYER.

A. Dex Holdings LLC, the Buyer, is a Delaware limited liability company recently formed for the purpose of purchasing the Dex publishing business. The Buyer is owned by The Carlyle Group ("Carlyle") and Welsh, Carson, Anderson & Stowe ("WCAS") ("Owners"). The Owners are established private equity investment companies.

Q. WOULD YOU ALSO PROVIDE SOME BACKGROUND REGARDING THE OWNERS?

A. Carlyle is a private global investment firm that originates, structures and acts as lead equity investor in management-led buyouts, strategic minority equity investments, equity private placements, consolidations and buildups, and growth capital financings. Since its inception, the firm has invested more than $7.2 billion of equity in 263 transactions with an aggregate acquisition value of over $19 billion. As of September 30, 2002, the firm had more than $13.9 billion of committed capital under management. We are headquartered in Washington, DC, and serve a diverse base of more than 550 investors in 55 countries worldwide. Carlyle has deep knowledge and experience across disciplines and industries that give it a competitive edge in all the markets in which it operates.

WCAS is one of the oldest and largest private equity investment firms in the United States. Founded in 1979, it has raised 12 investment partnerships with total capital of $12 billion. Its investment activities are exclusively focused in three industries: communications, information services, and healthcare. WCAS has completed over 100 buyouts and over 650 add-on acquisitions since its founding. Combined, Carlyle and WCAS have over $25 billion of committed capital under management. The Buyer's ability to raise the large amounts of capital needed to purchase, fund, and operate Dex has already been demonstrated in funding and closing the Dexter portion of the transaction, which required $2.75 billion in debt and equity capital.

Q. WHAT EXPERIENCE DO THE OWNERS HAVE IN OWNING AND MANAGING COMMUNICATIONS-RELATED BUSINESSES?

A. Carlyle and WCAS are among the largest and most successful private equity investment firms in the world. Their successes in communications investing result from investment professionals who have deep understanding of and respect for the unique responsibilities of owning regulated businesses. At Carlyle, one of my partners is James A. Attwood, who formerly served as Verizon's Executive Vice President for Strategy and served in that same capacity for GTE. Mr. Attwood is Co-Chairman of the Board of Directors of the Buyer. I also serve on the Buyer's board as a director and member of the Audit Committee. Other senior partners of Carlyle include former Secretary of State, Secretary of the Treasury, and White House Chief of Staff James A. Baker III and former Securities and Exchange Commission Chairman Arthur Levitt. At WCAS, Anthony J. De Nicola serves as Co-Chair of the Buyer's board of directors and brings several years of experience in overseeing WCAS's communications investments. WCAS's portfolio companies in telecommunications include Centennial Communications (a provider of rural wireless services), Valor Telecommunications (a rural wireline provider), and Amdocs (a provider of OSS and billing software to the communications industry). Carlyle also has extensive experience as a successful investor in communications and publishing. Its ownership experience includes Pacific Telecom (submarine fiber-optic cable), Neptune Communications (high-speed undersea fiber-optic networks), Genesis Cable (a U.S. cable television operator), Prime Cable (cable television operator in Montgomery County, Maryland, and Arlington County, Virginia), Entertainment Publications, Inc. (promotional coupon publishing and advertising), Taiwan Broadband (largest cable television provider in Taiwan), eAccess Broadband Services (Japanese ADSL provider), and Videotron Telecom Ltée (Canadian facilities-based CLEC),

III. BUYER'S PLANS TO PROVIDE HIGH-QUALITY SERVICES TO QWEST CORPORATION

Q. HOW CAN THE COMMISSION BE CERTAIN THAT QWEST CORPORATION WILL BE ABLE TO CONTINUE TO MEET ALL OF ITS REGULATORY OBLIGATIONS AND OTHER RESPONSIBILITIES REGARDING LISTINGS AND DIRECTORY PUBLICATION AND DISTRIBUTION AFTER DEX IS SOLD?

A. There are several reasons. First, no change in the management of Dex is contemplated as a result of this transaction. The current management will stay on and is very experienced in publishing and distributing directories in compliance with regulatory requirements. The testimony filed in this docket by George Burnett, the Chief Executive Officer of Dex, describes his qualifications as well as some of the accomplishments of Dex. Second, as I described earlier, both of the Owners have extensive experience in managing communications-related businesses, and understand the important position that the Commission's directory publishing requirements occupy. Finally, the penalty for the Buyer's failure to perform the publishing agreement at a level sufficient to meet Qwest's regulatory responsibilities would be severe—potential termination of the publishing agreement.

Q. YOU DISCUSSED THE LEADERSHIP OF DEX, DEX HOLDINGS, AND ITS OWNERS AFTER THE TRANSACTION. WHAT ABOUT THE RANK AND FILE WORKERS AT DEX?

A. One of the critical assets that we are acquiring is the existing management and staff at Dex. We do not want to jeopardize those human assets by engaging in shortsighted and imprudent cost-cutting measures, because the value of that human capital cannot be understated. Dex is already one of the most efficient directory publishers in the country. In addition, we plan to accept the collective bargaining agreements with the two unions that represent Dex workers. In fact, Qwest Dex and Dex Media recently agreed with the International Brotherhood of Electrical Workers ("IBEW") to extend the current agreement from May 2003 to May 2006. The agreement, which has been ratified by the IBEW, binds Qwest's successor and provides that there will be no material changes in compensation or benefits through the end of the extended term. Further, for the Communications Workers of America and other non-IBEW employees, Dex Media will keep in place, or put in place, pension, medical, life, and other benefit plans that are comparable to Qwest's current plans.

Q. WHAT ARE THE BUYER'S PLANS FOR QWEST DEX?

A. Dex Media East has already acquired Qwest's directory business in the eastern half of the Qwest states. The best way to characterize how things are working is "business as usual." The same will hold true after Dex Media West acquires the remaining Dex operations in the western region. We plan to continue to publish the high quality white and yellow pages that are familiar to Qwest's local exchange customers and other directory users. We do not plan any major changes to the directories. Qwest subscribers and other directory users will continue to see the same familiar look and contents of the product. Dex Holdings will continue to include the government listings, community information, and other features on which directory users have come to rely. While we plan to continue to refine and improve the Dex directories and to pursue expansion in related areas, such as Internet directory publishing, changes will be incremental, not radical.

Q. WHAT ENSURES THAT DEX WILL CONTINUE TO MEET REGULATORY REQUIREMENTS AND QWEST'S OTHER DIRECTORY RESPONSIBILITIES?

A. The Buyer is contractually bound to provide services necessary to enable Qwest to satisfy its directory publishing obligations that exist under Washington state statutes, regulations, interconnection agreements with CLECs, and perhaps other sources. More importantly, Dex's reputation and substantial goodwill are based on the public's perception that its directories are accurate and complete and on advertisers' confidence that the directories are widely distributed. This is an asset that the Buyer will protect above all by taking great pains to ensure full and complete listings and full and widespread distribution of the directories themselves, including placement at payphone stations. Thus, Dex will continue to include CLEC listings on the same basis as Qwest's own, and will ensure that every customer within the coverage area of the directory is able to obtain a copy of the directory, without regard for the identity of the subscriber's local exchange carrier ("LEC").

Q. WHAT IS THE BUYER'S PLAN REGARDING PUBLISHING SCHEDULES?

A. We do not plan to change publishing intervals. Most directories are published annually. We plan to continue with the current intervals, unless the public interest requires a change.

Q. WHAT WOULD BE AN EXAMPLE OF A NECESSARY CHANGE TO A PUBLISHING SCHEDULE?

A. If the area covered by a directory were undergoing a massive numbering change or the introduction of a new NPA it might be prudent to either delay or advance the publication of the directory or directories for that area.

Q. WHAT IS THE LIKELY COMPETITIVE IMPACT OF THE DIRECTORY PUBLISHING AGREEMENT BETWEEN QWEST AND DEX HOLDINGS?

A. The publishing agreement and related documents ensure that no LEC will have any competitive advantage or be subject to any disadvantage. The agreements provide that all of the obligations that would have applied to Qwest Dex will continue to be met pursuant to the publishing agreement between Dex Holdings and Qwest Corporation. Included in those obligations are provisions to ensure that both Qwest's and CLECs' customers are properly listed. In the CLECs' case, the publishing agreement ensures that the Buyer will take actions necessary to ensure that Qwest Corporation meets its obligations in its interconnection agreements with CLECs. Again, not only will Qwest's local exchange customers not notice a change upon closing of the sale, CLECs likewise will experience no material change in how their local exchange customers' listings are handled. As an independent publisher, we have an incentive to be even-handed in our treatment of all carriers.

IV. OTHER PUBLIC INTEREST BENEFITS

Q. ARE THERE OTHER PUBLIC INTEREST BENEFITS OF THIS TRANSACTION?

A. Yes. I see benefits flowing merely from the fact that the new owner is not an incumbent LEC. As the Buyer innovates and responds to increasing competition in the directory business, it will look at the business from the consumer's perspective and that of its advertising customers, rather than the perspective of a telecommunications provider. Today, Dex operates as part of an overall enterprise that includes local exchange, interexchange, and other operating entities. That enterprise is financially obligated to use the Dex profits to service a substantial debt load and to subsidize local exchange rates.

As an independent entity, Dex will have the ability to use the profits from its directory publishing business to research and develop new and improved products, maximizing the value of the directory publishing assets and providing new services to consumers and advertisers alike. In the past few years, we have all seen how the value of noncore assets can be maximized and services provided more efficiently and in a more competitively neutral way when those assets are divested from large ILECs. We have seen these benefits in the wireless tower, billing services, and customer care sectors. I also believe that Qwest's local exchange customers are benefiting financially from Qwest's decision to retain the directory business until now. Finally, Qwest's decision to sell will give its local exchange customers a tangible financial benefit while eliminating their exposure to the risks inherent in the increasingly competitive business of directory publishing.

Q. PLEASE START BY EXPLAINING WHY QWEST'S CUSTOMERS BENEFIT FROM THE TIMING OF THE SALE OF DEX.

A. Qwest is to be commended for how it has developed and grown its directory publishing affiliate. Few could have foreseen that yellow pages publishing would have seen the kind of growth in profits and revenues that Qwest was able to obtain in the 19 years ensuing since 1984. Qwest might have sold its directory publishing business in 1984 to a nonaffiliate, as some LECs did. As we know with 20/20 hindsight, Qwest would have received far less for the publishing business in 1984 than Dex Holdings is proposing to pay today. The relationship was obviously "win-win" for Qwest and its local exchange customers, reflecting the growth of Dex since 1984.

Q. GIVEN HISTORICAL REVENUE GROWTH AT DEX, WOULD QWEST'S LOCAL EXCHANGE CUSTOMERS BE BETTER OFF IF QWEST SIMPLY RETAINED DEX?

A. A key component of the answer to this question is the financial imperative that motivated Qwest's decision to divest its yellow pages business. As I noted previously, it is more appropriate for Qwest to address this issue. But putting the financial imperative issue aside, it is not possible to answer that question with any degree of certainty. Market trends do suggest, however, that the yellow pages business will become increasingly competitive, making that business more difficult to operate as a division of an ILEC. Some of these changes are driven by regulatory factors. For example, while I was Chairman of the FCC, we issued rules implementing Section 222, an important procompetitive provision of the Telecommunications Act of 1996. The FCC's implementing rules are designed to ensure that all directory publishers, not just the affiliate or "official" directory publisher of the LEC, have timely, accurate, and nondiscriminatory access to listing information necessary to publish full and complete directories. The rules ensure that all directory publishers have access to listing information at reasonable and nondiscriminatory rates.

In issuing these rules, we intended to prevent or remove any barriers to entry that may have existed to the yellow pages business for publishers that are not affiliated with a LEC. I believe we accomplished that. Thus, because the publishing business is competitive and with limited barriers to entry, Qwest's local exchange customers are exposed to the risk that Dex's revenues could decline or expenses could increase in order for Dex to retain its position in the market. After Dex becomes an independently owned yellow pages business, Qwest's customers no longer must assume this risk, and Dex will be better able to respond to competitive pressures. Thus, it should be possible today to satisfy the interests of Qwest's local exchange customers in a manner that is fair to both Qwest and Washington consumers, that removes the risk to Qwest's customers, and that frees Dex to continue evolving to meet new market challenges.

Q. IN ADDRESSING THE INTERESTS OF QWEST'S LOCAL EXCHANGE CUSTOMERS, SHOULD THE COMMISSION TRY INDEPENDENTLY TO DETERMINE THE VALUE OF DEX?

A. No. Without the benefit of a crystal ball, the best evidence of the fair market value of Dex is the actual price the competitive market produced. It would be impossible for the Commission to value Dex more accurately by second-guessing the market. The essential nature of the sale of a going concern business is that the purchase price is an up front payment of the present value of its expected future profits. Thus, when—as here—two very sophisticated parties, each armed with all the information it can reasonably obtain and each with other options, negotiate an arm's-length price for a business, the resulting price is by definition the "fair market value." That is particularly the case here because Qwest conducted a robust auction for the sale of

Dex. Bidders included several of the country's most well-funded private equity firms. Therefore, the purchase price reflects the market's best assumption of future profits.

Buyer and seller have both thoroughly and rationally evaluated all the risks. The parties' expectations may or may not be borne out. But it is impossible, and invariably far less precise, for policymakers to divine their own market price by second-guessing an auction process among parties willing to put very significant capital at risk. Thus, it is unwarranted to assume that Qwest's local exchange customers would be better off financially based on historic treatment of the publishing business if regulatory action prevented the transaction from closing. Similarly, it would be unwarranted to set regulatory concessions based on a value greater than the actual value the market has placed on Dex. Policymakers in this and other states reviewing the transaction should consider very carefully whether they want to have local exchange customers effectively "stay invested" in the increasingly competitive directory publishing business—which would be the result if they were to block the sale either outright or indirectly by setting the regulatory concessions so high as to compel that result.

Q. DOES THE THREAT TO REVENUE GROWTH COME ONLY FROM COMPETING PUBLISHERS OF PRINTED DIRECTORIES?

A. No. In addition, the growth in Internet directory publishing has been significant. Dex will have to continue to innovate to stay ahead of competitors in this increasingly competitive sector. The barriers to entry in Internet publishing are minimal. Thus, with nondiscriminatory access to directory listing information, Dex can expect Internet directory publishing to be highly competitive and, accordingly, will see downward pressure on advertising rates.

V. CONCLUSION

Q. COULD YOU SUMMARIZE YOUR TESTIMONY FROM THE PERSPECTIVE OF A REGULATORY REVIEW OF THE PROPOSED SALE UNDER A "PUBLIC INTEREST" STANDARD?

A. I appreciate that the Commission wants to make sure that it is doing everything that it can to protect the interests of Qwest's local exchange customers. But the Commission has every reason to find the transaction to be in the public interest and no reasons, other than speculative ones, to find that it is not. The Buyer is well qualified to own Dex and is well positioned to invest in this business and improve its products and services. The Buyer will thus be able to maximize the value of the Dex assets and to do so in a way that is competitively neutral and thereby further other important policy goals. For these reasons, this transaction is the right thing at the right time from a public interest standpoint. The directories will only get better. All regulatory requirements for publishing and distributing directories will be met, and there is no reason to believe that Qwest's local exchange customers would be better off financially if Qwest retained Dex. No one has a crystal ball, not Qwest, not the Buyer, and not the Commission. Over the last 18 years Qwest's local exchange customers have had the benefit of increasing imputation. As the fine print in investment ads always notes, however, "past performance is no guarantee of future returns."

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes. Thank you.